On the journey from understanding to complying with Korea Sarbanes-Oxley

Content

Introduction

In response to recently increasing number of accounting scandals in Korea and the public's less tolerance towards non-compliant behaviors of enterprises, the Korean regulatory bodies have actively enforced several reformations related to business internal control processes. Specifically, along with the latest revisions of the Act on External Audit , Korea Sarbanes-Oxley ("K-SOX") Act ("the Act") pays a significant attention to the Internal control over financial reporting ("ICFR") practice of both listed and unlisted entities. With limited resources available to global readers, our articles aims to address your major concerns regarding this topic with a focus on listed entities and the requirements at consolidated level.

What is K-SOX?

K-SOX refers to Korea's Internal Accounting management system that is introduced as part of 2017 regulatory reform. K-SOX closely follows the United States' Sarbanes-Oxley Act (commonly known as US-SOX) that was put into law in 2002 after a series of major accounting and corporate scandals broke out a few years prior. The Act aims to protect investors from fraudulent information published by companies by imposing more stringent internal control requirements. Based upon the fundamental standards issued by the current local regulatory authority, K-SOX focuses on Internal control over financial reporting (ICFR) and primarily reinforces responsibilities of the management, audit committee and external auditors. In simple terms, not only is the CEO of the list entity compelled to report on management's assessment of internal controls at the annual shareholders' meeting but a formal audit report of ICFR is also required to be presented at the meeting from the fiscal year 2023 onwards.

Who should be prepared for K-SOX?

When and which companies are affected by the Act are certainly the most asked questions. Generally, it is applicable to both listed and unlisted entities. While having been applied to separate financial statements since 2019, the requirements of K-SOX for consolidated financial statements has been changed from a review to an audit from the fiscal year 2023 for listed entities with total assets over 2 trillion won or more, from fiscal 2024 for listed entities with total assets over 500 billion won or more, and from fiscal 2025 for the entire listed entities. The above changes are expected to have major impacts on all listed companies along with their subsidiary companies who are under the effect of this Act.

Moreover, it is useful to note that one of the key factors that the auditor considers in order to identify a significant component for the purpose of a K-SOX audit is the following quantitative threshold:

- 5% of annual revenue, or
- 5% of pre-tax income, or
- 5% of total assets, or
- 5% of equity (if applicable)

Therefore, companies must consider not only their timing to adopt the new regulations but also their determination of significant component. This is especially important as many companies listed in the KRX have total assets well over 2 trillion won. Understanding these requirements will be the determining factor for a smooth transition to K-SOX.

A need to establish K-SOX along with US-SOX

US-SOX has proven its effectiveness and gained global popularity since 2002 in enhancing reporting and controlling quality. Many Korean companies have implemented this international Act to re-evaluate their original structures and systems of internal controls, and to refine responsibilities of individuals involved in the financial reporting process. Nevertheless, to better generate value from compliance while meeting local business demands, ICFR requires additional attention from the audit committee.

It is worth noting that K-SOX shares some conceptual common grounds with US-SOX along with other local guidance and interpretations available to facilitate the reformation. In fact, both regulations are built upon the COSO framework focusing on financial reporting matters. Basic concepts regarding risks and controls including Management Review Control (MRC), Information Produced by the Entity (IPE), End User Computing (EUC) are maintained consistently between these two Acts. Furthermore, the overall compliance lifecycle from risk assessment, design, controls testing, and monitoring to remediation and reporting of the two Acts are also similar. Still, there exists minor deviations in the fundamental reporting requirements and deficiency evaluation process.

So, the question is why do we need to establish K-SOX in conjunction with US-SOX?

01

K-SOX puts an emphasis on the auditors' role and responsibility in evaluating the internal control process over financial reporting of the groups, which should be operated and monitored at the consolidated level.

02

K-SOX makes audit on ICFR mandatory for separate financial statements of all entities from 2022, and for consolidated financial statements starting from 2023 based on total asset size.

03

To better assist local companies, there are also more specific practical guidance and interpretations issued by the local authority in Korea, impacting many aspects of management assessment as well as audit approaches.

Lessons from US-SOX

One of the main concerns on K-SOX is how much it will cost a company to comply with these requirements. This is a valid question since it's only natural that no matter how well-prepared a company is, there will always be unexpected events and expenses along the adoption process. As the transition is going to add more steps into the auditing process, the cost of future audits is expected to keep piling up.

To know exactly the cost and benefits of adoption, let's revisit the implementation period of US-SOX. In 2006, four years after the implementation of US-SOX, an organization called the Financial Executives International (FEI) did a survey on 168 companies on the cost of implementing section 404, a section on internal control of US-SOX which is also the focus of K-SOX. The survey found that the actual costs incurred were around $1.7 million for centralized companies and $4.0 million for decentralized companies[1].

The same survey was repeated in 2007 with the costs being between $1.3 million and $1.9 million, respectively[2]. This shows that the cost of compliance with US-SOX decreased in the following years as companies and accounting firms find more efficient ways to follow the new law. In April 2011, a study published by the Securities and Exchange Commission (SEC) revealed a downward trend in cost of compliance in the period from 2006 to 2009 regardless of firm size, after more guidance was made regarding the implementation of SOX[3].

There are good reasons to believe that the same trend will be observed in the future after the implementation of K-SOX. Firstly, K-SOX will be following US-SOX closely, especially Section 404 on internal controls. This means that the implementation process will be similar to that in the U.S. Secondly, US-SOX was completely new when it was signed into law, so extensive experimentation was made to achieve the right balance between cost and compliance. By learning from historical lessons, K-SOX is expected to result in a lower implementation cost compared to that of US-SOX.

1 "FEI 2007 Survey of SOX 404 Costs". Fei.mediaroom.com. April 30, 2008. Archived from the original on July 14, 2011. Retrieved June 29, 2022

2 "FEI Press Room – News Releases". October 11, 2007. Archived from the original on October 11, 2007. Retrieved June 29, 2022

3 "Study and Recommendations on Section 404(b)" (PDF). Securities and Exchange Commission. April 2011.

A good approach to K-SOX compliance

Like US-SOX, which serves as a crucial tool in improving the accuracy and reliability of the disclosures on financial reporting and thus regaining trust from stakeholders and the market, K-SOX is expected to become one of the most significant enforcement in Korea in the upcoming years. Therefore, It's not too early to start reviewing your business's internal control practices over the financial reporting process. Make time now for the work that matters in the future!

Until K-SOX for consolidated financial statements officially comes into effect, it is suggested that the management evaluate and identify if there are any gaps in current control policies over financial reporting process, unnecessary complexity, or difficulties in communication among business departments. To build a sustainable and cost-effective process, we recommend taking a critical look upfront at the following considerations:

Build upon current resources

Being one of the pioneers in adopting IFRS that effectively transitioned from K-GAAP, Korean entities have established a stable and strong base for internal policies. In addition, recent revisions of the External Audit Act have also strengthened and improved the transparency of reporting procedures. As a result, building upon this current foundation and resources will partially relieve the burden of the implementation process.

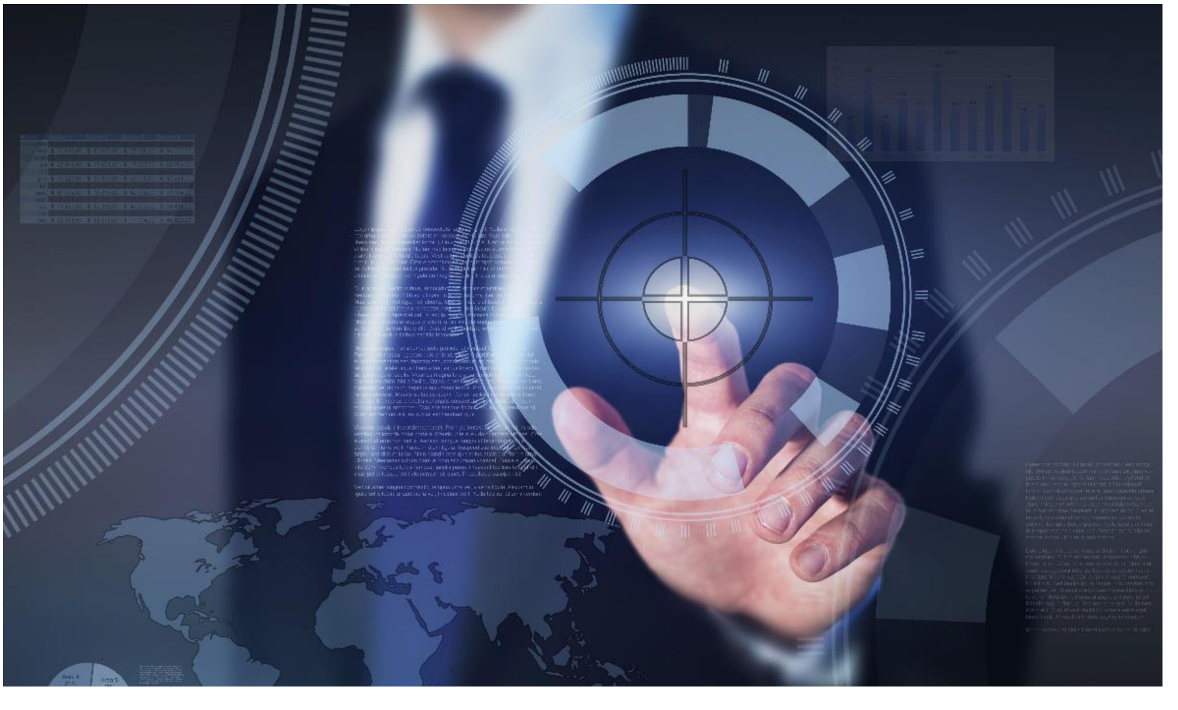
However, only taking advantage of current resources is not sufficient for companies to fully comply with K-SOX. It is necessary that not only the C-level or the Board of Directors but also all personnel within the company participate in future internal restructurings and reforms. In other words, decisions might come directly from the senior management, but the responsibilities to build an effective internal control must reach all corners of the organization to ensure that management strategies are incorporated into daily actions. The management may continue to utilize current resources and carefully re-evaluate existing key metrics to address crucial K-SOX requirements and make impactful decisions.

Leverage technology to deliver better outcomes

Since cost-efficiency of ongoing compliance and reduction in manual efforts are key concerns of every enterprise, it is a call for automated controls through the use of technology as a key enabler from the early stages of transformation. That is to say, companies should leverage the capabilities of the existing ERP systems that have complied with US-SOX and integrate further controls that satisfy the requirements of K-SOX. This utilization of technology, including automated compliance workflows, closing tasks, and control testing will not only help ease the compliance efforts with K-SOX but also mitigate risks and generate operational efficiencies.

Learn from the past

As previously mentioned, K-SOX is a close adaptation of US-SOX. We have discussed the reasons for the initial high implementation costs being that U.S. companies did not have any precedent to base their processes upon, which lead to considerable costs that could have been avoided otherwise. It is recommended that Korean companies study the journey of their U.S counterparts carefully to anticipate potential risk factors that might be prevalent later in the adoption process. Guidelines and technical materials from professional firms and regulatory bodies are especially useful for companies who are still struggling with the new practice. For example, the Deloitte Accounting Research Tool has numerous guidance on the implementation of Section 404 of US-SOX for reference purpose. Whatever the resource is, it is up to companies' executives to equip themselves with necessary knowledge about K-SOX to ensure a successful adoption.



How it is relevant to Korean subsidiaries in Vietnam

As K-SOX also emphasizes on ICFR at the consolidated level, in which the parent companies and their subsidiaries are considered as a single economic entity, subsidiaries of Korean groups in Vietnam should also pay closer attention to this Act. The role of subsidiaries, especially that of the significant components, is one of the key factors to ensure a full compliance with K-SOX of the entire groups.

In more details, there are **four main stages (Design, Operation, Supervision, and Report)** in the set up of an ICFR system compliant with K-SOX, which requires the participation of all executives and employees of the group including subsidiaries:

1. First and foremost, at the **design stage**, both Board of Directors and employees should clearly understand their responsibilities, scopes of works, and required procedures to follow. There should also be a thorough review of existing control environment of all entities with reference to the group's guideline and policy.

2. After designing specific control activities, it is time to start **operating** and assessing if those controls are performing as prescribed.

3. Following the operations stage is the **supervision stage**, in which the control processes are independently monitored by the Board of Directors, CEO, Audit committee, and ICFR team of the parent company.

4. Last but not least, subsidiaries are required to **report** on control deficiencies identified from the supervision stage to their parent company, evaluate their impacts on both separate and consolidated financial statements, and provide recommendations for improvements.

Conclusion

The new legislation not only affects the companies that are operating in Korea but also their subsidiaries in Vietnam. The road to reap benefits from the reformation efforts of the internal control over financial reporting in Korea is arduous and challenging, but undeniably worthwhile. On that account, companies should be vigilant of new developments but also need to kick-start the education process for their employees on K-SOX requirements very soon. With our experienced professional team and access to a unified pool of global expertise in many subjects, Deloitte is confident that we have adequate experiences to support companies in your journey to establish and implement effective Internal Controls over financial reporting at the consolidated and entity-level in compliance with K-SOX.

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