HISTORICAL DEVELOPMENT AND CURRENT STATE OF FINANCIAL REPORTING IN SOUTH KOREA

by

Youngok Kim
B.A. (HUFS), B.Comm (*Hons*) (Manitoba)

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A List of Corrections To the Thesis

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Youngok Kim

General Comments

3. Discussions on non-statistically significant results have been revised. This revision applies to the following pages: p. 119; pp. 122-123; pp. 142-144; and pp. 148-149.

5. The specific sentence has been deleted from the conclusion (Original Text, p. 145, Line 7: Finally, strong government was a colonial legacy passed on to Korea by the Japanese during the colonial period.)

Specific Points

1. Inappropriate words have been replaced:
    pp. 1, 4 & 92: peculiar--> particular
    p. 52: agenda on reserves~--> a list of reserves
    pp. 67, 98 & 147: clout--> influence

    Grammar break-down corrected: p. 58

2. Typo error corrected:
    p. 11: Micro--> Macro

3. Addition of a footnote on the advantages of recursive models:
    p. 29 (footnote 22); however, a lengthy discussion has not been made because the relevance of the recursive models is not clear in the context of this thesis.

4. Discussion on Korean accounting system before 1958:
    A paragraph has been added to address the potential influence of the pre-1958 system on Korean accounting development (pp. 36-37). It should be noted that the thesis is focussed on the post-1958 period, as mentioned in Chapter I.

5. Conclusion on the Korean Commercial Code (pp. 40-41):
    A paragraph has been added to show the reasoning process by which the specific conclusion (i.e., macro-user orientation of the Commercial Code) is drawn.

6. Discussions on consolidation practices and the causes of changes in consolidation rules:
    Provided in Section 4.3.1 (pp. 75-77). The purpose of the section on Measurement Rules in Chapter III is basically to describe how they have changed over time. Discussion on causes of those changes is mainly provided in Chapter IV by using six important environmental variables and partly in Chapters V and VI by an examination of company annual reports.

7. Sources (evidence) on the Government's attempts to reduce the power of *Chaebols*:
    Sources are provided in p. 67

8. Difference between the Korean and US system of "Due Process"
    has been more clearly explained (pp. 69-70)

9. Subscripting problems with mathematical expressions
have been corrected (pp. 130 & 132)

10. Effect of depreciation methods on company income
A qualifying sentence to the argument has been added (p. 136).

*** *n.b.* All page numbers are based on the corrected text, not the original text.

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Abstract

Increasing attention has been drawn to the diversity of national financial reporting systems as the demand for "comparable" financial information heightens with the internationalisation of capital markets. This attention has led to flourishing comparative financial accounting research, which is characterised by two opposing schools of thought: *culture-free* vs. *culture-grounded.* The *culture-free* thesis postulates that accounting attributes are universal and therefore are not contingent on the environment in which accounting operates. In contrast, the *culture-grounded* proposition posits that diverse financial reporting systems are a product of different national environments.

This thesis seeks to determine whether the *culture-grounded* hypothesis applies to Korea. Two closely-linked objectives are pursued: descriptive and explanatory.

First, the historical development and current state of the Korean financial reporting system are described comprehensively using a theoretical framework that encompasses three principal elements (i.e., broad aims, institutional environment of financial reporting regulation, and specific financial reporting rules and practices). The descriptive analysis reveals that:

- the*broad aims* of financial reporting in Korea have shifted from a macro-user orientation towards a micro-user perspective;
- the*financial reporting regulation* has been dominated by government or government agencies even though private-sector participation has been increasing steadily;
- *disclosure rules* have been strengthened further to incorporate non-financial information and the *extent of disclosure* shows a wide variation among individual companies; and
- *measurement rules* have been changing towards less conservative approaches, while *measurement practices* still reveal a relatively high degree of conservatism and uniformity.

Overall, a shift towards a micro-user view of accounting has been pronounced in the Korean financial reporting system since the 1980s. This shift has been found to be linked closely to the changes in the country's national environment, such as the liberalisation of the capital market, the diffuse ownership of business enterprises, and the diminishing role of government in regulating economic affairs in Korea.

Second, the six environmental factors identified in the framework (i.e., government, business enterprises, the accounting profession, economic factors, international influences, and culture) are evaluated in terms of their contribution to shaping the Korean financial reporting system. The six factors have been found to exert significant influences in shaping the country's financial reporting system. Among them, the influences of government, business enterprises and the capital market (one of the economic factors) have been the most significant in Korea. Prior to the liberalisation of Korea's capital market, heavy dependence of business enterprises on government for their financing allowed for heavy government intervention in financial reporting regulation. However, following further liberalisation and development of the capital market and resultant ownership diffusion, the shift towards a micro-user orientation became inevitable to enhance the comparability of financial reporting of Korean companies. Overall, the explanatory analysis suggests that the Korean financial reporting system has evolved as a distinctive system distilled from the country's unique political, economic and socio-cultural environment.

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List of Acronyms

AMD	Accounting Management Division
AGM	Annual General Meeting
APLC	Accounting Principles for Listed Companies
ARL	Asset Revaluation Law
ASAC	Accounting Systems Advisory Committee
BAP	Business Accounting Principles
BOK	Bank of Korea
CAPA	Confederation of Asian and Pacific Accountants
CC	Commercial Code
CPA	Certified Public Accountant
CTL	Corporations Tax Law
EAL	External Audit of Joint-Stock Companies Law
FAS	Financial Accounting Standards
FASB	Financial Accounting Standards Board
FCRLC	Financial Control Regulation of Listed Companies
FSR	Financial Statement Rules
FSRLC	Financial Statement Rules for Listed Companies
GAAP	Generally Accepted Accounting Principles
HCI	Heavy and Chemical Industries
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
JCC	Japanese Commercial Code
KDB	Korea Development Bank
KICPA	Korean Institute of Certified Public Accountants
KIRA	Korean Institute of Registered Accountants
KRB	Korea Reconstruction Bank

KSE	Korea Stock Exchange
KSEC	Securities Exchange Commission of Korea
KSSB	Securities Supervisory Board of Korea
LCM	Lower of Cost and Market
LDCs	Less Developed Countries
MOF	Ministry of Finance
MOFE	Ministry of Finance and Economy
MRFTA	Monopoly Regulation and Fair Trade Act
NIEs	Newly Industrialised Economies
OECD	Organisation for Economic Cooperation and Development
OLS	Ordinary Least Square
SEL	Securities and Exchange Law
TERCL	Tax Exemption and Reduction Control Law

CHAPTER I
INTRODUCTION

Profound changes have occurred in the political and socio-economic landscape of South Korea[1] since the 1960s. From utter devastation following the Second World War and the subsequent civil war, Korea has emerged as one of the "tiger economies"[2] of Asia. With Korea's rapid industrialisation, the standard of living of Koreans has increased significantly. GNP per capita in Korea rose to $US 10,076 in 1995 from $US 105 in 1965 (MOF 1992; MOTIE 1995).

Equally significant changes have occurred in the financial reporting[3] system of Korea. Since the Ministry of Finance promulgated the first modern accounting standards in 1958, Korea's financial reporting system has evolved as a particular system to accommodate changes in the country's business environment. Increasing attention has been drawn to the potential linkage between its financial reporting system and remarkable economic growth.

1.1 MOTIVATION AND JUSTIFICATION

The most important impetus for this study has been the need to test the assertion, expressed in prior research, that a country's financial reporting system is a product of its national environment. The country-based tests of this assertion, such as that conducted here for Korea, are significant in providing useful policy implications for harmonisation efforts that have been pursued at both regional and international levels in an increasingly globalised economy.

Korea has been selected because of its unique environment, its importance as a model to other less developed countries (LDCs), the paucity of research on Korea's financial reporting system in international accounting, and because of the author's familiarity with the Korean language, culture and history. First, Korea's remarkable

[1] Its official name is the Republic of Korea which refers to South Korea.

[2] The "tiger economies" include Hong Kong, Singapore, South Korea, and Taiwan; they are called also as Newly Industrialised Economies (NIEs).

[3] Financial reporting is defined as general-purpose reporting designed to meet the needs of a wide range of external users who are unable to command the preparation of reports tailored to satisfy their specific needs.

economic success has been attributed to the country's unique national environment. Of particular importance has been the strong involvement of government in the economic affairs of private business sector, especially of *chaebols*,[4] through control over allocation of capital. Allegiance of *chaebols* with developmental policies and strategies of the state is perceived also to have been another important factor in the country's economic growth (Steers *et al.* 1989; Chung and Lee 1989; Lau 1990; Chang and Chang 1994; Kwack 1994; Nam 1994).

Second, Korea, unlike the two city-states classified as "tiger economies" (i.e., Hong Kong and Singapore), is similar to other LDCs in terms of its natural resources and endowments (Lau 1990). This thesis will provide policy implications for the LDCs which seek to emulate the success of the Asian "tiger economies" by addressing related policy issues.

Third, Korea's economic success has led to a plethora of research on its economic development in international economic literature. Compared to the research on economic development, there has been a paucity of research on the country's financial reporting system in international accounting literature. This thesis is directed to providing descriptive assessment of the development and impact of Korea's financial reporting system. This study will help identify roles of financial reporting in different aspects and phases of the country's economic development.

Finally, as a native Korean, the author is familiar with the Korean language, culture and history. This familiarity has inspired the author's quest for an in-depth knowledge and understanding of the country's financial reporting system.

1.2 STATEMENT OF THE PROBLEM

The pursuit of regional and international harmonisation has been frustrated frequently by nation-specific idiosyncrasies in accounting rules which are alleged to be derived from the national environment. This *culture-grounded* proposition is represented in the work of those who argue that diverse financial reporting systems are a product of

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[4] Among the various definitions of *chaebols*, this study adopts a definition used by Yoo and Lee (1987, p. 97) in which a chaebol is defined as “a business group consisting of large companies which are owned and managed by family members or relatives in many diversified business areas."

different national environments and that these differences should remain varied because they serve a useful purpose within a specific country (Mueller 1967, 1968; Radebaugh 1975; Gray *et al.* 1984; Schweikart 1985; Radebaugh and Gray 1993; Nobes and Parker 1995).

In contrast, the *culture-free* hypothesis posits that accounting characteristics are universal and therefore are not contingent on the environment in which accounting operates (Aitken and Islam 1984). The relationships between contextual variables and the dimensions of financial reporting systems are similar across nations, as reflected in the similarities of the needs of users and in the movement toward international harmonisation. It is suggested, therefore, that harmonisation of diverse financial reporting rules and practices should persist to develop a set of harmonised and effective standards that transcend national boundaries.

These two conflicting views have not yet been resolved in the international accounting literature. Despite the difficulty of generally mapping out the effects of environmental forces on the development of national financial reporting systems in different countries, this thesis supports the *culture-grounded* proposition: it seeks to understand whether the Korean financial reporting system is distilled from its distinctive political, economic and socio-cultural environment.

1.3 SPECIFIC AIMS

This thesis has specific, interrelated descriptive and explanatory objectives outlined below.

1.3.1 Descriptive Aims

This thesis seeks to describe the development and current features of Korea's financial reporting system comprehensively. The descriptive analysis encompasses changes which have occurred since the first modern accounting standards were promulgated in 1958 in three principal dimensions of the Korean financial reporting system. These dimensions include broad aims in financial reporting, institutional environment of financial reporting regulation, and financial reporting rules and practices. The thesis also aims to assess the nature and extent of disclosure and the degree of uniformity and conservatism in measurement rules.

The overall descriptive objective is to increase current understanding of Korea's financial reporting system. In particular, the analysis should help facilitate foreign investors' interpretation of financial and other information contained in general-purpose financial reports of Korean companies. Furthermore, it should facilitate comparisons, presumably with those of other NIEs and LDCs, providing insight into the harmonisation of accounting rules and practices pursued at both regional and international levels.

1.3.2 Explanatory Aims

This thesis analyses economic, political and socio-cultural factors in Korea's national environment that are alleged to influence the development of its financial reporting system. The thesis examines also whether characteristics of Korean companies[5] influence their disclosure and measurement practices. It seeks to provide evidence regarding *how* and *why* a particular national financial reporting system has evolved in Korea as it has.

Overall, the explanatory aim is to enhance current understanding of the roles played by corporate, national, and international factors in shaping Korea's financial reporting system. Furthermore, this thesis seeks to provide a comprehensive explanatory framework through which similarities and differences in financial reporting systems across nations can be evaluated and generalisations developed. It also purports to provide policy implications for the harmonisation processes by testing the applicability of the *culture-grounded* hypothesis to Korea.

1.4 RESEARCH METHODS AND LIMITATIONS

The specific research methods used in this thesis are classified under "descriptive" and "explanatory" headings, as below. Limitations in applying each method and other general limitations are addressed also.

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[5] Companies included in the study are privately-owned profit-seeking companies listed on the Korea Stock Exchange as at December 31, 1994. One group of companies is selected from *chaebols* and the other from *non-chaebols*.

1.4.1 Descriptive Aspect

A comprehensive descriptive framework is used to assemble evidence regarding the three key elements of Korea's financial reporting system (i.e., the broad aims, institutional environment of financial reporting regulation and financial reporting rules and practices). The framework originally proposed by Craig and Diga (1996b) is very comprehensive in suggesting how a national financial reporting system may be described. The close linkage between the three elements incorporated in the framework is noted in prior studies (Radebaugh 1975; Puxty *et al.* 1987; Meek and Saudagaran 1990).

First, *broad aims* expressed in the country's legislation and accounting standards are examined, thus locating the Korea's financial reporting system within a broad framework of worldwide accounting systems (i.e., micro-user vs. macro-user orientation), as delineated by Mueller (1967) and Nobes (1983). Second, *institutional environment of financial reporting regulation* is analysed to identify the unique configuration of institutional mechanisms regulating financial reporting in Korea. Institutional arrangements for accounting standard setting and enforcement in Korea are examined historically. Finally, detailed *financial reporting rules and practices* (i.e., disclosure and measurement) are examined to highlight their nature and extent. Official documents,[6] relevant professional and academic literature and financial statements published by selected Korean publicly-listed companies are employed.

This analysis provides a comprehensive description of the development and current features of Korea's financial reporting system. However, a fundamental problem is that it does not provide explanations as to *how* and *why* the financial reporting system in Korea has developed into its specific form.

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[6] Official documents binding on corporate financial reporting are: Financial Accounting Standards (FAS) and FAS Working Rules, the Commercial Code, the Securities and Exchange Law, the Corporations Tax Law, the External Audit Law of Joint-Stock Companies, the Asset Revaluation Law, and other relevant laws and regulations.

1.4.2 Explanatory Aspect

To test the explanatory proposition regarding the influence of environmental factors on Korea's financial reporting system, six important national environmental factors are investigated. They include:

- government;
- business enterprises;
- accounting profession;
- economic factors;
- international influences; and
- culture.

The role of the variables in shaping the Korean financial reporting system is discussed.

In addition, as part of the explanatory analysis, appropriate statistical methods are used to test hypotheses regarding the impact of corporate factors on disclosure and measurement practices of Korean publicly-listed companies. Statistically significant differences between *chaebol* and *non-chaebol* companies in disclosure and measurement practices are examined by using both parametric and non-parametric statistical tests. In addition, multivariate tests (i.e., multiple regression analysis) are used to determine the effect of multiple company-specific characteristics on the extent of disclosure and conservatism of selected Korean publicly-listed companies.

The explanatory approach yields results which contribute substantially to understanding Korea's particular financial reporting system. It analyses the way in which the country's political, economic and socio-cultural environment influences financial reporting. However, the approach adopted focuses on the influence of environmental factors (organisational, national and international) in shaping the country's financial reporting system. It therefore provides limited and less coherent explanations given the lack of theory underlying the potential relationship between specific environmental factors and financial reporting systems. By recognising the reciprocal effects between environmental factors and the financial reporting system (as adopted in a portion of current comparative international accounting research, albeit implicitly), the comprehensiveness and coherence of explanations may be enhanced substantially.

1.4.3 Other General Limitations

In addition to the limitations discussed above, this thesis has additional general limitations. First, most of the official documents and financial statements used are written in the Korean language. As a native speaker of Korean, the author is capable of translating them into English; however, there are some drawbacks to translation of Korean into English, especially when complex terminologies (e.g., legal) are involved. To mitigate this problem, frequent consultation with Korean accounting and legal scholars and practitioners has been carried out to ascertain the faithfulness of the translation, but some loss in meaning still might be expected to occur.

Second, this thesis is limited only to financial reporting of profit-seeking enterprises in Korea. The findings obtained may not be generalisable to government or 'not-for-profit' organisations in Korea. However, the findings of the study may be built upon in future research in non-profit organisations to provide a more comprehensive picture of financial reporting in Korea.

1.5 ORGANISATION

Chapter II reviews prior research on comparative international accounting. A descriptive/explanatory framework is proposed for analysing Korea's financial reporting system. Chapter III uses the framework developed in Chapter II to analyse the broad aims of financial reporting, institutional frameworks for financial reporting regulation, and detailed financial reporting rules in Korea. Chapter III also discusses Korea's political, economic and socio-cultural environment. Chapter IV analyses the development of the country's financial reporting system in relation to six significant environmental factors:

- Government;
- Business Enterprises;
- Accounting Profession;
- Economic Factors;

- International Influences; and
- Culture.

Chapter V tests hypotheses that disclosure practices of Korean publicly-listed companies are influenced by company-specific factors such as affiliation with *chaebols*, size, profitability, financial leverage (i.e., debt-to-equity), and affiliation with Big-Six multinational accounting firms. Chapter VI measures the degree of uniformity and conservatism in measurement practices of Korean publicly-listed companies and relates it to company-specific factors. In particular, differences between *chaebol* and *non-chaebol* companies are examined in terms of the degree of uniformity and conservatism. Chapter VII provides conclusions and policy recommendations and suggests areas for further research.

CHAPTER II
THEORETICAL FRAMEWORK

2.1 INTRODUCTION

A theoretical framework is defined as "the body of methods used by researchers to analyse the relationships between patterns of accounting and social structure, to discover the underlying universal or culture-specific characteristics of accounting principles" (Wallace and Gernon 1991, p. 210). It is a conceptual device that highlights the relation between particular features of financial reporting systems and the political, economic and socio-cultural environment in which these systems operate.

This chapter proposes a theoretical framework for analysing the Korean financial reporting system in an international context. The framework is based on a review of prior descriptive and explanatory research. A theoretical framework is defined here as a set of descriptions of the historical development of a country's financial reporting system and explanations as to how and why the system has developed as it has. To address the descriptive aim of the thesis, the proposed framework assists in identifying nation-specific and company-specific factors which influence the development of a country's financial reporting system. The explanatory aim is addressed by providing plausible reasons as to how and why a country's financial reporting system has developed. The aim is to identify pertinent environmental factors which explain how and why Korea's financial reporting system has evolved as it has.

To develop a theoretical framework, both descriptive and explanatory research is critically reviewed. Sections 2.2 and 2.3 examine prior descriptive and explanatory research as a basis for developing the proposed theoretical framework. Section 2.4 discusses the features and limitations of the proposed framework. Section 2.5 provides conclusions.

2.2 FRAMEWORK FOR DESCRIBING NATIONAL FINANCIAL REPORTING SYSTEMS

Prior studies have provided a rich description of diverse financial reporting systems internationally. These studies have enhanced extant understanding of financial reporting systems in several ways. First, they provide evidence regarding diversity that exists in financial reporting systems worldwide. Second, they highlight areas of differences and similarities (Choi and Bavishi 1982; Cairns *et al.* 1984) and provide insights to patterns of regional and international harmonisation.

Descriptive studies have been criticised, however, for several reasons[7] (Nobes 1981; Meek and Saudagaran 1990). The most fundamental criticism is that they do not explain why national financial reporting systems have taken their specific forms and how they have been maintained or transformed over time. These studies do not examine underlying factors that have shaped financial reporting systems and therefore provide only a limited understanding of the system. A major limitation of extant descriptive studies is their lack of a comparative framework by which observed "similarities and differences may be evaluated and explanatory variables identified and generalizations developed" (Gray 1983, p. 40).

To address some of these criticisms, Craig and Diga (1996b) proposed a framework for comparing national financial reporting systems. Their framework encompasses three principal elements: broad user orientation, institutional environment of financial reporting regulation, and specific financial reporting rules and practices. The framework is illustrated in Figure 2.1 below.

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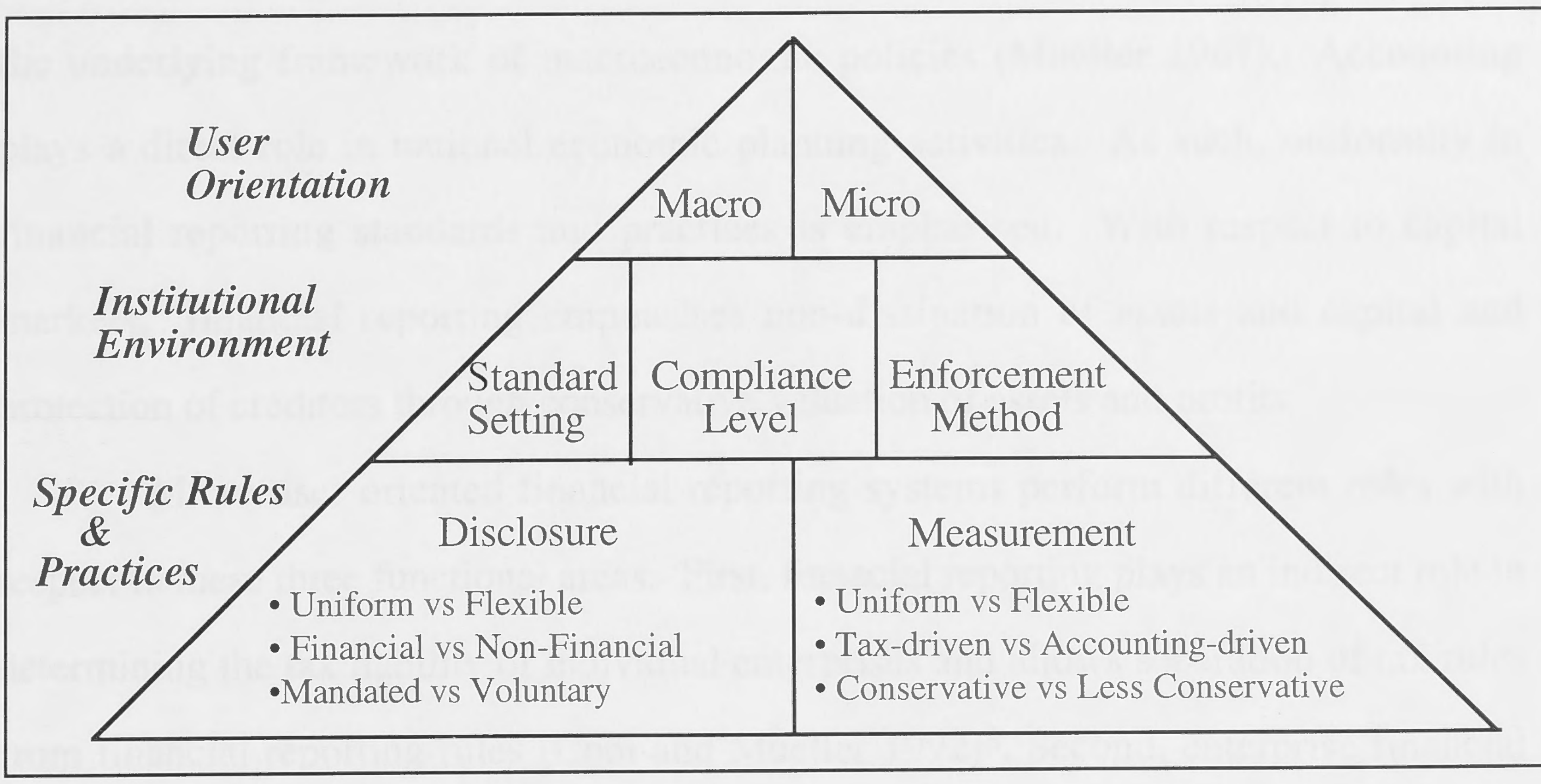
[7] The other frequently cited weaknesses with most descriptive studies are that: (i) there is an obscure distinction between officially pronounced requirements and actual reporting practices, as exemplified in the Price Waterhouse surveys (1973, 1975, 1979); and (ii) there has been a heavy focus on developed Western countries.

Figure 2.1
Comparative Framework for Financial Accounting Systems



Source : Craig and Diga (1996b), p. 26

The three elements in the framework are linked closely. The framework also "facilitates the search for patterns worldwide" and suggests fundamental differences between a micro-user view and macro-user view of accounting (Craig and Diga 1996b). These three elements are discussed further in Sections 2.2.1 to 2.2.3.

2.2.1 User Orientation

The broad dichotomisation between micro-user oriented and macro-user oriented financial reporting systems is accepted widely (Mueller 1967; Nobes 1983; Doupnik and Salter 1993). In countries with macro-user oriented financial reporting systems, accounting serves as a policy instrument for accomplishing tax and economic planning objectives. In contrast, in countries with micro-user oriented systems, accounting facilitates microeconomic transactions by providing information for resource providers such as shareholders, creditors and the capital market.

The functional roles of financial reporting systems relate, in general, to three areas: taxation, capital markets, and national economic planning. In macro-user oriented systems, a country's legal system exerts a high degree of influence on its financial reporting system. This influence is manifested through company laws, tax statutes, and commercial codes (Salter and Doupnik 1992). In particular, tax laws strongly influence financial reporting rules, i.e., differences between financial reporting and tax reporting practices are not tolerated in general (OECD 1987; Haller 1992; Nobes 1992; Nobes and Parker 1995). Accounting concepts are consistent also with the underlying framework of macroeconomic policies (Mueller 1967). Accounting plays a direct role in national economic planning activities. As such, uniformity in financial reporting standards and practices is emphasised. With respect to capital markets, financial reporting emphasises non-dissipation of assets and capital and protection of creditors through conservative valuation of assets and profits.

Micro-user oriented financial reporting systems perform different roles with respect to these three functional areas. First, financial reporting plays an indirect role in determining the tax liability of individual enterprises and allows separation of tax rules from financial reporting rules (Choi and Mueller 1992)[8]. Second, enterprise financial reports are not used to provide inputs for national economic planning. As such, standardised accounting plans (e.g., *Kontenrahmen*[9] and *plan comptable general*[10] in Germany and France, respectively) are not used. Finally, the role of financial reporting in capital markets is emphasised. This role is to provide a fair presentation or "true or fair" view of an enterprise's financial position and performance to individual users for making rational economic decisions.

2.2.2 Institutional Environment of Financial Reporting Regulation

The institutional environment of financial reporting regulation (Element 2) "encompasses the organisations, procedures and principles associated with preparing, disseminating and implementing authoritative financial accounting rules for business enterprises" (Craig and Diga 1996b, p. 11). Essentially, this element comprises approaches to financial reporting in a country in terms of financial reporting standard setting and enforcement. A country's regulatory mode is identified by examining who is responsible for the setting and enforcement of financial reporting standards.

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[8] However, tax rules may still exert some influence on financial reporting rules, e.g., Last-In-First-Out (LIFO) cost flow method allowed in inventory valuation in the US.

[9] *Kontenrahmen* is a model chart of accounts for different industries proposed in Germany by Schmalenbach.

[10] *Plan comptable general* was introduced in France in 1947, modelled after the German *Kontenrahmen*. It includes a numbered chart of accounts, definitions of accounting terms, rules on accounting valuation and measurement, methods for recording specific transactions, and uniform presentation formats.

The need for financial reporting regulation remains a controversial issue. Proponents of financial reporting regulation assert that regulation is essential because of the potential for market failure arising from two attributes of accounting information, i.e., the "public good"[11] nature of financial reporting information and its asymmetric distribution[12] among capital market agents (Gonedes and Dopuch 1974; May and Sundem 1976; Cooper and Keim 1983). They argue that mandatory rules regarding provision of accounting information help ensure an optimal supply of information which would enhance overall welfare in society.

In contrast, others reject financial reporting regulation as being costly and redundant (Benston 1976; Jensen and Meckling 1976; Atkinson and Feltham 1982). Agency theorists[13] argue that enterprises and managers have incentives to "voluntarily" provide financial and other information to capital providers. Empirical studies by agency theorists provide evidence regarding voluntary disclosure by enterprises even in the absence of mandatory regulations.

These opposing views on the need for financial reporting regulation suggest that accounting regulation is not simply a matter of economic efficiency or optimality. It is a social and political issue as well (Solomons 1978; Zeff 1978). Neoclassical economic theory (i.e., marginalism) can be used to justify both views on financial reporting regulation. Merino and Neimark (1982), Cooper and Keim (1983) and Tinker (1980, 1984) suggest that financial reporting regulation should address socio-political consequences as well as economic consequences.

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[11] The essence of a public good is that its provision to a single individual makes it equally and costlessly available to other individuals. Market failure occurs in the case of a public good because, since other individuals (i.e., 'free-riders') can receive the good, the price system cannot function. Public goods lack the exclusion attribute. Further, if one person's use of a public good does not reduce the "amount" or quality of the good that is available for other users, such goods possess "joint consumption" characteristics.

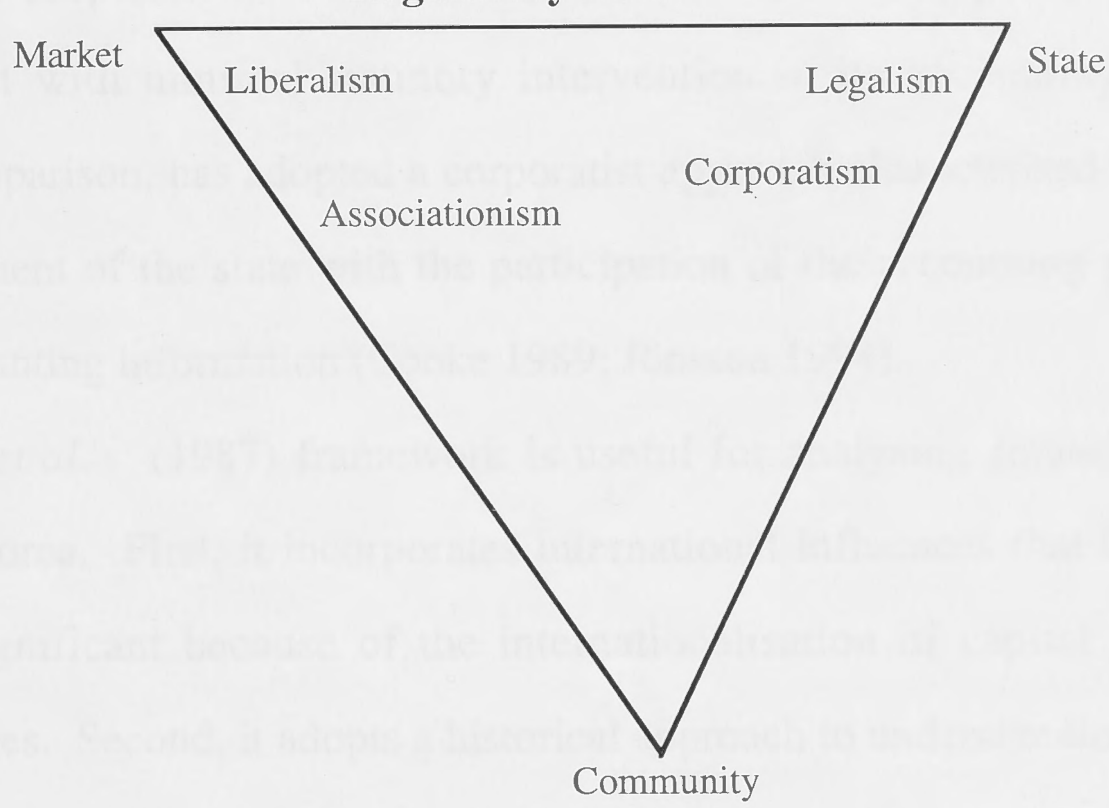
[12] The information asymmetry between buyers and sellers of securities and producers and users of information gives rise to "adverse selection" and "moral hazard" problems that are not amenable to a market solution. "Adverse selection" refers to a situation in which those individuals most likely to incur a loss (and thus those most in need of insurance protection) tend to be the only ones from a larger group who apply for a protection; "moral hazard" relates to mental attitude of the insured and his resulting behaviour regarding the probability of a loss; this is known to the insured but not the insurer.

[13] Agency relationship is a contract under which "one or more persons (principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent" (Jensen and Meckling 1976, p. 308).

(a) Accounting Standard Setting

Despite unresolved issues on the need for financial reporting regulation, such regulation is a common feature in most countries. However, differences exist in institutional arrangements found in various countries (Puxty *et al.* 1987; Chang 1988; Bloom and Naciri 1989; Willmott *et al.* 1992; Gorelik 1994; Craig and Diga 1996a). These differences can be described in terms of Puxty *et al.*'s (1987) four modes of accounting regulation[14] (Figure 2.2).

Figure 2.2
Regulatory Mode



Source : Puxty *et al.* (1987), p. 283

As shown in Figure 2.2, the four possible modes of regulation are legalism, liberalism, associationism, and corporatism. Under legalism, financial reporting is regulated through the application of state principles and the state's monopoly of the means of coercion. West Germany and Japan closely approximate legalism in which regulation is based predominantly on statutes, such as tax laws and commercial codes (Puxty *et al.* 1987 ; Choi and Hiramatsu 1987; Cooke and Kikuya 1992; Urasaki 1996).

Accounting is regulated exclusively through the discipline of market principles under pure liberalism. Regulation is left entirely to market forces, that is, pressures

[14] Based on Streeck and Schmitter's (1985) framework which identifies organising principles in society, i.e. the community, the market and the state, Puxty *et al.* (1987) analysed financial reporting regulation in the US, the UK, Germany, and Sweden. The framework was applied also by Demirag (1993) and Nobes and Parker (1995) to Turkey and NIEs, respectively. They demonstrated the applicability of the framework to non-developed countries and newly industrialised countries.

from capital markets and society. Accounting "regulation" in the US before implementation of the *Securities Act 1933* and the *Securities Exchange Act 1934* was predominantly liberal (Benston 1976; Watts and Zimmerman 1983). More recently, the liberal approach was used in Brunei and Honduras until the early 1990s (Foo 1993; Rivera 1995).

Associationism and corporatism are combinations of liberalism and legalism. Associationism is characterised by a strong influence exerted by market forces and the accounting profession on accounting regulation. Corporatism, in comparison, relies on a high degree of cooperation between the state and the accounting profession. The UK is associationist with minimal statutory intervention in its accounting regulation. Sweden, in comparison, has adopted a corporatist approach characterised by relatively strong involvement of the state with the participation of the accounting profession in regulating accounting information (Cooke 1989; Jönsson 1994).

Puxty *et al.*'s (1987) framework is useful for analysing financial reporting regulation in Korea. First, it incorporates international influences that have become increasingly significant because of the internationalisation of capital markets and business activities. Second, it adopts a historical approach to understanding accounting regulation. Historical tensions in the relationship between the three key actors (i.e., state agencies, professional accounting bodies and private business sector) are examined in the framework. Third, it draws attention to structured inequalities and conflicts within countries with regard to institutionalised regulation. In their framework, extant institutional arrangements for financial reporting regulation are perceived to legitimate and maintain systems of exchange within societies.

(b) Enforcement of Accounting Standards

Various mechanisms[15] have been adopted to enforce accounting standards promulgated by regulatory bodies in various countries. Among these mechanisms, the use of an independent audit is one of the most common. However, the auditing philosophy and auditors' roles are determined generally within a particular national context (Hussein *et al.* 1986; Morse 1993). In micro-user oriented countries, the major function of an

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[15] See Craig and Diga 1996b, Table 3, p. 20 for details.

independent audit is to attest to the "truth and fairness" or "fair presentation" of financial accounts. In comparison, independent audits tend to be used as a means of checking compliance with pertinent financial reporting and tax regulations in countries with macro-user oriented financial reporting systems (Craig and Diga 1996b, p. 16).

Despite the existence of various enforcement mechanisms, discrepancies between formal regulations and actual reporting practices have been noted in several studies (Tai *et al.* 1990; Tower *et al.* 1992; Ahmed and Nicholls 1994). These studies show that the level of compliance is influenced by the enforceability of standards and the acceptability of rules to preparers and users (Stamp 1979; Masel 1983). Compliance is related closely also to the unresolved issues regarding who should set accounting standards.

2.2.3 Specific Rules and Practices

The third element in the analytical framework is detailed financial reporting rules and practices. Given the diversity of these specific rules and practices supported by descriptive studies, disclosure rules and practices should be differentiated from measurement rules and practices. This approach is consistent with Nair and Frank's (1980) findings which showed that different environmental factors affect measurement and disclosure rules and practices.

In terms of disclosure, the framework considers the nature and extent of disclosure requirements and practices. Prior research provides evidence that enterprises in continental European countries are more responsive to social responsibility disclosures compared to those in Anglo-North American countries (Cairns *et al.* 1984; Meek and Gray 1992). The extent of disclosure (mandatory and voluntary) is different also among enterprises within a country and between countries (Cerf 1961; Singhvi and Desai 1971; Choi 1973; Buzby 1975; Stanga 1976; Barrett 1976; Belkaoui and Kahl 1978; Firth 1979; Chow and Wong-Boren 1987; Wallace 1988; Cooke 1989, 1991, 1992; Meek and Gray 1989; Hossain *et al.* 1994; Ahmed and Nicholls 1994).

Measurement rules and practices are discussed in terms of their degree of uniformity and conservatism. A broad distinction in the degree of uniformity of measurement practices exists between continental European countries and Anglo-North

American countries. Uniform measurement practices are common in most continental European countries, while substantial management discretion in the choice of measurement methods is allowed in Anglo-North American countries (Nobes 1983; Gray 1988; Nobes and Parker 1995). The degree of national and international harmony (uniformity) in measurement practices has been measured empirically using statistical tests in European and North American settings (van der Tas 1988; Tay and Parker 1990; Emenyonu and Gray 1992; Archer *et al.* 1995).

Conservatism is defined as "a preference for a cautious approach to measurement so as to cope with the uncertainty of future events as opposed to a more optimistic, *laissez-faire*, risk-taking approach" (Gray 1988, p.78). The extent to which companies adopt conservative approaches to measurement and valuation of transactions varies across countries (Abel 1969; Gray 1980; Choi *et al.* 1983; Gray 1988; Doupnik and Salter 1993). The degree of conservatism is affected also by tax rules. In highly conservative countries, there is little or no distinction between accounting rules and tax rules.

To compare the degree of conservatism between countries, Gray (1980) developed a method[16] for measuring the degree of conservatism. This method was used by Weetman and Gray (1991), Cooke (1993), and Norton (1995). Their findings indicate that countries tolerate different levels of conservatism in measurement rules and practices. Their findings are consistent also with Choi *et al.*'s (1983) study which showed that Korean and Japanese companies tend to adopt more conservative approaches than their US counterparts.

2.2.4 Limitations and Contributions of the Framework

The comparative descriptive framework adopted here has several limitations. First, it is limited to pure forms of micro- and macro-user models which may not capture fully some subtle features of particular national financial reporting systems. For example, Australia combines government-led standard setting with a strong micro-user view of accounting. Another limitation is that apparent characteristics may not accurately

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16 $CI = 1 - (R_A - R_D) / |R_A|$
where CI denotes conservatism index, with R_A being adjusted earnings and R_D being disclosed earnings.

reflect actual institutional arrangements. For example, accounting regulation which is apparently government-led could, in reality, be "captured" by private sector agencies. Third, the framework itself does not provide explanations for observed similarities and differences in a financial reporting system. Consequently, an explanatory framework is needed to provide plausible reasons for how and why these features emerge.

Despite these limitations, the framework comprehensively compares national financial reporting systems by highlighting the importance of three interrelated elements. The close linkage between these three elements is supported also by previous studies (Radebaugh 1975; Puxty *et al.* 1987; Meek and Saudagaran 1990). Radebaugh (1975, p. 40) asserted that the objectives of financial statements "provide the basis for developing accounting and reporting standards which in turn lead to specific practices." Puxty *et al.* (1987, pp. 273-274) pointed out also that "the mode of regulating accountancy is likely to affect the content and consequences of accounting policy and practices."

2.3 FRAMEWORK FOR EXPLAINING NATIONAL FINANCIAL REPORTING SYSTEMS

Given the diversity evidenced by prior descriptive studies, it is natural to question why these differences and similarities exist in financial reporting systems across nations. The purpose of explanatory studies is to provide underlying reasons regarding how and why a particular financial reporting system has evolved in a country. These explanatory studies take account of environmental factors, i.e., political, economic and socio-cultural factors, in explaining a country's financial reporting system. The basic proposition of these studies was put succinctly by Choi and Mueller (1978, p. 22):

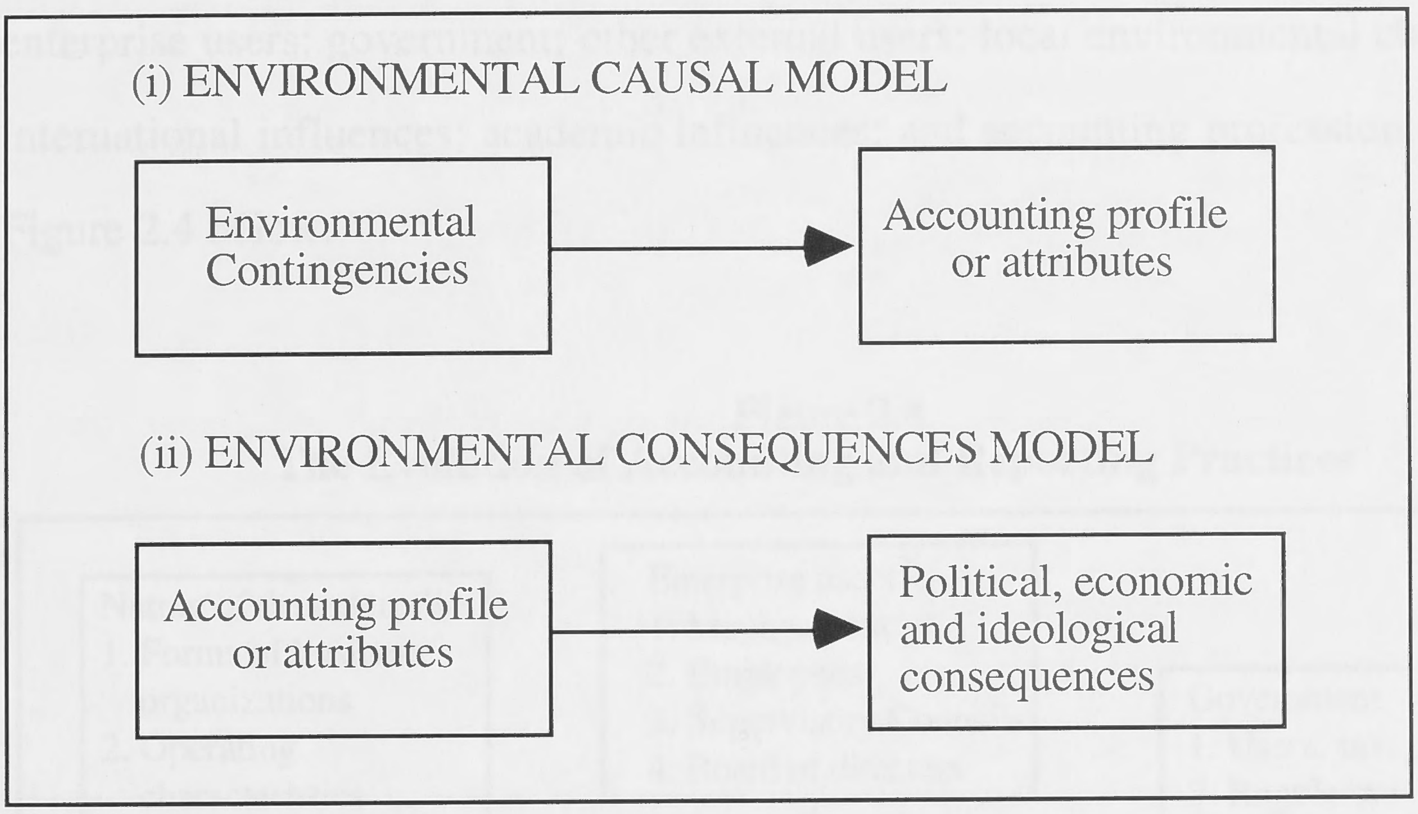
> If we. . . accept the proposition that the environments in which accounting operates are not the same in different countries. . . it stands to reason that accounting must necessarily differ from case to case if it is to retain the sharp cutting edge of social utility.

There are two generic explanatory models currently in use in various international accounting studies as delineated by the AAA International Accounting Section Committee on Research Methodologies Committee (1993). They are uni-directional and recursive models. Uni-directional models emphasise unilateral influence between accounting attributes and environmental variables, while recursive models acknowledge reciprocal effects between them.

2.3.1 Uni-directional Models

Uni-directional models focus on unilateral influence between accounting attributes and environmental variables.

Figure 2.3
Uni-directional Models in Explanatory Research



Source: AAA (1993)

As shown in Figure 2.3, two types have been identified under the uni-directional models. Environmental causal model suggests that national environmental factors affect the attributes and characteristics of national financial reporting systems. A contingency-based research fits in this environmental causal model. In contrast, the environmental consequences model emphasises the effects of a national financial reporting system in shaping a country's political, economic, and socio-cultural environment.

(a) Contingency Theory-Based Research

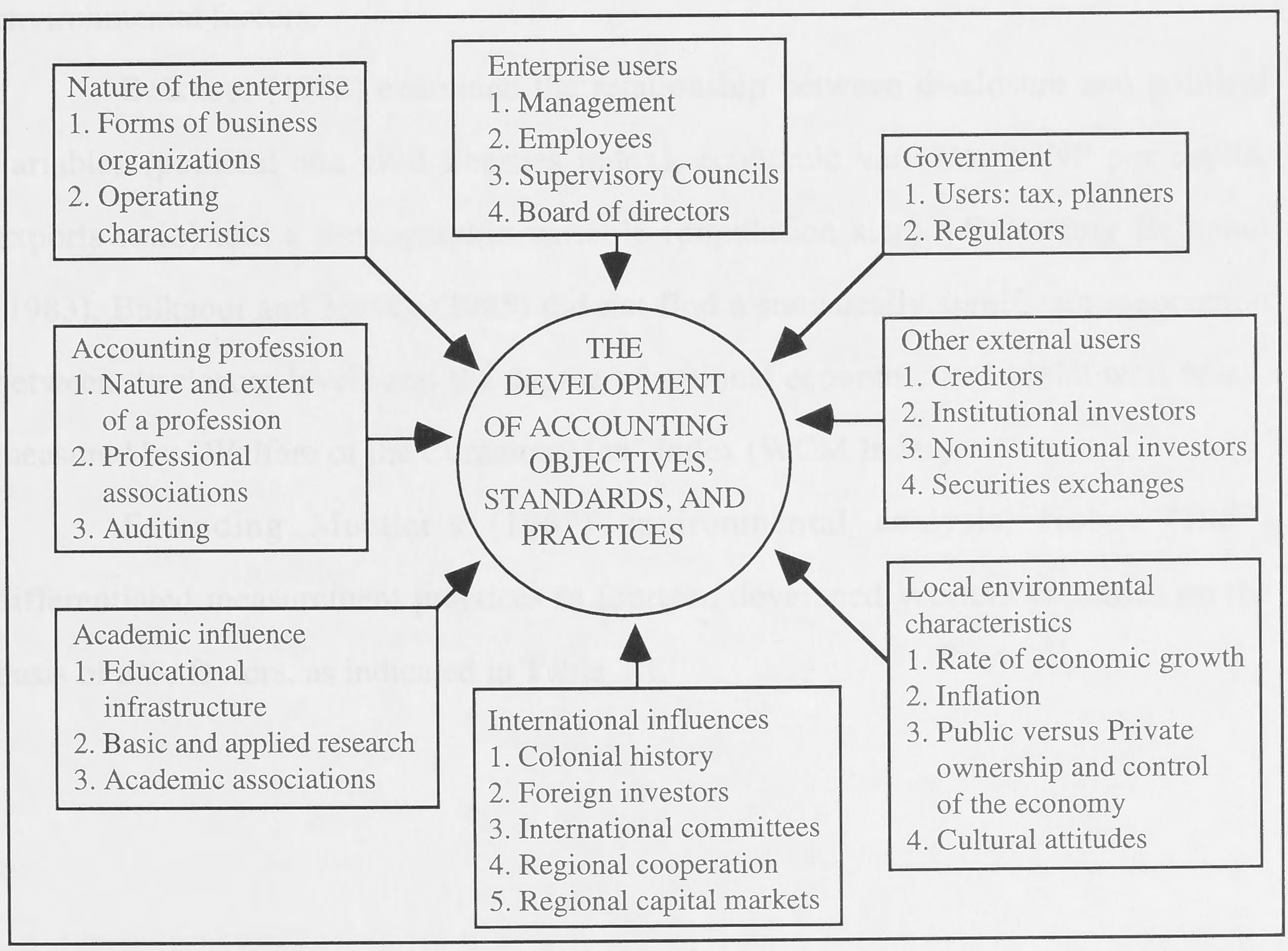
Contingency theorists in comparative international accounting literature argue that the emergence of a particular national financial reporting system is contingent on a country's national environment. The contingency theory-based research started with Mueller's (1967) classificatory work, which identified four distinct patterns[17] to

[17] They are macro-economic, micro-economic, independent discipline, and uniform approaches.

accounting development by reference to environmental factors which are classified broadly into economic, company-specific and institutional factors. In his later study, Mueller (1968) identified four major environmental factors that affect business environments and financial reporting practices. They are: stage of economic development, business complexities, political persuasion, and legal system.

Radebaugh (1975) developed a framework in which eight sets of major contingent environmental factors are deemed to influence the development of accounting objectives, standards, and practices. They are nature of enterprise; enterprise users; government; other external users; local environmental characteristics; international influences; academic influences; and accounting profession, as shown in Figure 2.4 below.

Figure 2.4
The Evolution of Accounting and Reporting Practices



Source: Radebaugh, L. H. (1975), p. 41.

Radebaugh's (1975) framework incorporates both international and domestic environmental factors including colonial history in explaining accounting development in a country. The framework, which was applied to Peru, may be useful in explaining the development of Korea's financial reporting system, particularly in view of the continuous changes Korea has experienced.

Following Mueller (1967) and Radebaugh (1975), various classificatory studies provided explanations of the observed diversity in national financial reporting systems. They include AAA (1977), Frank (1979), Nair and Frank (1980), Nobes (1983), and Yang and Lee (1994). The AAA (1977) presented a morphology for differentiating accounting systems on the basis of eight[18] underlying variables. Both Frank (1979) and Nair and Frank (1980) noted the effect of various environmental variables[19] on measurement and disclosure practices. In particular, Nair and Frank (1980) found that disclosure and measurement practices are influenced by different environmental factors.

Belkaoui (1983) examined the relationship between disclosure and political variables (political and civil liberties index), economic variables (GNP per capita, exports ratio) and a demographic variable (population size). Extending Belkaoui (1983), Belkaoui and Masky (1985) did not find a statistically significant association between disclosure levels and the degree of national economic and social well-being, measured by "Welfare of the Common Man" Index (WCM Index).

Extending Mueller's (1967) environmental analysis, Nobes (1983) differentiated measurement practices in fourteen developed Western countries on the basis of nine factors, as indicated in Table 2.1.

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18 The AAA identified eight explanatory variables affecting accounting systems: political system; economic system; stages of economic development; objectives of financial reporting; source of or authority, for standards; education, training and licensing; enforcement of ethics and standards; and client background.

19 Frank (1979) used three sets of variables for clustering countries included in his study: cultural links (proxied by official language); economic structure (proxied by per capita income, private consumption, gross capital formation, balance of trade, ratio of agricultural output); and international trade patterns.

Table 2.1

Nobes' Factors for Differentiating Accounting Systems

1. Type of users of the published accounts of listed companies
2. Degree to which law or standards prescribe in detail and exclude judgement
3. Importance of tax rules in measurement
4. Conservatism/prudence (e.g. valuation of buildings, stocks, debtors)
5. Strictness of application of historical cost (in the historical cost accounts)
6. Susceptibility to replacement cost adjustments in main or supplementary accounts
7. Consolidation practices
8. Ability to be generous with provisions (as opposed to reserves) and to smooth income
9. Uniformity between companies in application of rules

Source: Nobes (1983)

However, Nobes' nine factors capture only a limited subset of measurement rules of a country's financial reporting system. More importantly, all but the first two factors are discriminating features of measurement practices, not environmental variables. Nobes' (1983) framework, which was applied to developed countries only, may be applicable to the Korean setting, particularly Korea's extant reporting system.

Schweikart (1985) proposed a contingency framework for comparing diverse financial and management accounting systems. He argues that environmental variables (i.e., educational, political, economic, and social factors) provide the types of institutions (i.e., corporations, stock exchanges, controlling agencies) which, within a cultural framework, provide information to users of financial information.

The role of mediating variables (i.e., societal values and institutional arrangements) is emphasised in Gray's (1988) model which links Hofstede's (1980) four societal (cultural) values[20] to accounting values.[21] These accounting values, in turn, explain and determine structure and practice of accounting, including basic measurement and disclosure rules and practices. Gray (1988) noted:

> societal values are determined by ecological influences modified by external factors. . . . In turn, societal values have institutional consequences in the form of the legal system, political system, nature of capital markets, patterns of corporate ownership and so on. . . An extension of this model is proposed here whereby societal values are expressed at the level of the accounting subculture. . .

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[20] The four cultural dimensions proposed by Hofstede (1980) are as follows: individualism vs. collectivism; large vs. small power distance; strong vs. weak uncertainty avoidance; and masculinity vs. femininity.

[21] Gray (1988) developed four accounting values which would be linked to Hofstede's cultural values: professionalism vs. statutory control; uniformity vs. flexibility; conservatism vs. optimism; and secrecy vs. transparency.

Accounting 'values' will, in turn, impact on accounting systems (p. 75).

Gray's (1988) model focuses on the role that accounting values play in determining financial reporting practices (i.e., disclosure and measurement) and regulatory structures (i.e., authority and enforcement).

Gray's model was tested empirically by Salter and Niswander (1995) and they provided overall support for Gray's hypotheses. It was found to be statistically significant in explaining actual financial reporting practices, but was found to be relatively weak in explaining extant professional and regulatory structures. Two additional variables included in Salter and Niswander's (1995) study (i.e., financial markets and taxation) were found to enhance the explanations proposed by Gray (1988).

Financial disclosure regulation was found to be linked to both internal and external factors (Cooke and Wallace 1990). It is affected more by internal factors (e.g., stage of economic development, type of economic system) in economically developed countries, whilst, in developing countries, it is likely to be influenced more by external factors, such as colonial history, impact of transnational corporations (TNCs), and international accounting standards. Despite a blurred distinction between internal and external factors, their findings reveal the importance of both domestic and international influences in shaping a country's financial disclosure regulation.

Specifically, the extent of disclosure requirements and practices is associated with several corporate and national environmental variables, including equity market size, level of foreign sales, debt-to-equity ratio, firm size, and cultural values (Adhikari and Tondkar 1992; Zarzeski 1996). In particular, the positive relationship between the extensiveness of disclosure requirements and equity market size is supported also by Pratt and Behr (1987) and Ray and Gupta (1993). However, it is contrary to Saudagaran and Biddle's (1992) suggestions that overly rigorous disclosure requirements should be avoided to further develop a country's stock exchange. Thus the effects of various environmental factors in influencing national financial reporting systems differ across nations.

(b) Contributions and Limitations of Contingency Theory-Based Research

Contingency-based research has provided evidence regarding the effects of environmental variables on national financial reporting systems. However, there are several limitations with this stream of research. The most significant criticism is that there is a lack of theory underlying the potential relationship between particular environmental factors and financial reporting systems. A theory linking environmental factors to financial reporting systems would provide richer explanations of the observed diversity in national financial reporting systems. In addition, explanatory variables identified by a plethora of research have differing degrees of importance from country to country and cause enormous difficulty in developing a comparative explanatory framework which could be applied to any nation.

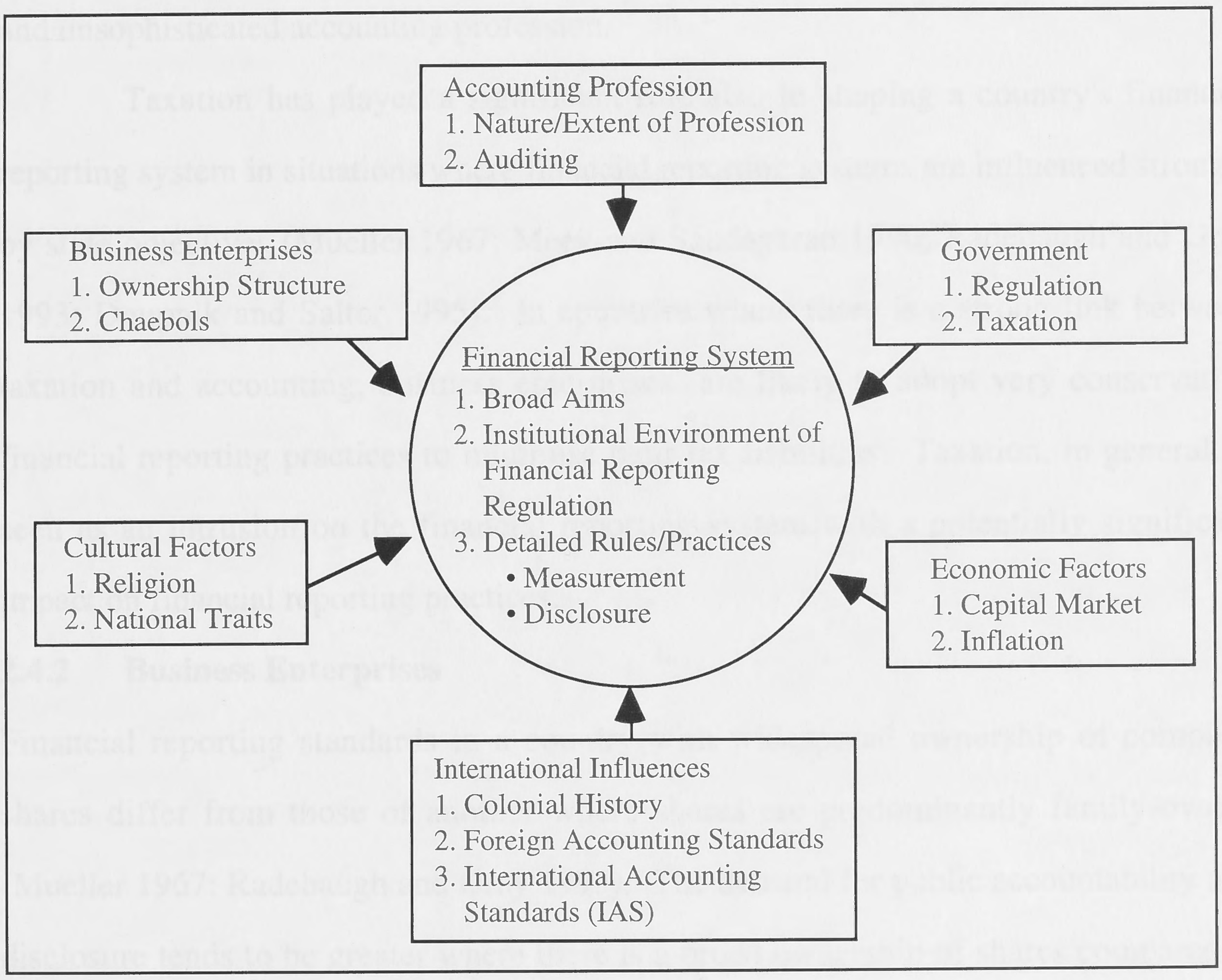
Some of these limitations were addressed in Doupnik and Salter's (1995) study which formulated a "general model of international accounting development." They suggested that a country's accounting development is influenced by its external environment, cultural values, and institutional structure, and that a more in-depth analysis be undertaken to determine how and why specific environmental variables affect the country's accounting practices.

Despite these limitations, contingency theory-based research has contributed substantially to current understanding of financial reporting systems. As discussed earlier, there are no established theories underlying the relationship between specific environmental factors and financial reporting systems. However, an in-depth study of a country's financial reporting system in relation to its environment would help develop a plausible comparative explanatory model. More importantly, this strand of research has been successful in highlighting the potential relationship between various environmental factors and financial reporting systems in different countries. An application of this contingency theory-based approach to Korea would enhance extant understanding of effects of environmental factors on the country's financial reporting system and possibly contribute to the development of a comparative explanatory framework.

2.4 FEATURES AND LIMITATIONS OF THE PROPOSED THEORETICAL FRAMEWORK

A theoretical framework (Figure 2.5), proposed for analysing the Korea's financial reporting system, has been developed by merging the descriptive framework proposed in Section 2.2 with an explanatory framework consisting of various environmental factors primarily derived from prior contingency theory-based research.

Figure 2.5
Theoretical Framework



The proposed framework contains three key interrelated elements of financial reporting systems: broad aims, institutional environment of financial reporting regulation, and detailed financial reporting rules and practices. As discussed earlier, an analysis of the three elements provides a comprehensive description of a country's financial reporting system.

To explain a country's particular financial reporting system, various explanatory variables are drawn from prior contingency theory-based research. As presented in Figure 2.5, they are: government, business enterprises, accounting profession, economic factors, international influences, and cultural factors. These variables are discussed next.

2.4.1 Government

Government has been one of the most persuasive forces in the development of financial reporting objectives, standards, and practices in various countries (Radebaugh 1975; Cooke 1989; Demirag 1993). The active participation of government in financial reporting regulation has been particularly significant in countries with a relatively weak and unsophisticated accounting profession.

Taxation has played a significant role also in shaping a country's financial reporting system in situations where financial reporting systems are influenced strongly by state objectives (Mueller 1967; Meek and Saudagaran 1990; Radebaugh and Gray 1993; Doupnik and Salter 1995). In countries where there is a strong link between taxation and accounting, business enterprises are likely to adopt very conservative financial reporting practices to minimise their tax liabilities. Taxation, in general, is seen as an intrusion on the financial reporting system with a potentially significant impact on financial reporting practices.

2.4.2 Business Enterprises

Financial reporting standards in a country with widespread ownership of company shares differ from those of another where shares are predominantly family-owned (Mueller 1967; Radebaugh and Gray 1993). The demand for public accountability and disclosure tends to be greater where there is a broad ownership of shares compared to family ownership.

2.4.3 Accounting Profession

The role of accounting profession in shaping a country's financial reporting system is evidenced in several studies. In countries with a strong and sophisticated accounting profession, active participation of the accounting profession in financial reporting regulation is common. More judgmentally-based financial reporting systems, as opposed to more centralised and uniform systems, are likely to occur in these countries.

The growing importance of independent audit requirements increases the demand for the services of public accountants and consequently, enhances their status in society.

2.4.4 Economic Factors

Capital markets, particularly securities markets, have been found to be a major element in economic growth in various countries (Sedaghat *et al.* 1994). As the size and complexity of capital markets increases, capital is raised increasingly from external shareholders and a broad ownership structure results. Consequently, public accountability and information disclosure become more important and lead to the development of an extensive financial reporting system (Pratt and Behr 1987; Meek and Saudagaran 1990; Adhikari and Tondkar 1992; Ray and Gupta 1993; Radebaugh and Gray 1993; Doupnik and Salter 1995). Countries with highly developed capital markets tend to adopt a professionally regulated, "true and fair" view audit system, engage in optimistic measurement practices and disclose relatively large volume of information (Salter and Niswander 1995).

Inflation has been also a major influence on accounting in countries with a high rate of inflation, e.g., Argentina (Meek and Saudagaran 1990). In these hyper-inflationary countries, some form of price index adjustment is called for and alternative measurement systems to the traditional historic cost approach are preferred (Radebaugh and Gray 1993, p. 45).

2.4.5 International Influences

Colonial influence on the development of financial reporting systems has been enormous in developing countries (Radebaugh 1975; Hove 1986). Business and accounting philosophies of developed countries have often been transferred and as a result, similar financial reporting systems have been instituted in their colonies.

In addition to the colonial influence, international pressures have led to an adoption of financial reporting systems generally accepted internationally. They include: growing international economic and political interdependence, foreign direct investment, multinational firms, the rapid growth of international financial markets, the expansion in business services, and the activities of international regulatory agencies.

In particular, internationalisation of business and financing activities have been influential in moulding financial reporting systems of various countries.

2.4.6 Culture

Culture is defined as "the mental programming of the mind which distinguishes the members of one human group from another" (Hofstede 1980, p. 25). The influence of cultural factors on financial reporting has been studied and accepted widely in various countries (Jaggi 1975; McKinnon and Harrison 1985; Harrison and McKinnon 1986; Gray 1988; Gerhardy 1991; Mathews and Perera 1996; Belkaoui and Picur 1991; Fechner and Kilgore 1994; Doupnik and Salter 1995).

Hofstede's (1980) four dimensions of culture have been tested widely to identify any potential linkage between cultural variables and characteristics of financial reporting systems. One of the principal dimensions of culture is religion. Strong bureaucratic involvement in financial reporting regulation in specific countries has been found to be linked closely to underlying Confucianist-based belief in the "moral basis of government."

2.5 CONCLUSION

This chapter provides a theoretical framework for analysing Korea's financial reporting system in an international setting. The framework is developed from a critical review of both descriptive and explanatory studies in international accounting literature. It encompasses three analytical elements for describing a country's financial reporting system: broad aims, institutional environment of financial reporting regulation and specific reporting rules and practices. These three elements are, in general, linked closely to each other and help provide a comprehensive descriptive picture of Korea's system and facilitate meaningful comparisons with financial reporting systems in other countries, particularly with NIEs, OECD (Organisation for Economic Cooperation and Development) members and LDCs. This descriptive analysis of Korea's financial reporting system adds to the diversity in national financial reporting systems. However, it does not provide explanations for how and why a unique financial reporting system has evolved in Korea over time as it has.

As mentioned in Chapter I, one of the important purposes of this thesis is to provide explanations for how and why Korea's financial reporting system has evolved. A plethora of explanatory research in international accounting literature has identified various environmental factors that are perceived to be important in explaining diverse financial reporting systems internationally. Two generic models have been identified in the literature: uni-directional and recursive models. Contingency-based studies implicitly adopt the uni-directional approach (i.e., environmental causal model), while a portion of emerging research assumes the two-way relationship between environmental factors and accounting system attributes.

Despite the perceived advantages[22] of the recursive models, this thesis focuses on the effect of environmental variables on a country's financial reporting system (i.e., environmental causal model) for the following reasons. First, given the state of the Korean financial reporting system, it may be extremely difficult to identify the effect of accounting attributes on the country's political, economic, and socio-cultural environment. Second, more importantly, an in-depth study of environmental factors affecting the country's financial reporting system may help identify environmental factors equally important to other countries, especially NIEs and other developing countries. Thus the development of a comparative explanatory framework may be facilitated.

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[22] These advantages are: (i) providing a rich foundation for developing theoretical frameworks by specifying the causal links between environmental variables and accounting system elements; (ii) providing comprehensive explanations by adopting an interdisciplinary approach which recognises the theoretical contributions of such related fields as economics, political science, sociology and cultural anthropology; and (iii) addressing how and why national financial accounting systems have changed over time as well as the current features of these systems. They are found in the following studies: Jaggi (1975), Tinker (1980), Burchell *et al.* (1980), Choi *et al.* (1983), Daley and Vigeland (1983), McKinnon and Harrison (1985), Chua (1986), Montagna (1986), Puxty *et al.* (1987), Hines (1988), Rivera (1989), Willmott *et al.* (1992), and Demirag (1993).

CHAPTER III

THE KOREAN FINANCIAL REPORTING SYSTEM DESCRIBED

3.1 INTRODUCTION

This chapter analyses the development and current features of the financial reporting system in Korea using the comparative descriptive framework outlined in Chapter II. The financial reporting system is analysed in terms of broad aims, institutional environment of financial reporting regulation, and specific financial reporting rules.[23]

The first element, the *broad aims* of financial reporting, is discussed to identify Korea's financial reporting system as either macro-user or micro-user oriented. The second element, *institutional environment of financial reporting regulation* (standard setting and enforcement), is analysed to identify the unique configuration of institutional mechanisms regulating financial reporting in Korea. Finally, detailed *financial reporting rules* (i.e., disclosure and measurement) are examined to highlight their nature and extent.

Section 3.2 describes briefly Korea's political, economic and socio-cultural environment, emphasising the period 1948 to 1996. This description provides the context for understanding the Korea's financial reporting system. Section 3.3 provides a brief description of the historical development of Korea's financial reporting system. Sections 3.4 to 3.6 discuss the three elements in the framework:

- broad aims expressed in legislation and accounting standards (Section 3.4);
- accounting standard setting and enforcement (Section 3.5); and
- detailed disclosure and measurement rules (Section 3.6).

Section 3.7 provides some conclusions regarding Korea's financial reporting system.

[23] Financial reporting practices of Korean publicly-listed companies are discussed in Chapters V and VI.

3.2 POLITICAL, ECONOMIC AND SOCIO-CULTURAL BACKGROUND

3.2.1 Korea Before 1945

Despite the difficulty in authoritatively estimating when people first settled in the Korean Peninsula, the origin of the Korean people is considered to be with the "Three-Kingdom Era."[24] The three kingdoms were unified in 668 A.D. by the Silla Kingdom (Lee 1984, pp. 36-65; Eckert *et al.* 1990). The Silla dynasty was succeeded by the Koryo dynasty (918 A.D. to 1392 A.D.). The Yi dynasty (1392 A.D. to 1910 A.D.) ruled the country through its dominant social class, the *Yangban*. This class directed the government, economy, and culture of the Yi society. Chinese influences had been ubiquitous until 1876 and Confucianism[25] was the predominant philosophical system used by the *Yangban* class.

Japan's influence on Korean society began with the Kangwha Treaty[26]. That influence became even more pronounced when the Japanese annexed Korea from 1910 to 1945. During the Japanese colonial period there was a huge influx to Korea of Japanese enterprises, mostly subsidiaries and branches of Japanese *zaibatsu*[27] (Kim 1991; Lee 1992, p. 61).

In 1948, three years after its independence from Japan, Korea was divided into two regimes: South Korea came under US influence and North Korea was influenced by the USSR. Since then, the two Koreas have remained distinct political entities characterised by pronounced ideological differences. South Korea pursued a capitalist path of development, while North Korea adopted a socialist developmental model.

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[24] The three kingdoms are Koguryo, Paekche and Silla that had centralised aristocratic states. Aristocratic classes enjoyed a position of primacy in political and economic spheres as well as cultural arenas. The influence of China on the three kingdoms was pivotal (Lee 1984, pp. 36-65).

[25] Confucianism is a philosophical thought which explains the origins of man and the universe in metaphysical terms. The political ethic it expounds stresses the mutual relationship of ruler and subject (Lee 1984, p. 166).

[26] By signing the Treaty, the Japanese obtained rights to trade and to establish businesses with Korea (Kim 1991, pp. 278-279). Prior to 1876, Korea had no industrial entrepreneurship and only a very weak mercantile class (Jones and Sakong 1980, pp. 19-22).

[27] *Zaibatsu* is used to refer to the large Japanese business groups which were dispersed by the Allied Forces after the end of the Second World War. The *zaibatsu* re-emerged as post-war *keiretsu*.

3.2.2 South Korea Since 1948

Since its establishment in 1948, South Korea (i.e., the Republic of Korea; *Taehan Min'guk*) has adopted a democratic constitution with a capitalist economy (Lee 1984; EWYB 1995). The post-war period is divided broadly into four subperiods on the basis of significant economic events (Lee 1992). These periods are economic recovery (1950-1961); economic growth through export promotion without specific sectoral focus (1961-1973); export promotion through heavy and chemical industries (1973-1979); and liberalisation and internationalisation of trade and capital markets (1980~present).

(a) Economic Recovery Period (1950-1961)

The Rhee government[28] focused on rebuilding the country's devastated economy after the Korean civil war (1950-1953). Subsequently, its policy emphasis shifted to stabilising prices of goods through adoption of an "import-substitution" industrialisation strategy (Hwang 1993). To support this strategy, the Ministry of Finance (MOF)[29] was charged with controlling the country's monetary policy. Nonetheless, under the General Banking Act (1954), the Bank of Korea[30] (BOK) was assigned regulatory authority over commercial banks. The Rhee government's *laissez-faire* ideology prompted transferring control of nationalised commercial banks to the private sector[31] (Cole and Park 1983; Fields 1995).

Despite the free-market principles introduced by Rhee, his government intervened heavily in industrial investment by controlling the allocation of domestic and foreign capital. The Korea Development Bank (KDB) controlled directly by the MOF provided medium-term and long-term loans to industrial enterprises.

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28 The first independent government was elected through a UN-supervised election. The US-educated president, Rhee Syngman, stepped down after a massive student uprising in 1960.

29 A list of acronyms is provided in pp. xv-xvi.

30 Since 1950 when the central bank, the Bank of Chosun, was transformed into the Bank of Korea, now the central bank in Korea.

31 The government initiated action to divest itself of its holdings of shares in commercial banks in 1954. The shares of the commercial banks not fully disposed until 1957 were mostly purchased by a small number of wealthy businessmen. (Cole and Park 1983, p. 53).

(b) Economic Growth through Export Promotion without Specific Sectoral Focus (1961-1973)

To accomplish the country's economic growth objectives, the Park regime[32] (1961-1979) undertook a series of comprehensive financial reforms in the 1960s. First, it nationalised commercial banks owned by large stockholders on grounds that their shareholdings were acquired illegally (Cole and Park 1983). Second, it revised the KDB's charter authorising the KDB to guarantee foreign loans obtained by privately-owned Korean companies. Third, the BOK Law was revised, bringing the BOK under control of the MOF in order to carry out the government's "economic growth-first" policies (Cole and Park 1983, pp. 57-58).

During this period, an export-oriented industrialisation strategy was pursued. A series of Five-Year Economic Development Plans[33] emphasised industrialisation, export promotion and investment in health, education and physical infrastructure (Kwon 1994). The period from 1963 to 1973 focused on exports without targetting specific industries and achieved a very high annual economic growth averaging 10.2% in real terms (Chiu 1992, p. 74).

(c) Promotion of Specific Industrial Sectors (1973-1979)

The high economic growth rates achieved during the earlier period (1961-1973) could not be maintained because of unfavourable internal and external factors, including rising labour costs, lack of domestic capital, and the first oil shock in the early 1970s. Consequently, the Park regime began to promote highly skilled and technology-intensive Heavy and Chemical Industries (HCI). Massive investment programs in these industries were financed largely by foreign loans and BOK loans. Companies involved in the HCI enjoyed various tax and financial privileges[34], which contributed significantly to the emergence and growth of big business conglomerates in Korea called *chaebols*. By controlling the award of these privileges, the government wielded

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[32] The military coup led by General Park Chung Hee in 1961 deposed the Chang Myon government (1960-1961). The Park regime spanned nearly two decades until President Park's assassination in 1979.

[33] The first Five-Year Economic Development Plan was launched in 1962, followed by the second and third Plans in 1967 and 1972, respectively. The fourth Plan was launched in 1977 during the Park regime and was pursued after President Park's assassination until 1981. During the earlier period of the Park regime, economic policy was thrust to the forefront of government policy.

[34] For tax incentives, see Choi and Kwack 1990, pp. 249-253.

enormous control over private enterprise activities in the 1970s and early 1980s (Kim 1991; Leipziger and Petri 1991; Lee 1992).

(d) Liberalisation and Internationalisation of Markets (1980-Present)

This period has been presided over by two regimes and one government: the Chun regime (1981-1988); the Rho regime (1988-1993); and the Kim government (1993-present). The Chun regime was faced with several internal and external problems, including domestic social and political problems following the assassination of President Park Chung Hee and the second oil shock in 1979. In an attempt to resolve these problems, the government launched its fifth Five-Year Economic and Social Development Plan (1981-1986), seeking to promote free-trade, liberalise financial policy, reduce state intervention in market mechanisms, and promote stability, efficiency, and balance among different geographical regions and income classes. This plan was not implemented successfully, however, prompting the government to revert to its earlier pro-growth strategy and reliance on the *chaebols* as the engine of growth (Fields 1995, p. 51).

The size and diversity of *chaebols* helped them to gain leverage in their dealings with the state. Their oligopolistic power was reflected in their share of total production (Jones 1991). The top 30 *chaebols* comprised more than 40% of the total manufacturing sales in 1985 (Lee 1990, p. 327). The government imposed measures to reduce the economic power of *chaebols*, including promulgation of the Monopoly Regulation and Fair Trade Act (MRFTA) in 1981 and further liberalisation of markets. However, in return for agreeing to increased foreign competition from trade liberalisation, the *chaebols* pressured the government to liberalise the country's financial system also. As part of financial deregulation, the government gradually divested its holdings in national commercial banks. Despite the 8 percent ceiling on ownership of a commercial bank by any single individual, *chaebols* managed to hold significant ownership of a bank through indirect holdings (i.e., insurance company investments). Many *chaebols* also had a controlling interest in some non-bank financial intermediaries. Thus the liberalisation exacerbated the concentration of economic power in the *chaebols*, contrary to its original purpose (Amsden 1989; Patrick and Park 1994).

The Rho regime continued the liberalisation initiated by the Chun regime. Financial markets were opened further to foreign investors from January 1992, albeit within strict limits and under strict controls (Kim *et al.* 1993; Patrick and Park 1994). The ceiling of aggregate foreign ownership in Korean companies was 10% in 1992 and increased up to 18% in early 1996 and 20% in late 1996 (Newsreview 1996a, b, d).

With the help of the Rho regime, Kim Young-Sam was elected in 1992 and has since adopted various measures to reduce corruption in business and politics (EWYB 1995). The Kim government sought to contain the economic and political power of *chaebols*. However, it has been difficult, for the government not to rely on *chaebols* to support the country's economic growth. The power struggle between *chaebols* (which demand complete autonomy to run their businesses) and the government (which wants to continue its interventionist industrial policy) seems likely to continue (The Economist 1996).

As discussed above, Korea's environment has undergone continuous changes. It can be concluded that Korea's financial reporting system may have evolved in response to the needs of this changing national environment. The effects of these environmental changes on the country's financial reporting system are discussed in Chapter IV.

3.3 HISTORICAL DEVELOPMENT OF KOREAN FINANCIAL REPORTING SYSTEM

Korea's financial accounting system has two sub-systems, the *Budgetary Accounting System* and the *Business Accounting System*. This thesis is concerned with the *Business Accounting System* that is applicable to corporate financial reporting. The development of financial accounting standards is divided broadly into three periods: before 1958; 1958 to 1980; and 1981 to 1996, based on knowledge of historical major events that have transformed Korea's financial reporting system.

3.3.1 Before 1958

Prior to the introduction of modern double-entry bookkeeping systems during the Japanese colonial period (1910-1945), a unique and informal accounting system was used by merchants in Kaesung.[35] The "Four Elements Bookkeeping Method"[36] (*Sagae Songdo Chibu Beop*) is thought to have been devised by merchants during the Koryo dynasty (918-1392 A.D.). It was used until Japanese annexation of Korea in 1910 (Sun 1976, 1977, 1978). This system was first recognised in the West by an Australian journal, *the Federal Accountant* in 1918 (Sun 1977, p. 3), as follows:

> Who first thought of bookkeeping as a business method? One would never think of Korea, and yet it was there, that double entry bookkeeping was invented and put in use. This was in the twelfth century, while it was not until the fifteenth century that a similar system was devised in Venice, then the commercial centre of the world (The Federal Accountant, July 1918, vol. 3, pp. 127-128).

The system, however, did not become a socially approved accounting system. It was replaced by Western-style double-entry bookkeeping during the Japanese colonial period.

A comprehensive introduction of the Western double-entry bookkeeping began in 1912 with the implementation of the "Provincial Civil Code Enforceable within the Jurisdiction of Vice-Roy Chosun" (*Chosun Minsaryeong*), based on the Japanese Commercial Code (JCC).[37] Protection of creditors, small shareholders, and the public interest were the JCC's main emphasis. The JCC, revised in 1938 to accommodate changes resulting from the Great Depression, was implemented in 1940 and was replaced by the Korean Commercial Code in January 1963. The revised JCC contained major changes.[38] For example, depreciation of fixed assets was first introduced and market-value accounting for assets was allowed.

The thesis is focussed on the post-1958 period in which the first sets of modern accounting standards were promulgated in Korea. However, this early adoption of the

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[35] Kaesung was the capital city of the Koryo dynasty (918-1392) and the centre of trade and industry of the Yi dynasty (1392-1910).

[36] For details, see pages 183-197 of Sun (1977) and 554-576 of KICPA (1992a).

[37] The JCC was drafted by a German, Herman Roesler, in 1881 and revised in 1899 and 1911. In addition to the JCC, other relevant laws or rules also facilitated the introduction of the Western accounting system. They are the Company Act, the Banking Act, and the Chosun Stock Exchange Ratification Act. Articles 25-29 of the JCC prescribed provisions on commercial books, whilst articles 190-199 stipulated accounting for joint-stock companies (Sun 1977 and 1978 and KICPA 1992a).

[38] These are detailed in Sun (1977, pp. 206-208 and 1978, p. 10).

Western double-entry bookkeeping during the Japanese colonial period implies that Korean financial accounting was brought into alignment with the Western system, albeit modified to accommodate the particular needs of business enterprises (i.e., mostly subsidiaries and branches of Japanese *zaibatsu*) in Korea. This indirect influence of the Western system on Korean financial accounting had continued through the adoption of the JCC until the early 1970s when more direct Western influences began to emerge.

3.3.2 1958 to 1981

The first sets of modern accounting standards in Korea, the *Business Accounting Principles* (BAP) and the *Financial Statement Rules* (FSR), were promulgated and implemented by the MOF in 1958 to provide a basis for taxation and foreign aid allocation (Sun 1976, 1978; Lee 1994; Nam 1994). The BAP was modelled on the Japanese BAP which, in turn, followed the SHM[39] accounting principles, the revised US Accounting Concepts and Standards and German balance sheet principles. The BAP required historic cost for asset valuation, consistent with most other industrialised countries in the 1950s. In comparison, the FSR stipulated terminologies and formats required to be used in preparing financial statements.

The *Accounting Principles for Listed Companies* (APLC) and the *Financial Statement Rules for Listed Companies* (FSRLC) were promulgated in 1974 and 1975, respectively. They were both influenced by US accounting standards and were supported statutorily by the Securities and Exchange Law (1973) (Art. 126(8)). Subsequently, the BAP and FSR were revised to reflect the requirements of the APLC and the FSRLC. As a result, dual business accounting standards existed in Korea from 1974 to 1981: one set of standards applied to publicly-listed companies and another for unlisted companies. However, differences between these two sets of accounting standards were minimal. The dual standards were amended again in 1980 and 1981. In December 1981, they were replaced by uniform standards called *Financial Accounting Standards* (FAS).

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[39] T. H. Sanders, H. R. Hatfield and U. Moore, A Statement of Accounting Principles, 1948.

3.3.3 1981 to April 1996

The External Audit of Joint-Stock Companies Law (EAL) provided a basis for the FAS, which were influenced substantially by US standards and International Accounting Standards (IAS). FAS were mandatory for companies subject to the EAL and have undergone seven changes since 1981. As of December 31, 1994, the following accounting standards applied:

- Financial Accounting Standards (FAS: 1994);
- FAS for Construction Industry (1992);
- FAS for Leasing Industry (1993);
- FAS on Consolidation (1994);
- FAS Working Rules on Consolidation (1994);
- FAS Working Rules on Interim Financial Statements (1992);
- FAS Working Rules on Business Combinations (1986);
- FAS Working Rules on R&D Costs (1987);
- Accounting Examples No. 1 to No. 117 (As of December 1994); and
- Industry-Specific Accounting Rules.[40]

The FAS consist of nine chapters[41] which contain general principles, measurement and disclosure requirements. The status of FAS and FAS Working Rules is recognised by various laws, specifically the Commercial Code (Art. 29), the Basic National Tax Law (Art. 20), the External Audit Law (Art. 13), and the Securities and Exchange Law (Arts. 92, 93). These laws require companies to prepare financial statements in accordance with the FAS and FAS Working Rules and Examples, unless stated otherwise. Strong legal backing for these accounting standards is a dominant feature of Korea's financial reporting system (Oh 1991).

In April 1996, the FAS were revised to enhance the global comparability of financial reporting by Korean companies. Important changes included introduction of:

- market-price valuation of marketable securities and selected long-term investments;
- income tax allocation accounting;
- special provisions[42] for small- and medium-sized companies; and
- social responsibility accounting, including environmental reporting.

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40 These accounting rules apply to: government, government enterprises, government investment organisations, financial institutions, credit unions, securities companies, insurance companies, mutual trust, and other not-for-profit organisations.

41 The subjects of the nine chapters are general rules; balance sheet; income statement; valuation of assets and liabilities; statement of appropriation of retained earnings; cash flow statement; footnotes and supplementary schedules; and supplementary provisions.

42 The following special provisions are awarded to small- and medium-sized firms: (i) revenue recognition when instalments are received; (ii) exemption from deferred income tax allocation; and (iii) exemption from present-value accounting for fixed assets acquired through long-term instalment transactions.

As discussed above, the Korean financial reporting system has changed frequently. The Western-style bookkeeping was introduced extensively during the Japanese colonial period. Consequently, the Japanese influence was strong in shaping Korea's financial reporting system in the earlier period of its accounting history. However, since the mid-1970s, the influences of US accounting concepts and standards and IAS have been increasing steadily, particularly due to globalisation of trade and capital markets. Recently, the increasing importance of comparability of financial reporting has prompted Korea to adopt several IAS which are generally in conformity with Anglo-North American standards.

3.4 BROAD AIMS

A distinction was drawn in Chapter II between macro-user and micro-user oriented financial reporting systems. Broad aims expressed in statutes, legislation and accounting standards are examined to identify Korea's financial reporting system as either micro-user or macro-user oriented.

3.4.1 Aims Expressed in Statutes and Legislation

Corporate financial reporting in Korea is regulated mainly by four major legal requirements: the Commercial Code (CC); the Securities and Exchange Law (SEL); the External Audit of Joint-Stock Companies Law (EAL); and the Corporations Tax Law (CTL). An analysis of the influences of each type of legislation on the country's financial reporting follows.

(a) The Commercial Code (CC)

The Commercial Code (promulgated in January 1962 and last revised in 1994) contains general commercial and company laws. It is administered by the Ministry of Justice. The CC requires that every individual or company engaging in business activities prepares books of account and a balance sheet to show its financial position and profit or loss (Arts. 29-33). In preparing commercial books,[43] accounting standards generally accepted as fair and appropriate (i.e., FAS and FAS Working Rules) should be applied

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[43] When the CC was revised in 1984, the suggestion that income statement be included in commercial books was made but was not adopted (Chang 1988, p. 73).

unless otherwise prescribed in the CC (Art. 29). Commercial books prepared in accordance with the provisions should be kept for a minimum of 10 years.

In regard to financial reporting by joint-stock (i.e., stock) companies, the CC includes rules on asset valuation and on accounting for deferred charges, reserves, dividend distribution, and other transactions (Arts. 447-468 and 516). The CC requires also that every joint-stock company prepare financial statements[44], a business report (*Youngup Bokosuh*), and a statutory auditor's report (Arts. 447, 447-2), as shown in Table 3.1.

Table 3.1
Commercial Code Requirements for Joint-Stock Companies

REQUIREMENT	KOREAN JOINT-STOCK COMPANIES
Financial Statements Required	Balance sheet; Income Statement; Statement of Appropriations of Retained Earnings (or Statement of Disposition of Deficits); Business Report; Statutory Auditor's Report
Guidelines for Preparing Financial Statements	Must accord with accounting standards generally accepted as fair and appropriate (i.e., FAS and FAS Working Rules)
Recipients of Financial Statements	All shareholders; Statutory auditor; Ministry of Justice
Audit Requirements	Must be audited by statutory auditor
Specific Disclosure Requirements	None specified

The financial statements and business reports should be made available in the company's principal office and all of its branches for inspection by shareholders and creditors at least one week before the annual general meeting (AGM)[45] of shareholders. The statutory auditor is responsible for examining the company's accounts and general operations and for reporting findings to the AGM. However, the auditor need not be independent of the company he/she audits. The company should have the financial statements approved at the AGM and then should publish the approved balance sheet.

The CC has contributed to the development of Korea's financial reporting system by emphasising the importance of maintaining adequate company records and by requiring the preparation and distribution of financial statements to users (i.e., government agency and shareholders). However, the CC, with the exception of a

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44 Financial statements required under the CC include: balance sheet, income statement, and statement of appropriations of retained earnings (or disposition of deficits).

45 The AGM of shareholders should be held within three months of financial year-end.

limited set of provisions on measurement, does not specify detailed rules. This enhances the potential power of government agencies to prescribe accounting rules and also allows for greater flexibility in rule-setting.

Governing all commercial transactions,[46] the CC draws upon the Japanese Commercial Code (JCC), particularly provisions dealing with safeguarding creditors (KICPA 1992a, pp. 520-522). For example, it requires that joint-stock companies set aside sufficient reserves including statutory legal reserves against possible bankruptcy. This strong creditor orientation appears to be consistent with a macro-user oriented perspective.

(b) The Securities and Exchange Law (SEL)

The SEL (first enacted in 1962 and last revised in 1994) was patterned after the *US Securities Act* (1933) and *Securities and Exchange Act* (1934). It was intended to facilitate the circulation of securities and to protect investors by encouraging the issuance, buying and selling of securities in a fair manner (Art. 1). It has undergone several changes in response to developments in Korean securities markets. The Ministry of Finance and Economy (MOFE, formerly, MOF) has been responsible for interpreting and enforcing the SEL and supervising the Securities and Exchange Commission of Korea (KSEC), the Securities Supervisory Board of Korea (KSSB) and the Korea Stock Exchange (KSE).

The SEL regulates financial reporting of publicly-listed[47] companies and is concerned primarily with specifying disclosure requirements. Each listed company is required to file an annual operating report (*Saup Bokosuh*), a semi-annual operating report, a securities report, and to make other occasional disclosures[48] with the KSEC and the KSE (Arts. 7, 86, 92, 93; Shin *et al.* 1992; Hwang 1995). Financial statements filed with the KSEC and KSE should be prepared in accordance with accounting

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[46] These are defined as ones performed for business purposes, excluding transactions which occur for wages or salaries (Arts. 46, 47).

[47] The SEL also regulates financial reporting of companies seeking listing on the KSE.

[48] For details, see Shin *et al.* (1992), pp. 255-256 and Article 186(1) of the SEL.

standards issued by the KSEC. The SEL also authorises the KSEC to prescribe the Financial Control Regulation of Listed Companies (FCRLC)[49] (Art. 192).

As shown in countries whose securities laws are US-influenced (e.g., the Philippines and Thailand), the SEL in Korea allows government agencies (i.e., KSEC and KSSB) to intervene in financial reporting regulation by providing them with statutory powers to determine generally accepted accounting standards. The roles of the KSEC and the KSSB in regulating financial reporting are discussed in Section 3.5.

(c) The External Audit of Joint-Stock Companies Law (EAL)

The EAL was first enacted in December 1980 (last revised in 1993) to help enhance the productivity and efficiency of business enterprises and to further boost economic growth. Its stated objectives are to protect various stakeholders and to promote sound development of business enterprises. It requires a joint-stock company subject to the EAL to undergo an independent audit by a certified public accountant (CPA).

The KSEC has been given statutory powers to promulgate and issue accounting standards with the approval of the MOFE also under the EAL (Art. 13). These regulations (i.e., FAS and FAS Working Rules and Examples) apply to all joint-stock companies whose total assets at the previous fiscal year-end exceed the prescribed amount[50] established by a presidential order. The independent audit requirement applicable only to listed companies under the SEL was expanded to include unlisted companies subject to the EAL (Art. 13).

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[49] This regulation was enacted in July 1977 to ensure sound financial management of listed companies and includes provisions preventing the deterioration of a company's financial structure. In addition, it contains rules on dividend distribution; maintenance of reserves; and transfer of capital surpluses to capital stock (Nam 1994).

[50] According to the EAL Implementation Ordinance (as amended on 27 May 1993, Art. 2), the EAL applies to any joint-stock company whose total assets at the end of the immediate previous period are more than 6 billion *won*. However, in the December 1980 Implementation Ordinance companies with capital stock of 500 million *won* or more or total assets of 3 billion *won* or more were required to be independently audited (KICPA 1992a, p. 332).

(d) Corporations Tax Law (CTL)

Domestic and foreign corporations are subject to income tax under the Corporations Tax Law[51] (CTL) in Korea. Computation of taxable income is shown in Table 3.2 (Kim and Kim 1990, p. 233):

Table 3.2

Relationship between Accounting Income and Taxable Income

Accounting Income	Gross Revenue	(-) Expenses and Losses
Adjustments	(+) Inclusion items (*Ik-keum*) (-) Non-inclusion (*Ik-keum*)	(+) Deductibles (*Sohn-keum*) (-)Non-deductibles (*Sohn-keum*)
Taxable Income	Gross Income	(-) Deductible Expenses

Accounting income is a starting point for calculating taxable income. Under the CTL, accounting income should be computed in accordance with established accounting standards, i.e., FAS, FAS Working Rules, and any specific provisions imposed by relevant tax laws (Art. 20, Basic National Tax Law). Financial accounting and tax accounting differ with respect to their nature and objectives. Consequently, taxable income and accounting income may be incongruent, as indicated in Table 3.2. Major areas of difference between Korea's financial accounting and tax rules are outlined in Appendix 1A.

As indicated in Appendix 1A, differences between accounting rules and tax rules reflect their incompatible objectives, i.e., tax rules are designed generally to promote or restrict business activities based on macroeconomic policies, while accounting rules seek to provide useful information regarding the performance and financial position of business entities. Because of these differences, companies are required to present a reconciliation between their accounting income and taxable income prepared by an independent CPA.

Despite these differences, there are similarities between tax rules and accounting rules (Appendix 1B). Appendix 1B shows strong tax influences on financial

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[51] Under the Korean tax system, corporations are subject to different kinds of taxes. They are: corporation tax, value added tax, asset revaluation tax, securities transaction tax, education tax, special rural tax, and local taxes. Among them, the corporation tax is the most important business taxation.

accounting in various areas. First, depreciation expense must be charged in financial accounts to be considered deductible for tax purposes (Kim and Kim 1990, p. 275). Second, special depreciation methods allowed under the CTL and the Tax Exemption and Reduction Control Law (TERCL) were incorporated in FAS to provide tax privileges for business entities engaged in government-promoted activities. Finally, statutory legal reserves have been influenced by the CTL and the CC.

Despite the absence of mandatory provisions for tax and accounting harmony in Korea, the effects of tax laws on financial reporting practices are predominant. The choice of accounting methods in various areas including inventory valuation and depreciation method is dominated frequently by desire to minimise tax liabilities rather than to reflect economic reality of business transactions. Given the requirement of reconciliation between taxable income and accounting income, companies may be motivated also to minimise the extent of reconciliation by adopting accounting methods in accordance with the CTL. Actual measurement practices are discussed in Chapter VI.

3.4.2 Aims Expressed in Accounting Standards

(a) Objectives of Financial Reporting

Since the country's first modern accounting standards were promulgated in 1958, financial reporting objectives have changed frequently. Objectives of financial reporting stipulated in accounting standards promulgated by the MOF and KSEC are presented in Table 3.3.

Table 3.3
Objectives of Financial Reporting

YEAR	OBJECTIVES
1958 (APL) (Introduction)	To provide stakeholders with "truthful" information on increases/decreases in economic assets of business enterprises.
1974 (APLC) (Article 1)	To provide users with "truthful" accounting information prepared in accordance with systematic bookkeeping to assist them in making decisions on matters affecting their business entities
1976 (APL) (Article 1)	To provide users with "truthful and useful" accounting information prepared in accordance with systematic bookkeeping to assist them in making decisions on matters affecting their business entities
1981 (FAS)~ 1994 (FAS) (Article 1)	To provide users with "useful and adequate" accounting information prepared in accordance with generally accepted accounting principles to assist them in making decisions on matters affecting their business entities

The concept of accountability to shareholders and creditors was emphasised in the 1950s. However, the increasing diversity of stakeholders and their information needs encouraged a shift to a "decision-usefulness" objective in the 1970s (Koh 1988, pp. 48-52). It is expected that the adoption of the "decision-usefulness" objective will continue to gain increasing significance with the further liberalisation and internationalisation of Korea's capital market in the 1990s. The emphasis on the "decision-usefulness" view seems to reflect an increasing shift towards a micro-user orientation in broad aims of financial reporting.

(b) Conceptual Frameworks

A conceptual framework is defined by the Financial Accounting Standards Board (FASB, 1976, p. 2) as

> a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes nature, function, and limits of financial accounting and financial statements.

Following the FASB's Statements of Financial Accounting Concepts project, conceptual frameworks have been developed and adopted in several countries, including Australia, Canada, New Zealand, the UK, and the USA. IAS also contain a conceptual framework.[52]

The existence of conceptual frameworks appears to be a characteristic of countries embracing a micro-user oriented view of accounting. Conceptual frameworks may have been developed to legitimise accounting standards promulgated by professional accounting bodies in these countries. In contrast, there appears to be less need to develop or adopt conceptual frameworks in countries with macro-user oriented systems because government agencies are awarded the legitimate statutory powers to promulgate and enforce accounting standards.

Like most macro-user oriented countries, the lack of a systematic conceptual framework in Korea appears to be associated with its government-directed accounting regulation. Despite the absence of a systematic conceptual framework, there have been efforts to include basic qualitative characteristics in the country's accounting standards.

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[52] It is developed to facilitate an international harmonisation of accounting standards, to help developing countries develop their own accounting standards, and to help users understand accounting information contained in financial statements properly.

The historical development of these qualitative characteristics is outlined in Table 3.4 below.

Table 3.4
Qualitative Characteristics of Accounting Standards

1958	1976	1981~1994
• truthfulness • proper bookkeeping • materiality • certainty • consistency • distinction between capital and operating transactions • conservatism • clarity • uniformity	• reliability • consistency • materiality • conservatism • understandability • sufficiency (adequate disclosure)	• reliability • understandability • sufficiency (adequate disclosure) • comparability • materiality • conservatism

Source: KICPA (1992a, b)

The qualitative characteristics are linked closely to objectives of financial reporting (Ijiri 1983). Because of the emphasis on accountability in the 1958 BAP, "truthfulness" was deemed the most important qualitative characteristic. However, in view of growing importance of capital markets as a source of capital, the "decision-usefulness" objective has gained significance since the mid-1970s in Korea. The inclusion of "reliability" and "adequate disclosure" reflects this shift toward decision usefulness-based accounting. With increasing internationalisation of financing activities since the 1980s, the importance of "comparable" financial information has increased also. "Comparability" was added to the 1981 FAS. Other than these basic qualitative characteristics included in accounting standards, however, FAS do not define financial statement elements or specify recognition and measurement criteria.

Current government-directed accounting standard setting in Korea has been criticised frequently for its vulnerability to political pressure. Standard setting on an ad hoc basis is likely to continue in Korea given the lack of resources to support the Accounting Management Division (AMD).[53] The standard setting body lacks expertise and adequate financial support. There have been moves to develop a Korean conceptual framework which provides a logical and consistent theoretical basis for

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[53] Even though the official responsibility of accounting standard setting rests with the KSEC and KSSB, the actual work is done by the AMD, a subdivision under the KSSB.

promulgating new accounting standards (Jang *et al.* 1994). The framework will help contribute to the sound development of accounting theory and practices in Korea.

3.5 INSTITUTIONAL ENVIRONMENT OF FINANCIAL REPORTING REGULATION

Section 3.4 drew attention to the statutory powers of securities market regulators (i.e., KSEC and KSSB) to promulgate and enforce accounting standards in Korea. Government-directed accounting regulation has been a dominant feature in the country since the late 1950s. Table 3.5 shows the different government agencies involved in promulgating and enforcing accounting standards from 1957 to 1994.

Table 3.5
Accounting Standard-Setting Bodies in Korea

Standards-Setting Bodies	Ultimate Authority	Member Representation	Accounting Standards
SGCBAR* (1957)	MOF	8 from government 1 from academia 1 from KICPA and academia	-BAP and FSR
BASDC† (1973)	MOF	15 from academia, KICPA and industry	-Discussion on revision of 1958 BAP, FSR
BAS‡ (1973)	MOF	11 members from various sectors	-Revision of BAP, FSR -Auditing Rules
AMD^ ASAC# (1981)	KSEC	AMD consists of government officials ASAC consists of 13 members 7 from academia 3 from KICPA 3 from government	- FAS - FAS Working Rules
AMD ASAC (1994)	KSEC	ASAC consists of 9 from academia; 6 from government; 6 from KICPA; 3 from industry	- Revision of FAS and FAS Working Rules

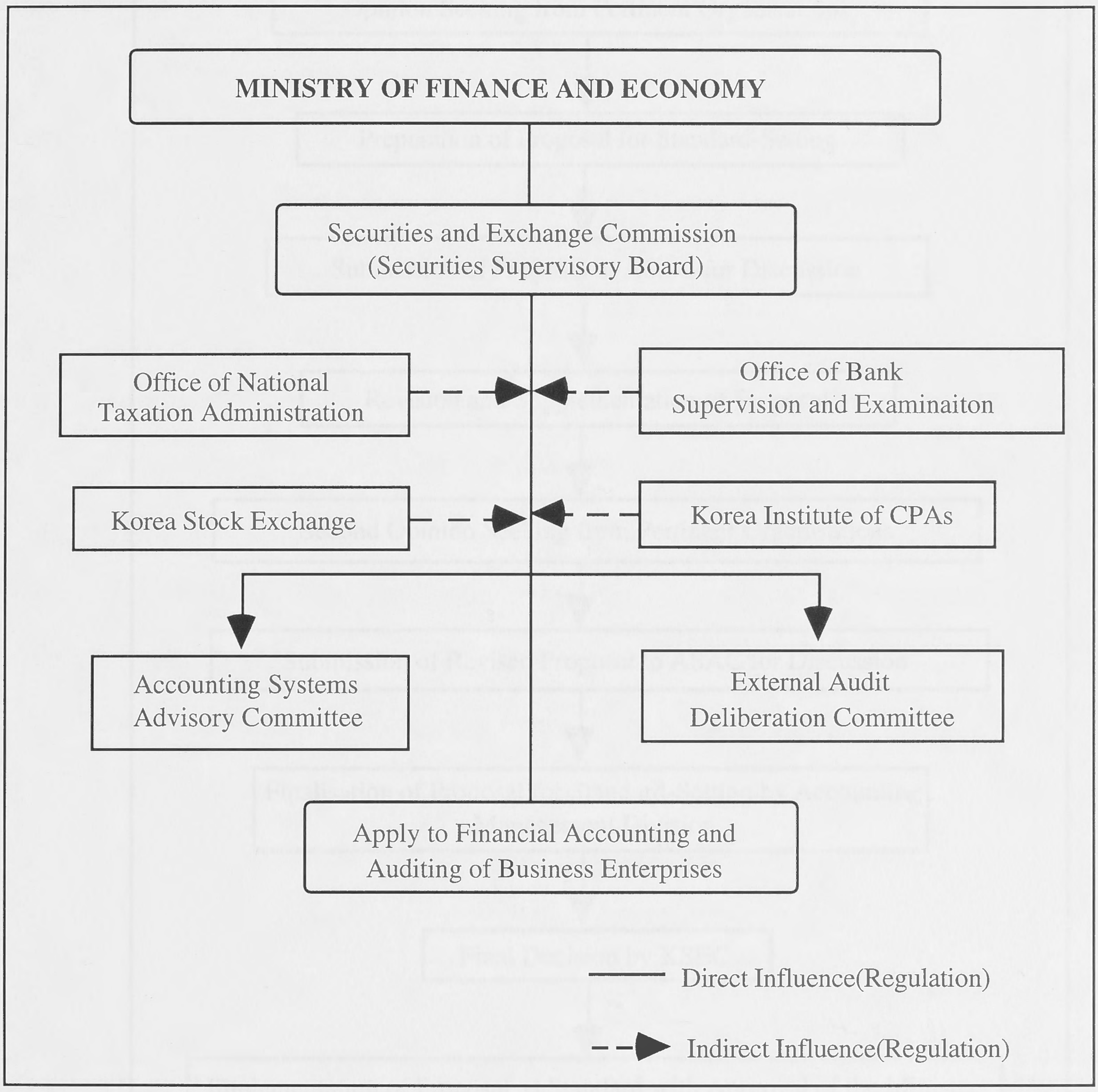
Source: Koh (1988); KICPA (1992a) and Lee *et al.* (1994)

* Small-Group Committee for Business Accounting Rules KSSB
^ Accounting Management Division under KSSB
† Business Accounting Systems Deliberation Committee
# Accounting Systems Advisory Committee to KSEC
‡ Business Accounting Sub-Committee

Table 3.5 shows that ultimate responsibility for promulgating accounting standards has always rested with government agencies (MOF and KSEC). However, the role of the professional accounting body, KICPA, was notable also through publishing several opinion releases and pronouncements in the 1970s. The ASAC's (Accounting Systems Advisory Committee) involvement in standards setting, albeit in an advisory capacity, has increased also since 1977, but its influence is limited because its financing and appointment of members is controlled by the KSSB.

The current institutional arrangement for financial reporting regulation in the country is shown in Figure 3.1.

Figure 3.1
Current Regulatory Framework



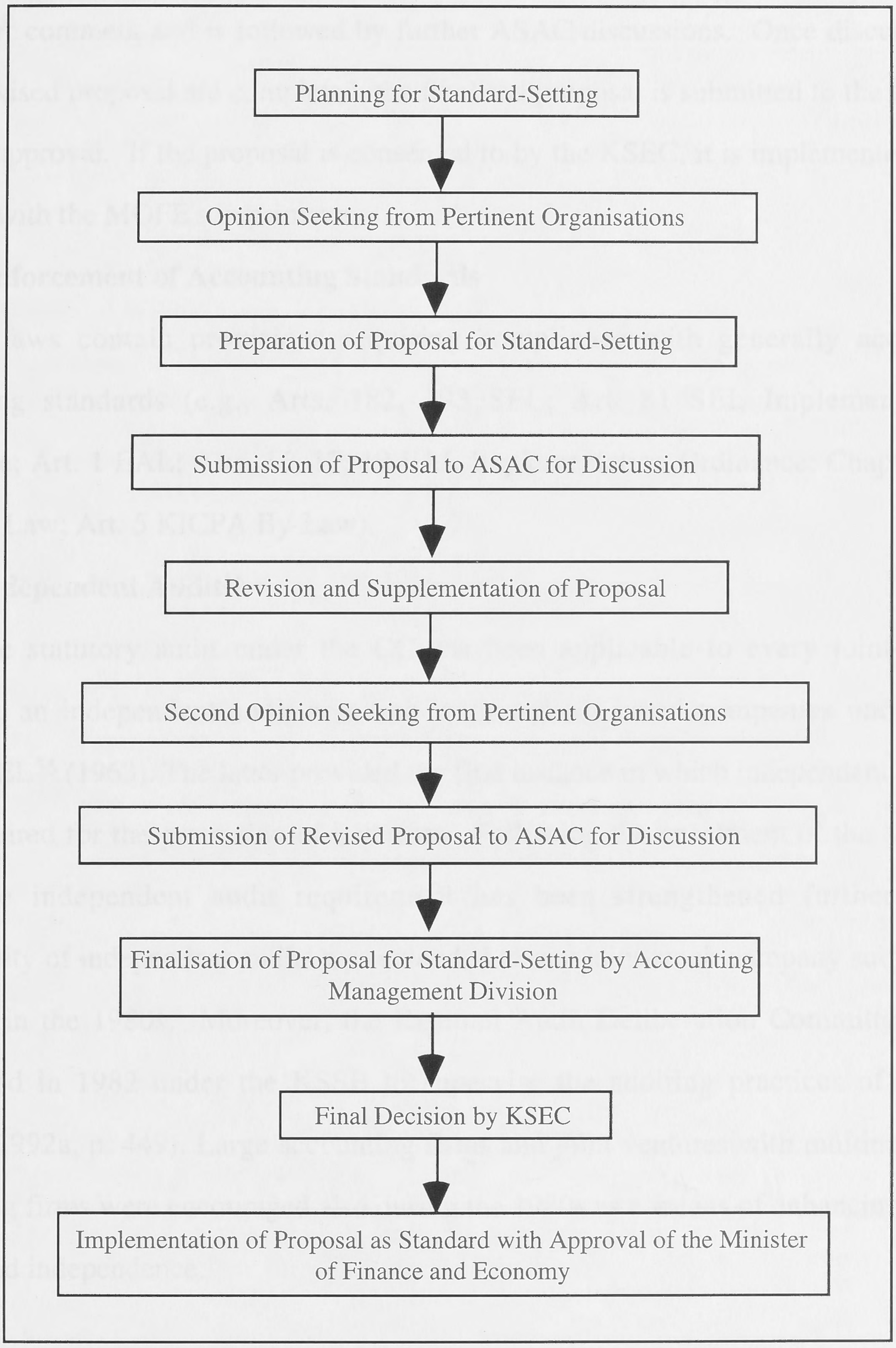
Source : Nam (1994), p. 314

The MOFE is ultimately responsible for promulgating accounting standards in Korea. However, various other organisations are involved also in regulating financial reporting either directly or indirectly, as shown in Figure 3.1.

3.5.1 Accounting Standard Setting

Figure 3.2 details the generally practised accounting standard setting process.

Figure 3.2
Standard-Setting Process
(FAS and FAS Working Rules)



Source : Lee *et al.* (1994), p.386

Even if no officially stipulated procedures have been set, standard setting begins with recommendations given to AMD from academia, government and/or industry. Based on the recommendations received, the AMD initiates a plan to formulate new or revised accounting standard(s). Once this initial planning is completed, opinions are sought from pertinent organisations.[54] Then the AMD prepares a proposal for a standard and submits this proposal to the ASAC. The proposal is revised and supplemented based on discussions with ASAC. The revised proposal is sent to the pertinent organisations for further comment and is followed by further ASAC discussions. Once discussions on the revised proposal are completed, the finalised proposal is submitted to the KSEC for final approval. If the proposal is consented to by the KSEC, it is implemented as a standard with the MOFE's imprimatur.

3.5.2 Enforcement of Accounting Standards

Various laws contain provisions requiring compliance with generally accepted accounting standards (e.g., Arts. 182, 193 SEL; Art. 81 SEL Implementation Ordinance; Art. 1 EAL; Arts. 16, 17, 19 EAL Implementation Ordinance; Chapters 2, 6, 7 CPA Law; Art. 5 KICPA By-Law).

(a) Independent Audit[55]

While the statutory audit under the CC has been applicable to every joint-stock company, an independent audit was first instituted for listed companies under the revised SEL[56] (1963). The latter provided the first instance in which independent audits were required for the protection of investors. Following the enactment of the SEL in 1963, the independent audit requirement has been strengthened further. The applicability of independent audits was extended to any joint-stock company subject to the EAL in the 1980s. Moreover, the External Audit Deliberation Committee was established in 1982 under the KSSB to supervise the auditing practices of CPAs (KICPA 1992a, p. 449). Large accounting firms and joint ventures with multinational accounting firms were encouraged also during the 1980s as a means of enhancing audit quality and independence.

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[54] These include: the Korean Accounting Association, the KICPA, the Association of Listed Companies of Korea, the Korea Chamber of Commerce, the Korean Federation of Small Businesses, the Office of Bank Supervision and Examination, and the Office of National Tax Administration.

[55] The objective of an independent audit is specified in Article 3 of the Auditing Standards promulgated by the KSEC in December 1991 and amended in September 1992. Its objective is "to enhance the reliability of financial statements of an entity and to help financial statement users in making proper decisions on the entity through an independent auditor's expression of an opinion on the financial statements as to the fair presentation of financial position, results of operations and other financial information in conformity with financial accounting standards."

[56] The 1963 SEL 126 (2) stipulates an independent audit by registered accountants.

When independent auditors violate any EAL provision, the KSEC may recommend suspension to the MOFE. Auditors are held responsible for any damage they cause to their client company or to a third party due to negligence of duty. Auditors also face imprisonment or fines when they are involved in illegal acts such as bribery (EAL Implementation Ordinance 16, 17, 19). The SEL (Art. 193) stipulates that the EAL (Art. 17) be applied to auditors' liabilities for any damage caused to investors.

(b) The Certified Public Accountants Law (CPA Law)

After the Registered Accountants Law, the CPA Law was enacted in 1966 to govern the qualifications and responsibilities of CPAs and handle matters relating to accounting firms, the KICPA, and disciplinary actions (Cheng and Jain 1973; KICPA 1992). CPA examinations are held by the MOFE at least once a year (CPA Law Implementation Ordinance 6(1)). Matters relating to the CPA examinations are supervised by the CPA Examination Committee[57] established under the MOFE. Any CPA intending to practise should register with the MOFE by submitting an application form with required documents attached (Chapter 3, CPA Law). The MOFE has to provide a registration certificate to the CPA and also notify the KICPA to enter the CPA in the register of CPAs. Any changes in registration should be notified immediately to the MOFE.

Chapters 6 and 7 of the CPA Law specify provisions on disciplinary proceedings and legal actions that can be taken against a CPA who violates relevant regulations or laws. If the MOFE decides that complaints made against a CPA need to be investigated further, then the complaints are forwarded to the CPA Disciplinary Committee established under the MOFE. The MOFE may suspend the CPA, on the recommendation of the Committee, either permanently or for a period of less than 2

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[57] The Chairman of the KSSB is the Chairman of the Committee. Other *ex officio* members are appointed or chosen by the Chairman of the KSSB from the ranks of well-known academicians and practitioners (Implementation Ordinance 7; SEL 133). Subjects included in examinations are determined by the Examination Committee. Candidates for the first-level examination take accounting principles, accounting theory, management, economics, commercial law, introduction to tax law, and English. The second-level examination can be taken only by candidates who have passed the first examination or who are waived from taking the first examination as specified under the CPA Law 2(2). Subjects tested in the second examination include financial accounting, cost accounting, auditing, tax law, and financial management.

years. The CPA may face fines or imprisonment depending on the seriousness of violations specified in Chapter 7.

As discussed above, government agencies have been involved strongly also in enforcing accounting standards. Particularly, prior to the 1980s, audit job allocation among CPAs was controlled by government or government agencies. However, this government-controlled audit environment changed to a market-based system. Free competition was instituted to improve audit quality and independence following the enactment of the EAL in 1980. Changes in the audit environment are discussed further in Section 4.4.

3.6 DETAILED FINANCIAL REPORTING RULES

Historical development of reporting rules is analysed: disclosure and measurement rules.

3.6.1 Components of Financial Statements

Financial statements required to be submitted by joint-stock companies under the 1962 CC included a list of assets, balance sheet, business report, income statement, and a list of reserves and distribution of dividend (KICPA 1992a, p. 495 and Sun 1977, 1978). Since the 1984 amendment, the following financial statements have been required: balance sheet, income statement, statement of appropriations of retained earnings (or disposition of deficits), and their supplementary schedules.

The following financial statements should be contained in annual and semi-annual operating reports under the SEL: audited balance sheet, income statement, statement of appropriations of retained earnings (or disposition of deficits), and cash flow statement. In 1993, the disclosure requirements[58] for financial information were strengthened with the promulgation of the "Guidelines to Preparation of Operating Report and Securities Report."

58 The requirements are: the most recent five-year summary financial statements; financial statements adjusted after incorporating audit opinion; audited consolidated statements with consolidation basis and rationale for non-consolidation indicated; more useful, simpler, and understandable 12 supplementary schedules; the most recent two-year semi-annual reports (interim reports)

The scope of financial statements required under accounting standards has undergone several changes also since 1958 (Table 3.6).

Table 3.6
Components of Financial Statements under Accounting Standards

Year	Components
1958	income statement, statement of retained earnings, statement of appropriations of retained earnings, balance sheet, and supplementary schedules
1974	income statement, statement of appropriations of retained earnings (disposition of deficits), balance sheet, supplementary schedules, and consolidated income statement and balance sheet if applicable (implementation deferred until 1976)
1976	balance sheet, income statement, statement of appropriations of retained earnings (or disposition of deficits), supplementary schedules, funds employment schedule, and schedule of unappropriated retained earnings, with consolidation if applicable and interim reports to be implemented from 1977
1981	comparative (two-year) financial statements: balance sheet, income statement, statement of appropriations of retained earnings (disposition of deficits), statement of changes in financial position, supplementary schedules
1990	comparative (two-year) financial statements: balance sheet, income statement, statement of appropriations of retained earnings (disposition of deficit), statement of changes in financial position, and supplementary schedules
1992	independently-audited consolidated financial statements, if applicable
1994	the same as the 1990 requirements except for cash flow statement replacing statement of changes in financial position

As indicated in Table 3.6, components of financial statements have changed since 1958. Consolidated statements became mandatory in 1976 as the power of big business groups increased rapidly owing to the government-promoted HCI drive. Comparative financial statements became compulsory also in 1981 to enhance the comparability of financial statements of Korean companies. Consolidated financial statements[59] have been required to be audited independently since 1992. The adoption of cash flow statements in 1994 was consistent with international trends.

3.6.2 Disclosure Rules

(a) Legislation and Accounting Standards

Extant disclosure regulations in Korea are examined to highlight their nature and extent. The disclosure requirements are found in FAS and FAS Working Rules, EAL,

[59] The 1994 transition provisions allowed preparation of consolidated statement of retained earnings and cash flow statement to be deferred until fiscal year starting after April 30, 1994. Consolidation of foreign subsidiaries was deferred also until fiscal year starting after January 1, 1995. More detailed disclosure requirements are detailed in article 29 of the Consolidation Standards.

SEL, and CC. The disclosure requirements stipulated by the CC, SEL, and EAL are provided in Table 3.7 below.

Table 3.7
Disclosure Requirements in Legislation

LEGISLATION	DISCLOSURE REQUIREMENTS
CC	
Financial Statements	- balance sheet; income statement; statement of appropriations of retained earnings (or disposition of deficits); supplementary schedules
Business Report	- brief information about company - operations - parent, daughter company and consolidation - recent three-year financial performance and position - impending issues - directors and auditors - major shareholders and their ownership interest - equity investment in daughter companies and others - major creditors - post-balance sheet events - details in debt guarantees - other important issues
Audit Report	- report prepared by statutory auditor
SEL	
Securities Report	- general information about company - operations - independently-audited financial statements
Operating Report	- general information about company - operations - financial information - audit report
Interim Report	- semi-annual operating report
Occasional Disclosures	- important issues affecting stock prices of company
EAL	
Financial Statements	- independently-audited financial statements and consolidated statements, if applicable
Audit Report	- report prepared by independent auditors

Sources: Commercial Code; Securities and Exchange Law; and External Audit of Joint-Stock Companies

As shown in Table 3.7, the legislation prescribes disclosure of non-financial information as well as financial information. However, it does not contain detailed disclosure requirements for preparing financial statements. The extent of disclosure requirements of financial information in Korea appears to be determined largely by accounting standards (i.e., FAS and FAS Working Rules) promulgated by the KSEC.

An index is used to measure the extent of required financial disclosures applicable to publicly-listed companies in the country. The index analyses the requirements found in FAS and FAS Working Rules as at 31 December 1994 because these rules contain the most detailed disclosure requirements that should be complied with in preparing financial statements. FAS and FAS Working Rules contain provisions on non-financial as well as financial information disclosures (Appendix 2). The analysis results in 365 individual items of disclosure. However, 27 items relating to consolidation are excluded from the empirical study on disclosure practices conducted in Chapter V.

However, as mentioned briefly in Section 3.3, the increasing importance of disclosure of non-financial information is reflected in the 1996 FAS which introduced disclosure items on employee, environmental and other social matters. Clearly, these items are potentially important in the context of a company's overall disclosure to investors and the public for their economic decision making.

(b) Korea Stock Exchange (KSE)

Founded in 1956, the KSE has achieved enormous growth, particularly since the mid-1980s. It is currently the second largest stock market in Asia in terms of number of listed companies (Shin *et al.* 1992). The KSE is a semi-autonomous juridical entity owned and operated by its member companies. It has been responsible for listings and trading and for control of its members, but it is still under the considerable influence of the MOFE and the KSEC in its policy making.

The KSE has been an important source of disclosure requirements and imposes reporting requirements that contain specific items of disclosure. The current requirements were strengthened further in 1993 by promulgating "Guides to Preparation of Operating Report and Securities Report" in order to provide more reliable information useful for investors' decision making (Chusik 1995). Table 3.8 provides disclosure requirements that should be contained in operating reports filed with the KSSB.

Table 3.8

KSE Disclosure Requirements for Operating Reports

REQUIREMENTS
1. GENERAL INFORMATION (a) Objectives of the company (b) History of the company (c) Changes in paid-in-capital (d) Total number of shares (e) Voting rights (f) Dividend distribution
2. INFORMATION ON BUSINESS OPERATIONS (a) Outline of businesses (b) Major products and raw materials (c) Production and facilities (d) Sales (e) Amount of orders (f) Major contracts (g) Research and development
3. FINANCIAL INFORMATION (a) Historical summary of important financial data (five-year summary) (b) Information to be noted, such as violations of GAAP (c) Financial statements (balance sheet; income statement; statement of appropriations of retained earnings (disposition of deficits); cash flow statement; notes; and pre- and post-adjusted statements) (d) Supplementary schedules (e.g., statement of cost of goods manufactured) (e) Consolidated statements (3-year) (f) Financial statements (pre- and post-business combinations): 3-year (g) Interim reports (h) Supplementary schedules (12)
4. AUDIT REPORT (a) Auditor's opinion (b) Internal auditor's opinion (c) Auditor's report on consolidated statements (d) Other important issues
5. INFORMATION ON AFFILIATED COMPANIES (a) Control structure (b) Information on parent company (c) Information on subsidiary company (d) Summary financial data
6. INFORMATION ON STOCKS (a) Distribution of stocks (b) Recent 6-month stock prices and trading
7. DIRECTORS AND EMPLOYEES (a) Names and stock ownership of directors (b) Employees of each office (c) Labour unions
8. TRANSACTIONS WITH INTERESTED PARTIES (a) Transactions with affiliated companies (b) Transactions with shareholders, directors and employees
9. OTHER IMPORTANT ISSUES (a) AGM minutes (b) Investments in other entities (c) Contingent liabilities (e.g., pending litigation, debt guarantees, liens) (d) Cash and MS lending (e) Post-balance sheet date events

Source: Chusik (1995)

Disclosure requirements imposed by the KSE include financial and non-financial information. In view of the increasing importance of competitive capital markets as a source of capital, the KSE will continue to play an important role in shaping Korea's financial reporting system.

3.6.3 Measurement Rules

Measurement rules in Korea are prescribed in FAS and FAS Working Rules, the CC and the ARL. Among them, FAS and FAS Working Rules currently provide the most detailed measurement rules. This study focuses on the historical development of measurement rules prescribed under accounting standards promulgated by the MOF and the KSEC.

(a) Marketable Securities and Long-Term Investment

Table 3.9 shows that conservative approaches (cost or LCM) have been required for the valuation of both marketable securities and long-term investment until 1996. The revisions in that year required market valuation of marketable securities, and market value, cost or equity valuation method for long-term investment.

Table 3.9
Valuation of Marketable Securities and Long-Term Investment

	Marketable Securities	Long-Term Investment
1958	Market Valuation	Cost
1974	Cost; Market for irrecoverable diminution	Cost; Writedown for investment in affiliated companies
1981	Cost; LCM for irrecoverables; 30% criterion for irrecoverability; Recovery up to acquisition cost	Cost; LCM (30% and 50%)
1984	Cost; LCM strengthened; Provision for valuation	Cost; LCM (only 30%); Provision for valuation; Recovery up to acquisition cost
1990	LCM; 30% criterion abolished; Transition provision[60]	LCM; Criterion abolished; Transition provision
1994	LCM; Transition provision	LCM; Transition provision
1996	Market valuation; Valuation gains or losses treated as period gains or losses	Market value; Cost; Equity method; Valuation gains or losses treated as capital adjustment account

(b) Inventories

Inventories are required to be recorded by major categories,[61] using any of the following cost methods: specific identification, first-in first-out, last-in last-out, weighted average, moving average, and retail inventory method, unless written down.

[60] The implementation of LCM valuation of marketable securities and long-term investment (i.e., equities) was deferred until further notice by the KSEC.

[61] These are: merchandise, finished goods, work-in-process, semi-finished goods, raw materials, by-products, and scrap.

Table 3.10
Valuation of Inventories

1958	1974	1981	1990	1996
Cost; LCM allowed	Cost; LCM for irrecoverables	Cost; LCM (30%)	Cost; LCM allowed	LCM

Table 3.10 shows that the country has adopted conservative approaches to the valuation of inventories historically, i.e., cost or LCM. With the 1996 amendment, LCM became a mandatory requirement.

(c) Tangible Fixed Assets

Historical cost valuation for tangible fixed assets is supported by both the CC (31(2))[62] and the FAS,[63] with the exception of upward revaluation under the Asset Revaluation Law (ARL)[64] and present-value accounting for fixed assets acquired through long-term instalment transactions. When revalued upward, revaluation increments are recorded as asset revaluation reserves under the capital reserve, not as gains. The revaluation reserves can be appropriated only for the purposes[65] prescribed in Article 28 of the ARL. A limited set of depreciation methods is allowed under FAS: straight-line, declining balance, units of production, or other reasonable method. Unlike FAS, the CTL specifies depreciation methods for each category of tangible fixed assets. Depreciation amount is based on revalued amount, if revalued.

(d) Goodwill

The CC requires that goodwill be valued at acquisition cost and be amortised in an equal amount or more within 5 years from purchase. FAS requirement is basically the same as the CC; however, the amount of amortisation may be different because goodwill should be amortised in an equal amount from the year of acquisition under FAS.

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62 The CC (31(2)) requires that fixed assets be valued at acquisition cost or manufacturing cost minus accumulated depreciation, and that the cost be written down for unexpected damage.

63 Article 96 of FAS (1994) stipulates that tangible fixed assets should be valued at production or purchase cost plus incidental expenses minus accumulated depreciation.

64 The ARL has been effective in Korea since 1965. Under the law, upward revaluation is permitted if the wholesale price index has increased by 25% or more from the date the related assets were acquired or from a previous revaluation date (Art. 5 ARL Implementation Ordinance).

65 Revaluation reserve can be appropriated only for payment of revaluation tax, transfer into capital stock, recovery of operating loss carry-overs, and offsetting of exchange-rate reconciliation. (Article 28, ARL).

(e) Research and Development Costs

FAS Working Rules on Research and Development were promulgated separately in July 1987 on the basis of Article 132 of FAS. Research and development costs should be capitalised in certain circumstances[66] and amortised over no more than five years, with actual cost net of amortisation being recorded under deferred charges. Other recurring research and development costs are treated as selling and general administrative expenses.

(f) Translation of Transactions Denominated in Foreign Currencies

Table 3.11 indicates that foreign-currency translation first introduced in the 1974 APLC has shifted to a less conservative approach which treats gains as well as losses as period profit (or loss) when incurred.

Table 3.11
Translation of Foreign Currency Transactions

1974 APLC	1981	1990
Losses amortised; Gains not recognised	Losses recognised; Gains recognised except huge temporary gains	Losses/gains recognised when they are incurred

(g) Translation of Financial Statements- Foreign Subsidiaries

Provisions on foreign currency translation of foreign operations were first introduced in 1981. In principle, the valuation basis applicable to foreign-currency transactions should be applied in translating assets and liabilities of overseas business branches or offices. However, assets and liabilities may be translated at the exchange rate valid on the balance sheet date, whilst revenues and expenses may be translated at the average rate. Differences between losses and gains must be recorded as foreign-operations currency translation debits or credits in the shareholders' equity section. Losses or gains are to be recognised only on the closing of foreign operations.

(h) Consolidated Financial Statements

Currently, consolidation applies to a company that owns more than 50% of outstanding voting stock or owns more than 30% of voting stock and is the largest stockholder. It

66 For example, when: (i) the non-ordinary costs are incurred in relation to a specific product or technology for which costs are identifiable and for which future benefits are expected to be sufficient to recover the related costs and are reasonably measurable; or (ii) prepaid royalties, patents and similar rights and intangibles have future benefits from which to recover their cost.

also applies to companies (a combination of parent and subsidiary or subsidiary and subsidiary) that own more than 30% of outstanding voting shares and are the largest stockholder of a third company, as discussed in Section 4.3.1.

Table 3.12
Criteria for Consolidation

Year	Criteria for Consolidation
1974	50% or more ownership in outstanding stocks
1984	'Control' factor added to 50% ownership criteria
1985	'Control' factor and 30% or more ownership
1994	Criteria for consolidation further strengthened - more than 50% ownership - more than 30% ownership and largest shareholder - more than 30% combined ownership and largest shareholder

(i) Leases by Lessee

FAS for Leasing Industry distinguish between finance and operating leases. If prescribed criteria[67] are met, leases are required to be capitalised as assets and depreciated in the same way as other purchased fixed assets are. In comparison, operating leases are treated as operating expenses.

(j) Reserves

There are currently two types of reserves under the shareholders' equity: capital surplus and retained earnings. Capital surplus (*Ja-Bon Ing-Yeo-Keum*) includes capital reserves (i.e., paid-in capital in excess of par value, excess of par value over the amount paid of retired capital, gain on business combination, and other capital surplus) and asset revaluation reserves. Retained earnings include legal reserves, other statutory reserves, discretionary reserves and unappropriated retained earnings or undisposed deficit. Retained earnings should be appropriated to legal reserves at the amount of 10% or more of cash dividend paid with respect to the earnings of the current year until the accumulated legal reserve equals 50% of paid-in-capital.

67 Leases are capitalised (i.e., finance leases) when: (i) there is ownership transfer from lessor to lessee; (ii) the lease contains a bargain purchase option at end of lease; or (iii) the lease life is in excess of the leased asset's useful life.

(k) Accounting for Income Tax

No deferred income taxes are provided for temporary differences between accounting income and taxable income. Net operating losses may be carried forward to offset future income for up to three years but are not carried back. Operating loss carryforwards are not required to be disclosed under Korean GAAP (Coopers & Lybrand 1991). However, in 1996, income tax allocation was introduced for implementation from 1998.

(l) Accounting for Business Combinations

Accounting for business combinations has been subject to FAS Working Rules on Business Combinations, first implemented in 1986. Business combinations should be accounted for on the purchase method only unless any relevant regulation requires application of pooling of interests method (Art. 5). Whichever method is used, deferred charges and credits should be treated as zero. Combined company's treasury stock should be recorded at the acquired company's book value.

(m) Pension and Retirement Benefits

Under the 1994 FAS (Art. 47-2), companies should set up a severance and retirement accrual on the balance sheet date, assuming all directors, officers and employees are to terminate employment as of the date. The Korean Labor Standards Law entitles employees with more than one year of service to receive a lump-sum payment upon termination of employment. The amount of benefit is based on the length of service and rate of pay (i.e., defined benefit plan). A National Pension Scheme, a defined contribution plan, came into effect in 1988 (Coopers & Lybrand 1991).

(n) Revenue Recognition

Accrual and realisation principles have been applied to revenue recognition except a few special types of sales, such as consignment, instalment, conditional, subscription, and construction-type contracts. Percentage of completion has been allowed for long-term construction subscription sales and construction contracts since 1981 and 1990, respectively. Under the 1996 FAS, long-term instalment sales that have been required to be recognised when each instalment becomes due are now required to be recognised with delivery of goods.

As noted previously, a shift towards less conservative approaches to asset valuation and profit measurement has been pronounced in Korea since the 1980s, despite the existence of historical-cost asset valuation and various types of reserves. The shift is reflected in the following areas: upward revaluation of tangible fixed assets; capitalisation of R & D costs, goodwill, and leases; recognition of foreign-currency translation gains; present-value accounting for fixed assets acquired through long-term instalment; revenue recognition with delivery of goods sold on a long-term instalment basis; market valuation of marketable securities and long-term investment; and deferred income tax allocation.

3.7 CONCLUSION

This chapter has analysed and described the historical development and current state of Korea's financial reporting in terms of three key elements, i.e., broad aims, institutional environment of financial reporting regulation, and detailed financial reporting rules.

In regard to broad aims, Korea initially adopted a strong macro-user orientation as evidenced in legislation, particularly tax laws and in the first modern accounting standards promulgated to provide a fair basis for tax collection. This macro-user orientation began to shift to a micro-user orientation in the mid-1970s when Korea's equity market grew rapidly through government promotion. Since then, a "decision-usefulness" objective of financial reporting is becoming increasingly important in the country as a result of the increasingly diffuse ownership of business enterprises. The diverse stakeholders, including existing and potential investors, demanded more reliable information useful for their economic decision making. Consequently, "reliability" and "comparability" became the two most important qualitative characteristics of financial information. Even though most accounting-related laws and statutes currently do not specify a preference for either macro- or micro-user view of accounting, they appear to accept the objectives of financial reporting adopted in FAS.

Second, strong government involvement in financial reporting regulation has always been a dominant feature in Korea. Government agencies (KSEC and MOFE) have been awarded statutory powers to promulgate and enforce accounting standards.

However, the feasibility of heavy state intervention became questionable because of changes in the country's environment, including more liberalised trade and capital markets, particularly since the early 1980s. These changes are reflected also in financial reporting regulation through increasing private-sector representation (i.e., academia, industry, and KICPA) on the ASAC and through a shift to a market-based audit environment from government-controlled audit job allocation among CPAs.

Finally, as expected for most macro-user oriented systems, conservative approaches to asset valuation and profit measurement prevailed in Korea except in a few areas such as upward revaluation of tangible fixed assets. However, with the increasing importance of economic substance over legal form, the country began to adopt less conservative approaches to reflect economic reality of business transactions more properly. They are revealed in the following areas: recognition of translation gains as current income; market valuation of marketable securities; present-value accounting for fixed assets acquired on a long-term instalment basis; revenue recognition of instalment sales on delivery of goods; and deferred income tax allocation.

Similarly, disclosure requirements have been strengthened further to provide information useful for investors' economic decision making. The significance of disclosure of non-financial information is noted in the 1996 FAS. The FAS require that companies disclose information on environmental effects of their productive activities and information on their employees. Efforts to bring Korea's FAS into harmony with IAS are notable. In addition, the KSE disclosure requirements comprise detailed non-financial and financial information about business entities listed or seeking listing on the KSE.

As discussed above, Korea's financial reporting system contains both macro- and micro-user components even though a micro-user perspective is increasing in its importance. In addition to the descriptive analysis undertaken in this chapter, an analysis of the country's environment in relation to features of its financial reporting system will enrich current understanding of and provide explanations as to how and why the particular system has evolved in Korea. These explanations are provided in Chapter IV.

CHAPTER IV

THE KOREAN FINANCIAL REPORTING SYSTEM ANALYSED

4.1 INTRODUCTION

Several environmental variables have been found to influence the essential elements of a country's financial reporting system in varying degrees (Mueller 1967, 1968; Radebaugh 1975; Nobes 1983; Gray 1988; Cooke and Wallace 1990; Meek and Saudagaran 1990; Adhikari and Tondkar 1992; Doupnik and Salter 1995). This chapter seeks to analyse the development and current state of Korea's financial reporting system in relation to the explanatory variables proposed in the framework in Chapter II. These explanatory variables are: government; business enterprises; accounting profession; economic factors; international influences; and culture.

Building upon the descriptive analysis undertaken in Chapter III, this explanatory analysis explores how and why the unique financial reporting system arises, is maintained, and transformed over time in Korea. It enhances current understanding of the country's system and also helps to identify environmental factors equally important to other countries, especially, NIEs and other developing countries, thus facilitating the development of a comparative explanatory framework.

The role of the variables in shaping the country's financial reporting system is discussed in Sections 4.2 to 4.7. Section 4.2 discusses the role of government in financial reporting regulation. The impact of business enterprises on financial reporting is analysed in Section 4.3. Section 4.4 examines the role of accounting profession in regulating financial reporting. The effects of economic factors are discussed in Section 4.5 followed by a discussion of international influences on the country's financial reporting system in Section 4.6. Section 4.7 provides evidence that Korea's financial reporting system has been influenced by the country's unique cultural background. Section 4.8 provides some conclusions regarding the contribution of this explanatory approach to understanding development and current features of Korea's financial reporting system.

4.2 THE ROLE OF GOVERNMENT

In general, the government is one of the most influential forces in the development of accounting objectives, standards and practices. It plays a significant role in shaping a country's financial reporting system as a regulator and as a user (Radebaugh 1975; Cooke 1989).

4.2.1 Financial Reporting Regulation

Until the early 1980s, the Korean state (i.e., government or government agencies) had been pre-eminent in its relationship with the private business sector and the accounting profession. The nature of domestic capital markets and the scarcity of capital overall had shifted the balance of power toward the government and those groups with access to government-controlled financial resources. The role of the state as a major financier to the private sector has engendered a close relationship between government and businesses similar to that observed in Japan. However, the government was clearly in a superior relationship with the business sector (Jones and Sakong 1980; Chung and Lee 1989; Chen 1995). Moreover, the state traditionally has controlled the accounting profession also with respect to its examination, registration and practices.

A strong state had played a pivotal role also in regulating financial reporting through legislation of various laws and rules (see Sections 3.4 and 3.5). Government agencies had been involved heavily in setting and enforcing accounting standards. The MOF was given ultimate responsibility for promulgating and enforcing accounting standards. Also prior to the enactment of the EAL in 1980, the allocation of audit work among CPAs had been determined by government agencies (Park 1990; KICPA 1992a).

Thus, the institutional framework for financial reporting regulation prior to the 1980s appears to have been predominantly legalistic because the regulation relied upon reserved application of state principles rather than market principles. In legalistic countries, laws are enforced not by commercial failure but by the state's monopoly of the means of coercion (Puxty *et al.* 1987; Parker and Nobes 1995).

However, the asymmetric relationship between the business sector and the state has changed substantially since the early 1980s following the liberalisation of various economic sectors, especially the capital market. Economic liberalisation has reduced the degree of influence of the state in industrial and financial policy determination. In contrast, the private business sector, particularly *chaebols*, have enjoyed and gained political and economic ascendancy. This power struggle has become more apparent during the current government's (1993-1998) administration, with the state undertaking various measures to reign in the power of *chaebols* (EWYB 1995, The Economist 1996, Newsreview 1996e).

The deregulatory trend of government is reflected also in increasing private-sector representation on the ASAC. Since its establishment in 1977, the ASAC has acted in an advisory capacity to the KSEC in setting accounting standards. As shown in Table 3.5, the ASAC consists of representatives from various sectors. Government representation is currently low (i.e., 25 per cent) compared to 75 per cent when the country's first modern accounting standards were promulgated in 1958. In contrast, private-sector representation (i.e., academics, CPAs and industry representatives) comprises 75 per cent of the current ASAC membership.

Various explanations have been provided for Korea's adoption of market-based economic principles since the early 1980s. One explanation is that such principles are essential to overcome the inefficiency of state intervention in credit allocation processes. Another explanation is that the huge influx of US-educated economists has created a group with a vested interest in maintaining its influence on economic policy-making process. A third explanation is that the liberalisation policy is an attempt to consolidate the political legitimacy of the Chun regime which obtained its power through a military coup in 1980. By opening the country's market, the government sought legitimacy from the US which was then pressuring it to open the country's markets to US products. While it is acknowledged that heavy government intervention in the economy should be reduced to meet the demands of changing domestic and international environments, the uncritical adoption of neoclassical market economic principles has been criticised also. "Indirect control" by government has been suggested to ensure that a country's industrialisation progresses at a satisfactory rate (Amsden 1991; Chung 1994).

Despite the changes in financial reporting regulation that occurred during the 1980s and 1990s, the ultimate authority in accounting standard setting and enforcement still remains with the government. The government-directed legalistic approach has been accepted traditionally by most stakeholders. However, there could be problems associated with the government-directed financial reporting regulation, including inefficiency, low industry acceptance, slow responses to changing needs, and susceptibility to political pressures from special interest groups. For example, the fourth and the fifth amendments to FAS that occurred in 1990 and 1992 were the result of political pressures from the private sector, especially financial institutions. Both amendments deferred the implementation of lower of cost and market valuation of marketable securities and long-term investments because the implementation would have resulted in huge valuation losses for the financial institutions who had been encouraged by the government to invest enormously in the country's ailing stock market. Another example of political pressures is the abolition of the requirement to disclose a statement of cost of goods manufactured in the 1996 amendment. The private sector was concerned about the release of cost information to foreign competitors and pressured the accounting standard setting body to abolish the requirement.

These two examples reflect the political nature of implementing specific accounting standards. The numbers in financial statements have a social impact because they affect the expectations and behaviour of various stakeholders including business, government, investors and creditors (Zeff 1978; Solomons 1978). It is recognised that imperfections in the financial information market are likely to exist, but it does not necessarily follow that the market must be regulated by government or government agencies (Benston 1980; Cooper and Keim 1983; Dye 1985).

Nonetheless, considering the country's current business environment, government-directed regulation appears to be appropriate even though a shift toward less government intervention may be desirable in the future. Private-sector regulation might not be effective in ensuring corporate compliance because accounting practices at an enterprise level have been affected frequently by the desire to minimise tax liability and to assure sufficient capital retention. Compliance with accounting standards can be enhanced by strong government-directed legislative backing and enforcement. Similarly, accounting regulation by the KICPA may be dangerous because the regulatory machinery may be captured by a small group of KICPA members, as discussed in Walker (1987) and Godfrey *et al.* (1994). Beginning in the 1990s, consolidation regulations were strengthened and made more sophisticated in Korea. These new mandatory independent audits of consolidated statements by CPAs have increased the demand for CPAs' expertise and skills in preparing these statements substantially. Accounting is often used to maintain and enhance a particular group's interests. Accounting regulation by government may be just a "necessary evil" designed to mitigate the danger of being captured by a small group of social interests including the accounting profession (Ronen 1979; Tinker 1980, 1984). The state regulation emerges to protect the general or collective interests of capital and the requirements of the capital accumulation process.

As Lee *et al.* (1994) suggested, government-directed accounting regulation should be maintained in Korea. With respect to accounting standard setting process in the country, some notion of "due process" is observed, as reflected in consulting with various "constituents" in government and the private sector (see Section 3.5.1). However, the process appears to be less rigorous than those found in Anglo-American countries, especially that adopted in the USA. First, the level of transparency of the process is lower than that of the USA. The exposure of proposed standards for public comment as well as the involvement of various user groups is lacking in Korea. Participation of the various user groups in the process is justified considering the objective of financial statements, which is to serve primarily those who have limited authority, ability or resources to obtain information about an economic enterprise's activities (Cyert and Ijiri 1974, p. 41). A more transparent standard setting process, which incorporates the views of various user groups including the public, may be desirable in order to alleviate problems associated with the government-directed regulation (Cyert and Ijiri 1974; Dyckman 1988; Johnson and Solomons 1984). Second, as described in Section 3.4.2, Korea lacks a systematic conceptual framework.

Consequently, the process may be prone to various political pressures. Frequently still, the standard setting process is perceived to be a means of increasing the economic power of specific interest groups (Zeff 1978; Solomons 1978; Solomons 1983). The formulation of a conceptual framework has been suggested to provide a more logical and consistent basis for accounting standards setting (Dopuch and Sunder 1980; Agrawal 1987; Jang *et al.* 1994). Despite general criticisms of the conceptual framework, several benefits have been identified also (Wolk *et al.* 1992; Mathews and Perera 1991). Among these benefits, one of the most important is that of providing a theoretical basis for the information to be included in general-purpose financial reports.

4.2.2 Financial Reporting and Taxation

As the Korean economy has developed, the country's tax system[68] has changed too (Appendix 3). An outstanding feature of Korean tax policy since the 1950s has been its ability to adapt to substantial changes in economic and social policy directions, and its capacity to facilitate strong economic performance (Kim and Kim 1990; Whalley 1991). For example, the government recognised the importance of developing a strong domestic equity market to generate and channel domestic capital into government-promoted industries. To this end, it structured tax laws to encourage companies to be listed on the KSE and to induce greater investor interest. Also, the government introduced different tax rates on dividend income depending on a company's public-listing status (Haskins *et al.* 1996). Lower tax rates were imposed on dividend income received from publicly-listed corporations.

Financial reporting practices have been influenced strongly by national tax policies (Kim 1986; Nam 1994; Song and Yoon 1995; Kang 1995). First, depreciation expenses must be charged in financial accounts to be considered deductible for tax purposes (Kim and Kim 1990, p. 275). The CTL specifies rules on depreciation, including the useful life, residual value, depreciation rates and depreciation method for each asset category. Most companies claim the same amount of depreciation on their

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[68] For a detailed discussion of the chronological development of Korean tax system, see pp. 602-607 of KICPA (1992a). The first National Tax Law was enacted in December 1949. The tax system from 1954 to 1960 focused on capital accumulation for economic recovery by reducing tax rates. In contrast, the tax system since the early 1960s has been directed towards economic development and distribution of wealth. In particular, the 1974 tax reform saw an introduction of full-scale income tax system.

financial reports and tax returns to minimise their tax liabilities. Second, *Guides to Formation of an Audit Opinion on Financial Statements* (*Cheung-Yi*)[69] were implemented by the MOF in 1975 to ensure companies deviating from prescribed accounting standards to obtain government incentives (e.g., tax privileges) were not penalised by a "qualified" or "adverse" audit opinion. Third, special depreciation methods allowed under the CTL and the *Tax Exemption and Reduction Control Law* (TERCL) were implemented to provide tax privileges for business entities engaged in government-promoted activities. Fourth, statutory legal reserves and other types of reserves have been encouraged by the CTL and CC.

Despite extant differences between accounting rules and tax rules, their relatively high degree of congruence (as indicated in Appendix 1B) implies the importance of financial reporting in tax collection. However, steps have been taken to minimise these tax influences on financial accounting. Since 1968 (i.e., 1967 tax reform), companies have been required to submit tax reconciliations prepared by CPAs to regulatory bodies when filing their tax returns. Also *Cheung-Yi* and special depreciation allowed under the CTL were abolished in 1984 and 1994, respectively. Finally, tax effect accounting rules were introduced in 1996 to further distinguish between tax and accounting practices.

4.3 THE IMPACT OF BUSINESS ENTERPRISES

The ownership structure of business enterprises in a country influences the financial reporting system, particularly the nature and extent of information disclosure. Korea has a range of business organisations similar to those in other capitalist countries. Under the CC, four types of business entities are recognised:

- joint-stock corporation (*Chusik Hoesa*);
- private limited liability company (*Yuhan Hoesa*);
- unlimited liability company (*Hapmyung Hoesa*); and
- company with limited and unlimited partners (*Hapja Hoesa*).

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69 The following areas were acceptable under the *Cheung- Yi* if treated in accordance with relevant tax laws: provision for retirement and severance benefits; provision for bad debts; special depreciation; reserves for mining; reserves for securities transactions; and reserves for technology development (KICPA 1992a, p. 613).

In addition, three other types of business organisations exist (Jang 1996):

- partnership (*Johap*);
- branch of a foreign corporation; and
- sole trader.

In general, joint-stock corporations have a broader ownership base than sole traders, partnerships and other types of companies. Consequently, disclosure by joint-stock corporations tends to be more extensive. A joint-stock company in Korea may be formed by seven or more investors with a minimum capitalisation of 50 million *won* (about $US 61,478 in 1996). It must maintain a legal reserve to protect creditors by annually allocating an amount equal to 10 per cent of its annual cash dividends until the reserve reaches 50 per cent of its paid-in-capital. Joint-Stock corporations have increased from 12.3% in 1976 to 35.8% of the total number of 73,364 business organisations in 1993. Over the same period sole proprietorships have decreased from 85.7% to 64.2%. In mid-1995, approximately three per cent of joint-stock corporations were listed on the KSE (Jang 1996).

Modern joint-stock corporations have had a relatively short history in Korea (Moskowitz 1989). Most have been closely-held firms controlled by their founders or some families, particularly until the Korean government initiated a "going-public" drive through legislation in the late 1960s. The laws included the *Capital Market Promotion Law* in 1968 and *Going-Public Encouragement Law* in 1972. The government's sustained efforts to boost the domestic equity market have increased the number of listed companies to 721 in 1995 from a mere 24 in 1967.

As mentioned in Section 4.2, the government intervened strongly in private sector industrial activities through control over capital allocation. Business enterprises involved in government-promoted industries enjoyed tax and financial privileges. These perquisites contributed substantially to the emergence of *chaebols* in Korea. The economic power of *chaebols* has since increased enormously such that Korea's economy is now dominated by the top 30 *chaebol*s, whose combined sales comprise approximately 75 percent of Korea's GNP (Haskins *et al.* 1996). In view of their economic significance, analysis of their characteristics and their influence on Korea's financial reporting system will provide a better understanding of the country's financial reporting system.

4.3.1 Nature and Ownership Structure of *Chaebols*

A *chaebol* is defined as "a business group consisting of large companies which are owned and managed by family members or relatives in many diversified business areas" (Yoo and Lee 1987, p. 97). *Chaebols* are considered a product of Korea's distinctive political, economic and socio-cultural environment.

The characteristics of *chaebols* have been studied extensively by Steers *et al.* (1989), Hattori (1989), Lee (1992), and Chang and Chang (1994). The distinctive features of *chaebols* are summarised as follows:

- unity of ownership and control;
- diversified business activities;
- vertical integration;
- close relationship with government; and
- centralised planning and coordination.

Among these features, the ownership structure is discussed further because of its relevance in influencing Korea's financial reporting system.

Despite many varieties of ownership structures, *chaebols* commonly are owned and controlled by founders and their immediate family members through direct and interlocking ownership among affiliated companies. Figure 4.1a shows a typical ownership structure of Korean *chaebols*, whereas Figure 4.1b illustrates that of Japanese pre-war *zaibatsu* and post-war *keiretsu*, respectively.

Figure 4.1a
Ownership Structure of Korean *Chaebol*

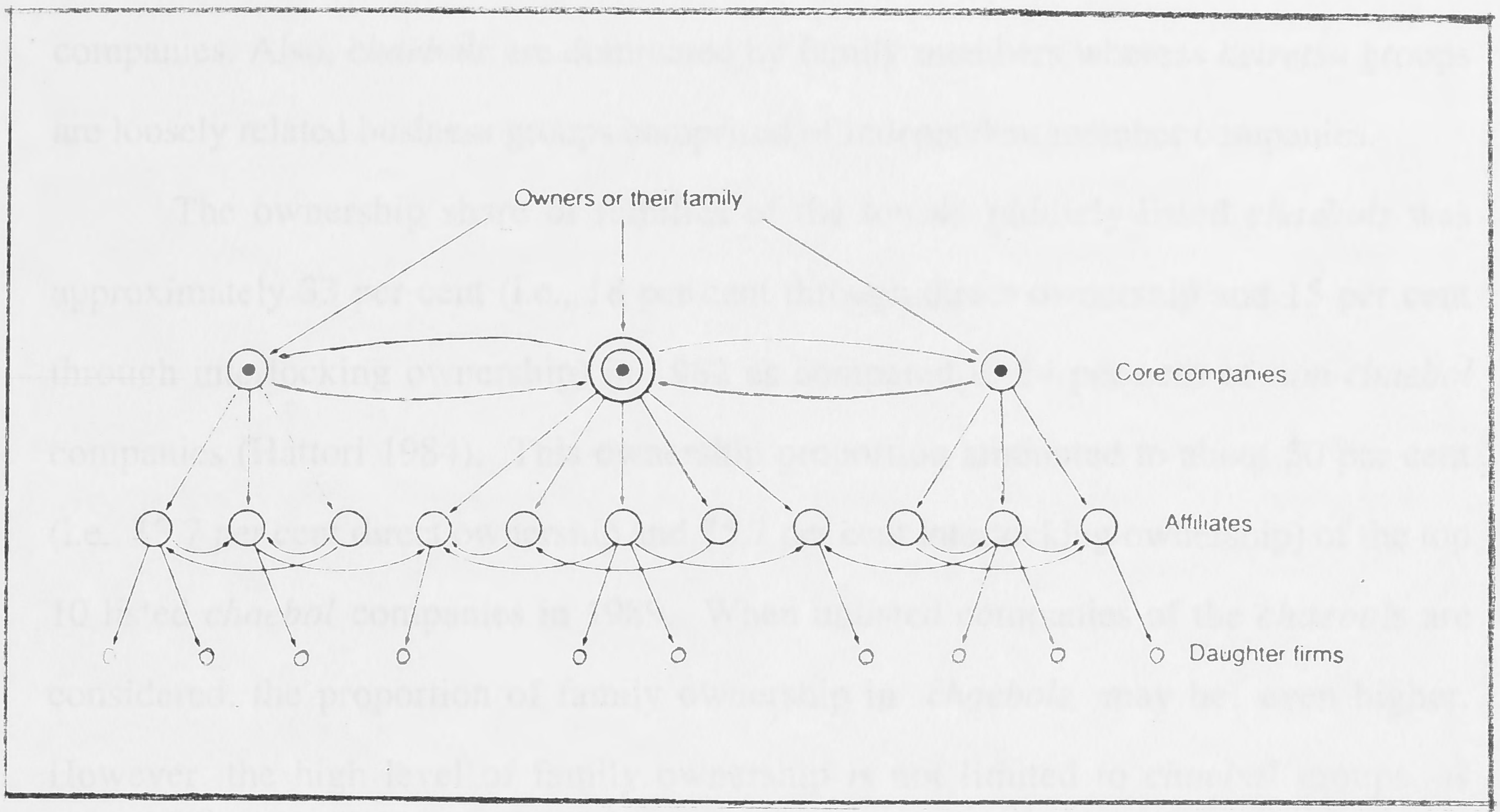
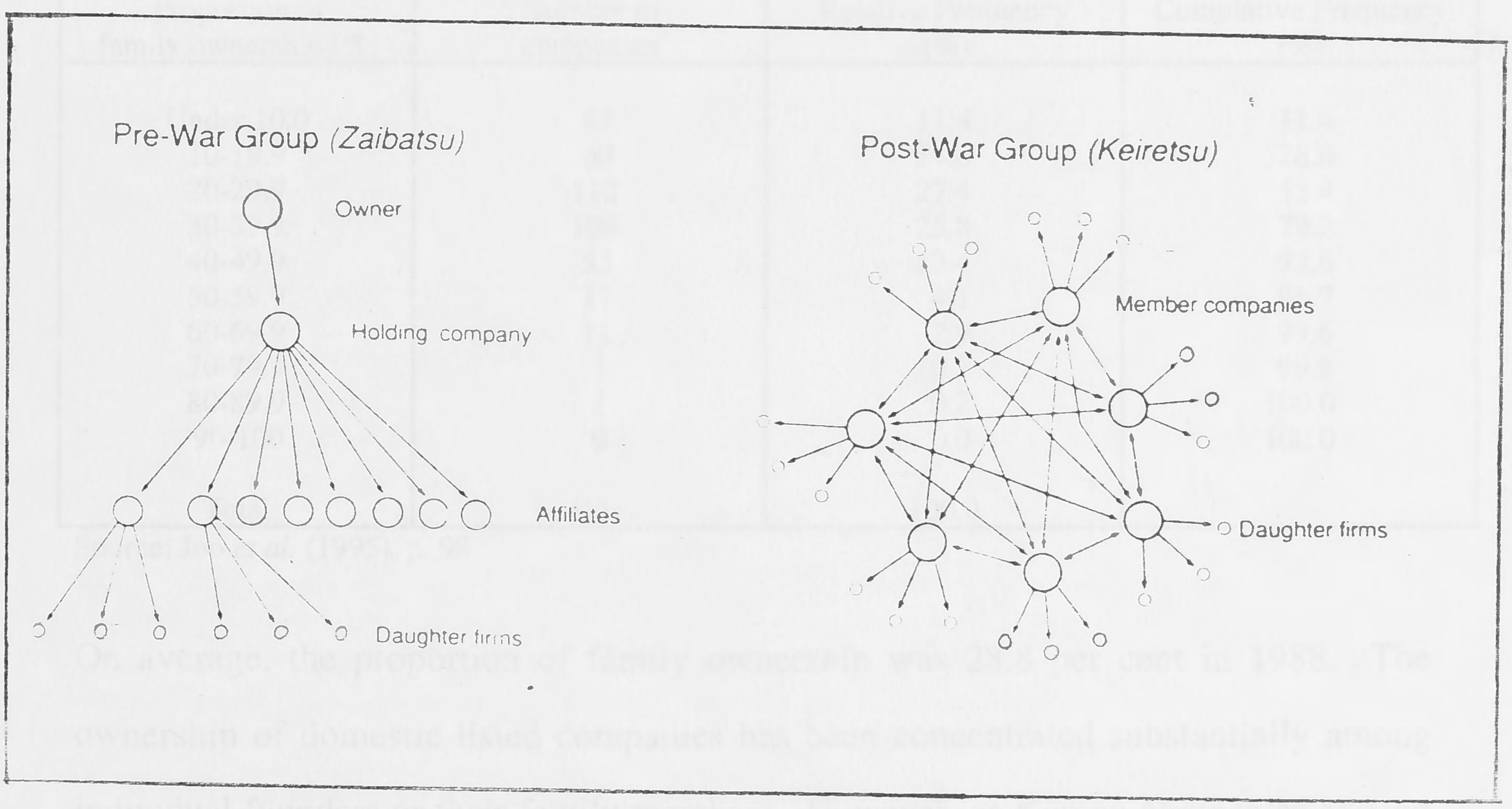


Figure 4.1b
Ownership Structure of Japanese Business Groups



Source: Lee (1992), p. 72

It is evident from Figures 4.1a and 4.1b that *chaebols* are different from Japanese pre-war *zaibatsu* and post-war *keiretsu* groups. Unlike *zaibatsu*, *chaebols* have no holding companies. Also, *chaebols* are dominated by family members whereas *keiretsu* groups are loosely related business groups comprised of independent member companies.

The ownership share of families of the top 41 publicly-listed *chaebols* was approximately 33 per cent (i.e., 18 per cent through direct ownership and 15 per cent through interlocking ownership) in 1982 as compared to 24 per cent of *non-chaebol* companies (Hattori 1984). This ownership proportion amounted to about 50 per cent (i.e., 13.7 per cent direct ownership and 35.7 per cent interlocking ownership) of the top 10 listed *chaebol* companies in 1989. When unlisted companies of the *chaebol*s are considered, the proportion of family ownership in *chaebols* may be even higher. However, the high level of family ownership is not limited to *chaebol* groups, as evidenced by the proportion of family ownership of 411 publicly-listed industrial corporations as of December 1988 (Table 4.1).

Table 4.1
Proportion of Family Ownership of 411 Listed Companies

Proportion of family ownership (%)	Number of companies	Relative Frequency (%)	Cumulative Frequency (%)
Under 10.0	47	11.4	11.4
10-19.9	60	14.6	26.0
20-29.9	112	27.4	53.4
30-39.9	106	25.8	79.2
40-49.9	55	13.4	92.6
50-59.9	17	4.1	96.7
60-69.9	12	2.9	99.6
70-79.9	1	0.2	99.8
80-89.9	1	0.2	100.0
90-100	0	0.0	100.0
Total	411	100.0	

Source: Joo *et al.* (1995), p. 98

On average, the proportion of family ownership was 28.8 per cent in 1988. The ownership of domestic listed companies has been concentrated substantially among individual founders or their family members. However, as Korean companies expand domestically and internationally, the ownership base is expected to widen also .

With the increasing economic power of *chaebols*, their financial reporting practices have attracted the attention of Korea's regulatory bodies. Regulations on consolidation were introduced in 1974[70] APLC to monitor and control the amount of credit allocated to large business groups. Increasing liberalisation and internationalisation of trade and capital markets since the 1980s has provided further impetus to set regulations concerning consolidated financial reports. Separate FAS on Consolidation and FAS Working Rules on Consolidation were promulgated in 1985 and 1987, respectively. However, business acceptance of the consolidation regulations had been slow because of the lack of independent audit requirements. It was not until the 1992 and 1994 amendments to FAS on Consolidation and FAS Working Rules on Consolidation requiring independent audits of consolidated financial statements that consolidation rules were enforced widely.

However, the 1992 and 1994 amendments have been criticised for their incompatibility and inappropriateness in Korea's business environment. First, the criteria for consolidation (following US criteria on ownership and control) have resulted in a smaller number of companies being subject to consolidation because of the unique control structure of Korean business groups (Chun 1995). Few companies satisfy the designated ownership criterion (i.e., 50% of outstanding voting stocks). The "control" criterion (i.e., 30% of outstanding stocks and the largest shareholder) recommended under the regulations is deemed weak because of complicated intercompany influences within a *chaebol* group. The "control" in Korean business organisations actually occurs in management participation and personnel management. The problems arising from the application of Anglo-American and IAS consolidation rules to countries with different business environments are discussed by McKinnon (1984b) and Gray *et al.* (1991).

Second, the criteria for excluding subsidiaries from consolidation are quite broad as compared to US rules. Under FAS on Consolidation (Art. 4), a subsidiary is excluded from consolidation if at least one of the following conditions is satisfied:

- the subsidiary is in receivership or bankruptcy;
- the subsidiary is in liquidation or has not been in operation at least one year;
- overdraft provision has been suspended by the Banking Law;
- events of uncontrollable nature have occurred (natural disaster or war);

[70] The regulations on consolidation were first introduced in the 1974 APLC for implementation from 1976.

- parent and subsidiary are in finance and non-finance, respectively or vice versa;
- the subsidiary is under temporary control by parent; and
- no material impact exists if not included in consolidation.

The above criteria are much broader than those accepted under the IAS and US standards, which are very restrictive so that consolidated information is useful for economic decision making by investors. Both IAS and US standards do not exclude from consolidation subsidiaries that are in industries different from their parent companies.

Third, complexities involved in preparing consolidated financial statements (i.e., four statements) have made it difficult and costly for most companies to comply because of their lack of expertise and inexperience. Many companies actually depend on CPAs for the preparation of these statements.

The ownership structure of *chaebols* has influenced Korea's financial reporting system, especially in regard to public perception of financial reporting rules and the status of the accounting profession. In view of the relatively closely-held ownership structure common in Korea, adequate and reliable disclosure of financial information to external users has not been considered a high priority. Financial reporting has been regarded by most *chaebols* just as a legal formality to preclude further scrutiny and adverse government regulation, rather than as a means to provide information useful to external users. Given their size and industrial sophistication, the financial statements prepared by *chaebols* are noted primarily for their terseness. Consequently, accounting professionals in Korea are not regarded as well as those in other industrialised countries, such as Australia, the US, and the UK. Moreover, the peculiar ownership structure of *chaebols* has made the uncritical adoption of foreign standards (e.g., consolidation regulations) ineffective in improving financial disclosure practices. In a move to enhance reporting practices, the government's 1996 *chaebol* policy stipulates that the 30 leading *chaebols* disclose more financial information by bringing in outside auditors to their boards, and that minority shareholders should be allowed to scrutinise financial statements and file charges, if necessary, in the case of improper corporate management practices (Newsreview 1996e, p. 27; *The Economist* 1996).

4.4 THE ROLE OF THE ACCOUNTING PROFESSION

The first post-war professional accounting body, the Korean Institute of Registered Accountants (KIRA),[71] was organised in Seoul in 1954 with 36 members. The name was changed to the KICPA in 1966 following the enactment of the CPA Law (Cheng and Jain 1973; KICPA 1992). The KICPA was organised under the CPA Law (Chapter 5) based on the approval of the MOF. In particular, the Securities and Insurance Bureau under the MOF has supervised the KICPA. The MOF (now MOFE) exercises considerable control over the practices of CPAs. Also, it is empowered to request the KSSB to audit the activities of the KICPA. Any CPA and CPA firm should also be registered with the KICPA and with the MOFE before being able to practise in Korea. As the sole professional accounting body in Korea, the KICPA has its own by-laws dealing with the qualifications of its members.

The accounting profession[72] has always been under the supervision of government agencies (e.g., the MOF, the KSEC, the KSSB, the MOFE) since it was first organised in 1954. The status of KICPA (formerly, KIRA) improved substantially, beginning in the 1960s, because of the government's heavy reliance on professional accountants to oversee business enterprises. Under the Park regime in the early 1960s, several KICPA members were assigned to audit large private companies that allegedly accumulated their wealth illegally during the previous Rhee regime (1948-1960).

The increasing importance of independent audits since the early 1960s has reinforced the profession's role in administering government policies and has enhanced its status in Korean society. Even though the professional body has not been involved directly in accounting standard setting, it has influenced the country's financial reporting regulatory environment through its professional accounting pronouncements and involvement in regulatory bodies. Currently, the KICPA participates in setting accounting standards through its involvement in the ASAC's activity. The KICPA has

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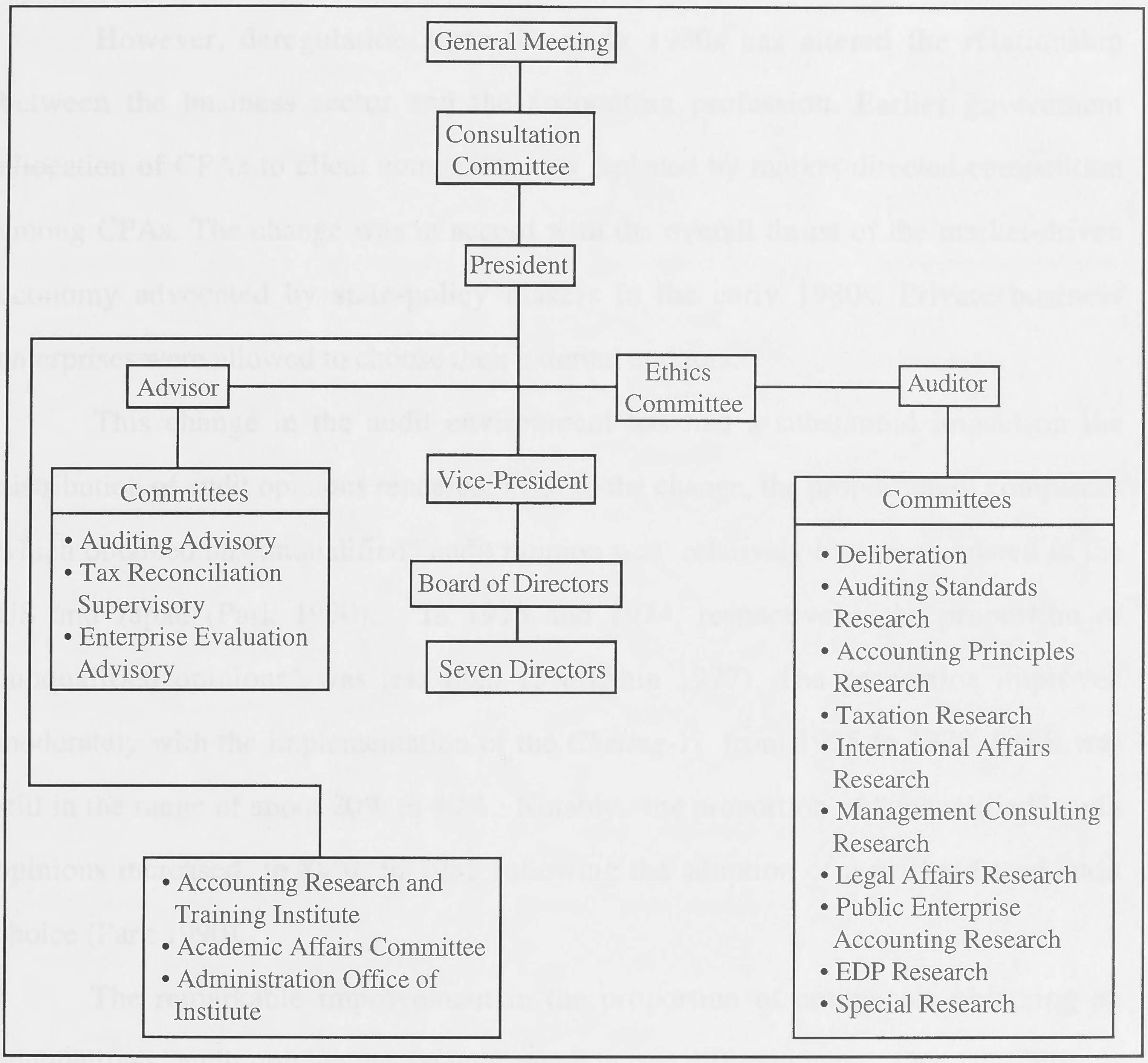
[71] A pre-war professional accounting body called the *Chosun* (Korean) Accountants Association was established in 1944 during the Japanese colonial period with approximately twenty accountants. However, in general, the KIRA established in 1954 is considered the first official professional accounting body in Korea.

[72] "Accounting profession" refers to those people who practice accounting in Korea after passing CPA examinations prescribed by MOFE.

developed its organisation through its Articles of Incorporation. Figure 4.2 shows the organisational structure of the KICPA.

Figure 4.2
Organisation of KICPA



Source: KICPA 1992a, p. 736

As shown in Figure 4.2, various KICPA committees issue practical accounting interpretations and guidelines, perform in-depth research and provide policy recommendations to improve the theory and practice of accounting, auditing, taxation, and managerial advisory services (KICPA 1992a).

Nonetheless, KICPA has been supervised closely by government agencies with respect to its members' examination, registration and practice. Significantly, audit clients (auditee companies) were assigned to auditors in a general ratio to firm size prior to the enactment of the EAL in 1980. The state maintained its close control over the accounting profession by allocating audit assignments until the early 1980s. Because of government support during this period, the accounting profession enjoyed greater independence from their audit clients in rendering audit opinions on financial reports.

However, deregulation since the early 1980s has altered the relationship between the business sector and the accounting profession. Earlier government allocation of CPAs to client companies was replaced by market-directed competition among CPAs. The change was in accord with the overall thrust of the market-driven economy advocated by state-policy makers in the early 1980s. Private business enterprises were allowed to choose their external auditors.

This change in the audit environment has had a substantial impact on the distribution of audit opinions rendered. Prior to the change, the proportion of companies which obtained an "unqualified" audit opinion was relatively low as compared to the US and Japan (Park 1990). In 1973 and 1974, respectively, the proportion of "unqualified opinions" was less than 15% (Shin 1977). The proportion improved moderately with the implementation of the *Cheung-Yi* from 1975 to 1978, but it was still in the range of about 20% to 40%. Notably, the proportion of "unqualified" audit opinions increased to 88% in 1985 following the adoption of a market-based audit choice (Park 1990).

The remarkable improvement in the proportion of companies obtaining an "unqualified" audit opinion can be interpreted in two different ways. One possibility is that compliance of Korean companies with mandatory regulations has improved for various reasons. Alternatively, management's newly acquired power to retain or change its auditors could have reduced auditors' ability to maintain their independence and audit quality. The second explanation appears to be more persuasive when increasing incidence of legal actions against auditors of several Korean companies is considered, particularly beginning in the 1990s. The deterioration of audit independence and quality probably justifies stronger government intervention in the choice of auditors.

In recent years, the audit profession internationally has been faced with two major challenges in general: a demand for quality audit service and the complexity of audits (Lampe and Sutton 1992). Awareness of audit quality and independence began to rise in Korea among investors and the public following legal action against the auditors of Heung-Yang Ltd. in 1991. This case[73] was succeeded by a series of more serious legal challenges including those pertaining to the audit of Shin-Jung Papers Co[74] (Choe and Choi 1996, pp. 4-5). In both of these cases, auditors were held liable for investors' losses arising from their unsatisfactory and negligent audit conduct. As discussed earlier, Choe and Choi (1996) asserted that collusion between enterprise managers and auditors stems from the imposition of a market-based free contract system. The increasing incidence of legal actions against independent auditors questions the effectiveness of enforcement mechanisms, particularly the independent audits of financial statements in the country.

The EAL (1980) has led also to the increased corporatisation and internationalisation of Korean audit firms to cope with the increasing power of the private business sector, *chaebols*. In particular, some Korean local firms have affiliated with multinational accounting firms and have established their own subsidiaries in foreign countries. Table 4.2 shows Korean Big-Nine audit firms and their international affiliation.

Table 4.2
Affiliations between Korean and Multinational Accounting Firms

Korean Big-9 Audit Firms	Multinational Accounting Firms	Relationships
1. Samil	Coopers & Lybrand	Member Firm
2. Ahnkun-Sewha	Deloitte Tohmatsu Touche International	Member Firm
3. Sandong	Klynveld Peat Marwick Goerdeler	Member Firm
4. Anjin	Arthur Andersen	Member Firm
5. Youngwha	Ernst & Young	Member Firm
6. Sedong	Price Waterhouse	Member Firm
7. Samduck	NEXIA International	Member Firm
8. Chungwoon	Howarth International	Member Firm
9. Shinhan	RSM. International	Member Firm

Source: Jang (1996), p. 27

73 The auditors of Heung-Yang Ltd. provided an "unqualified opinion" on the 1990 financial statements of the company, which undervalued its debt substantially. The following year, the company went bankrupt and the auditors were sued by investors in the company (Choe and Choi 1996, pp. 4-5).

74 Upon the request of the company's managers, the auditors assisted the company to obtain a listing on the Korea Stock Exchange by providing an "unqualified opinion" on the financial statements. Three months after its listing, the company went bankrupt. Legal suits were brought against the company's large shareholders, auditors, main creditor bank, and the KSEC.

The first six local audit firms in Table 4.2 were affiliated with "Big-Six" multinational accounting firms in 1995. Such affiliation is explained as an effort by these local firms to maintain their independence in dealings with audit clients and to broaden their expertise and skills. However, alternative explanations are provided by Montagna (1986) and Taylor (1987). Affiliation with multinational accounting firms is considered an act to increase their power to lobby for legislation favourable to their clients and to engage in oligopolistic audit practices, including price-cutting tactics.

From 1954 to 1994, the KICPA has expanded in its size and activities considerably. The membership has increased from 36 in 1954 to 3287 in 1994. However, it is still much smaller than that of most Anglo-American countries.[75] To broaden its members' skills to keep up with international accounting developments, the KICPA has sponsored continuing professional development programs and has participated in several international organisations, including CAPA (Confederation of Asian and Pacific Accountants), IFAC (International Federation of Accountants) and IASC (International Accounting Standards Committee).

4.5 THE EFFECTS OF ECONOMIC FACTORS

The evolution of a country's financial reporting system is linked closely to the country's economic development. The discussion here focuses on the influence of Korea's capital market and inflationary environment on the development of its financial reporting system.

4.5.1 Modern Development of Korea's Capital Market

Broadly, a capital market[76] encompasses institutional arrangements and instruments through which savings are directed. Here, a capital market includes a country's non-securities market (i.e., banks and non-bank financial intermediaries) and securities market (i.e., stock and bond markets) which provide long-term financing to private enterprises.

The domestic financial system comprises the central bank, banking institutions, non-bank financial institutions, and securities market (Cole and Park 1983; Aliber

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[75] See Morse (1993), p. 351 for details.

[76] In a narrower sense, capital markets are markets where bonds and shares are bought and sold.

1991; FTBI 1993; Patrick and Park 1994). Korea's capital market has undergone several stages of development, consistent with the country's economic development. Korea's financial reporting has changed also to meet the needs of its evolving capital market. Under the barter economy, business enterprises relied upon grain loans as the main form of credit. Such credit was provided by government or voluntary private associations called *kye*[77] (Cole and Park 1983, pp. 42-43) and was based on personal and informal networks. Consequently, the role of accounting was minimal before the emergence of a modern banking system in 1876. This was the case even though a unique and informal accounting system, *Sagae Songdo Chibu Beop*, was used among Kaesung merchants, as mentioned previously in Chapter III.

This informal small-scale lending environment changed when Korea was brought into Japan's sphere of influence (1910-1945). During this period, Korea experienced rapid modernisation in its financial system. In particular, with the swift industrialisation engendered by Japanese-owned companies, the need for a modern banking system was heightened. After the first branch of a Japanese bank, the *Daiichi Ginko*, was founded in Pusan in 1876, several government and private financial institutions were established. Among these, the government-owned *Agriculture-Industry Bank* played a major role in providing long-term financing to Japanese-owned business enterprises. In addition to banks, the *Chosun Stock Exchange* was established in 1943 to channel savings through the issuance of bonds into the Japanese war effort. Following the emergence of modern business enterprises during the Japanese colonial period, a double-entry bookkeeping system was introduced. Accounting rules during the Japanese colonial period emphasised conservative approaches to asset valuation and profit measurement to protect banks, then the major capital providers (Sun 1977 and 1978; KICPA 1992a).

Korea's capital market was dormant during the 1950s because of lack of public confidence in financial instruments and a strong preference for real assets as opposed to

[77] Originally, *kye* was a voluntary private association which pooled resources to provide loans to members. However, it underwent a gradual transition with economic development from a barter to money-based economy. The *kye* currently is an instalment system for deposits and loans which pools small savings to make a lump-sum amount of money. In the 1950s and 1960s, the *kye* market was very extensive (Cole and Park 1983, pp. 113-115).

financial assets. In the early 1950s, the new central bank, BOK, was the dominant institution in financing the war effort (i.e., Korean civil war). In comparison, special banks became the major dispensers of credit received from foreign financial aid during the late 1950s. The KDB (formerly, KRB), a special bank established directly under the MOF, was responsible from 1954 for allocating both domestic and foreign capital to manufacturing industries. Table 4.3 shows the proportion of bank capital loans to fixed capital formation from 1956 to 1958.

Table 4.3
Ratio of Bank Capital Loans to Fixed Capital Formation 1956-1958

Banks	Sectors	1956 (%)	1957 (%)	1958 (%)
KRB (KDB)	Manufacturing	44.9	48.6	72.6
	All sectors	13.7	15.0	19.5
Commercial Banks	Manufacturing	15.0	3.9	2.3
	All sectors	4.6	2.9	17.6
All Banks	Manufacturing	59.9	52.4	74.9
	All sectors	18.3	17.9	37.1

Source: Chiu (1992), p. 94

As shown in Table 4.3., manufacturing firms relied heavily on bank loans from 1956 to 1958. For example, in 1958, approximately 75% of their financing was sourced from banks, especially the KDB (72%). The KDB's role as a provider of finance to the private business sector continued. During the late 1960s, the KDB and commercial banks were major financiers through massive foreign-loan guarantees (Chiu 1992, p.96). The heavy dependence of business enterprises on banks for their financing continued until the mid-1970s. The first two sets of modern accounting standards in Korea, *BAP* and *FSR*, were promulgated to provide a basis for the KDB's decision making for loans to the private sector. Accordingly, they adopted a strong creditor orientation also by stipulating various types of reserves, including legal reserves and the use of historical cost valuation methods.

However, in the early 1960s, securities markets began to be promoted also through various legislation aimed at mobilising much needed domestic capital into government-promoted business activities. These laws included the SEL (1962), the *Capital Market Promotion Law* (1968), and the *Going-Public Encouragement Law*

(1972). Various tax and financial privileges were granted to publicly-held companies. As mentioned in Chapter III, *Cheung-Yi* was implemented in 1975 to provide tax benefits for business enterprises who complied with development policies of the government. As a result, the country's equity market grew rapidly in the 1970s. The number of companies listed on the KSE increased from 24 in 1967 to 356 in 1978. The amount of corporate financing raised from 1963 to 1978 is presented in Table 4.4 below.

Table 4.4
Corporate External Financing, 1963-1977
(billion *won*)

Year	External Financing	Bonds	Equities	Borrowings*	Borrowings**	Trade Credits	Foreign Liabilities
1963	36.2	1.1	9.0	9.3	7.5 (2.1)	1.0	8.3
1964	26.9	0.0	7.2	5.7	7.0 (3.3)	4.3	2.7
1965	48.4	0.0	9.4	21.4	7.8 (2.3)	4.8	4.7
1966	107.9	0.3	12.9	17.1	20.2 (9.6)	8.6	48.8
1967	198.6	1.3	16.0	64.3	30.9 (23.2)	21.5	64.6
1968	321.7	-0.1	25.0	116.2	32.6 (13.1)	39.3	108.7
1969	412.9	2.1	68.5	130.9	67.5 (21.8)	19.8	124.1
1970	471.0	4.9	62.1	153.3	67.5 (25.3)	36.9	146.3
1971	528.2	6.3	91.2	189.7	67.8 (24.4)	36.1	137.1
1972	560.6	29.6	125.9	158.1	90.3 (-24.2)	53.9	102.8
1973	928.6	17.8	169.1	411.7	83.3 (0.4)	62.6	184.1
1974	1497.8	1.5	174.8	694.9	92.2 (-23.2)	288.1	246.3
1975	2095.0	27.9	303.0	594.0	165.1 (8.5)	211.7	793.3
1976	2252.2	64.8	459.0	660.9	264.2 (-5.8)	379.7	621.9
1977	2936.3	155.4	593.6	885.0	480.3 (45.4)	361.9	573.7
1978	4958.0	303.0	1043.1	2107.3	706.2 (101.8)	429.9	358.5

* Borrowings from banks, insurance and investment & finance companies and government
** Unofficial money market borrowings

Source: Cole and Park (1983), p. 104

Table 4.4 reveals that the long-term securities market has not generated a substantial amount of new capital or reduced the heavy reliance on bank and foreign-loan financing, nor has it reduced the direct links between the government and the principal owner-managers of large corporations. The proportion of external financing provided by the equity market stayed at approximately the same level from 1963 to 1978, i.e., 24.9% in 1963 and 21.3% in 1978. The heavy reliance on debt financing was notable. The debt-to-equity ratio of Korean manufacturing firms in 1978 was 366.8% compared to 160.3% and 92.8% for the US and Taiwanese counterparts, respectively (Leipziger

1988, p.128). However, continuous efforts by the Korean government to boost the securities market have led to a more diffuse ownership structure and diversified sources of finance since the mid-1970s. In turn, stakeholders have called for more reliable accounting information so various stakeholders can make informed economic decisions on business enterprises. For example, consolidated statements were newly required in the 1974 APLC. It was in the 1970s that the "decision usefulness" criterion for accounting information was incorporated in the APLC (1974) and the revised BAP (1976). The inclusion of "reliability" and "adequate disclosure" as two important qualitative characteristics in the 1976 BAP reflects the shift toward decision usefulness-based accounting.

The 1980s and 1990s saw a massive liberalisation of the country's capital market (Cargill 1990; Chung 1994). Various financial deregulation[78] measures were launched in 1981 as part of an overall liberalisation of the country's economy. From 1980 to 1985, the securities market remained depressed because of an economic downturn. However, in the latter half of the 1980s, the optimistic economic outlook, coupled with tax and other incentives for investors, increased the level of activity in the securities markets. Foreigners have been allowed also to invest directly in Korean companies up to ceiling of 10 per cent ownership from January 1992. The equity ownership ceiling was raised to 20% in 1996 (Newsreview 1996a, b, d). In May 1996, stock market index futures market was launched on the KSE to further enhance the structure and competitiveness of the country's capital market (Newsreview 1996c). The growth in capital market activity from 1980 to 1995 is evident in Table 4.5.

Table 4.5 shows that the number of companies listed on the KSE has increased substantially from the late 1980s, more than doubling from 342 in 1985 to 721 in 1995. Similarly, market capitalisation and trading value have increased enormously from 6,570 and 3,620 billion *won* in 1985 to 141,151 ($US 173.5 billion) and 142,914 billion *won* ($US 175.7 billion) in 1995, respectively .

[78] Such as: breaking down artificial segmentation of financial institutions by product and service; partial deregulation of interest rates; gradual decontrol of foreign exchange transactions; opening of equity markets to foreign competition.

Table 4.5
Capital Market Indicators: 1980-1995 (billion *won*)

Year	Number of Listed Companies	Market Capitalisation	Value of Stocks Traded
1980	350	2,527	1,134.00
1981	343	2,959	2,534.00
1982	334	3,301	1,974.00
1983	328	3,490	1,753.00
1984	336	5,149	3,118.00
1985	342	6,570	3,620.60
1986	355	11,994	9,598.10
1987	389	26,172	20,494.00
1988	502	64,544	58,121.00
1989	626	95,477	81,200.00
1990	669	78,070	53,455.00
1991	686	70,470	62,565.00
1992	688	84,711	90,624.00
1993	693	112,635	169,918.10
1994	699	151,217	229,772.00
1995	721	141,151	142,914.00

Source: Patrick and Park 1994, p. 137; Jang 1996, p.14; Roc 1995, p. 110

The ownership structure of Korean enterprises is becoming even more diffuse with the liberalisation and internationalisation of the country's capital market-- a process which began in the early 1980s. As such, adequate disclosure of "comparable" corporate information has become increasingly more important in enhancing the competitiveness of Korean companies seeking foreign capital. Choi's (1973) study attests to the importance of a company's decision to raise capital in a competitive financial market. This supports the argument that company listing affects disclosure levels regardless of geographical considerations. Stricter independent audit requirements have been instituted to ensure that companies provide users with useful and adequate accounting information. Such requirements are prompted by the development of a larger and more complex capital market and are designed to reduce problems arsing from information asymmetry and opportunism in the market (Pratt and Behr 1987; Lev 1988; Ray and Gupta 1993). A public policy of information disclosure aimed at mitigating the adverse effects of the information asymmetry seems warranted in Korea.

The increasing significance of economic substance over legal form in enhancing the decision-usefulness of financial information has shifted measurement rules also towards less conservative approaches since the 1980s. The shift is reflected particularly in the following areas: recognition of foreign-currency translation; present-value accounting for fixed assets acquired through long-term instalment; revenue recognition with delivery of goods sold on a long-term instalment basis; market valuation of marketable securities and long-term investment; and deferred income tax allocation.

Both internal and external factors, as discussed in Cooke and Wallace (1990), will further change objectives of financial reporting and detailed financial reporting rules. Although the users of financial reports are not mentioned specifically, the objective[79] stated in FAS (1994, Article 2) implies the importance of financial reports in micro-level economic decision making. The FAS (1996) has shifted to an investor orientation from the traditional creditor orientation of Korean financial reporting (Choi 1995). This shift in orientation can be explained by the perceived need for enhanced comparability of financial statements provided by Korean companies internationally. The 1996 amendment adopts accounting standards acceptable under the IAS. The IAS are mostly in conformity with most Anglo-North American standards (Hoarau 1995; Rivera 1989). This change seems inevitable because the competitiveness of companies depends more and more on their financing being provided by various creditors, investors, and other stakeholders, both domestic and foreign. Thus, the analysis of Korea's capital market development highlights that the country's financial reporting system has evolved to reflect the needs of its capital market participants and in response to increased competition for capital.

4.5.2 Inflationary Environment

Korea has adopted predominantly conservative approaches to asset valuation and profit measurement. However, the upward revaluation of some categories of assets[80] has been allowed under the *Asset Revaluation Law* (ARL) since 1965 after two-time temporary revaluations of assets in 1958 and 1962. These assets have been allowed to be revalued at the beginning of each fiscal year provided the wholesale price index has increased by 25 per cent or more since the previous revaluation (ARL).

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[79] FAS (1994, Art. 2) states that the objective of financial accounting is to provide users with useful and adequate accounting information prepared in accordance with GAAP to assist them in making decisions on matters affecting their business entities.

[80] Under the ARL, the following assets may be revalued if criteria are met: fixed assets used in the ordinary course of operations, investments in stocks of other companies, and forest plantations.

The two-time temporary revaluations were implemented as a result of hyperinflation experienced during the 1950s and 1960s. From 1910 to 1961, the wholesale price index rose from 100 to about 19,000,000 (i.e., 190,000 times). In comparison, in the USA the price level in 1961 was about 2.5 times that in 1910 (Lee 1965, 1968). The *Property Revaluation Law* implemented in 1958 by the Rhee government was made compulsory for corporations. Multiplier tables were provided by the government to facilitate the revaluation of tangible and intangible business assets. Contrary to the expectation of a more stable economy after implementing the law, prices continued to soar. Eventually, a similar law, the *Special Property Revaluation Law*, was promulgated in 1962. Similar to the first law, multiplier tables were provided, but the Special Property Revaluation Law was made voluntary. However, both laws did not allow business enterprises to make additional price-level adjustments without government-approval.

Despite these efforts, the wholesale price index continued to rise, increasing 69% between 1962 and 1965. The Park regime was prompted to enact a third law, the *Asset Revaluation Law* which claimed to be unique in its approach. During these hyper-inflationary periods, optional taxation (*Inchung Kwase*) rather than accounting-based taxation was prevalent in business practices to minimise the huge tax liability resulting from the enormous inflation. Consequently, asset revaluation was instituted to provide a more equitable basis for taxation and to further develop a sound business environment. Shin (1956) urged the promulgation of generally accepted accounting principles and the adoption of stricter audit by CPAs to reduce the problems associated with using the optional taxation. For these purposes, regulators felt that realistic asset values and appropriate depreciation expenses in financial reports were necessary to cope with the country's inflationary economy, as shown in Table 4.6.

Table 4.6
Changes in Wholesale Price Index (%)

Year	Index	Changes	Year	Index	Changes
1970	18.6		1982	98.2	4.5
1971	15.8	-15.5	1983	98.4	0.2
1972	18.0	13.9	1984	99.0	0.7
1973	19.3	7.2	1985*	100.0	0.9
1974	27.3	41.9	1986	98.5	-1.5
1975	34.6	26.2	1987	99.0	0.5
1976	38.7	12.1	1988	101.7	2.7
1977	42.2	9.0	1989	103.2	1.4
1978	47.2	11.8	1990	107.5	4.1
1979	56.1	18.6	1991	113.2	5.3
1980	78.0	39.0	1992	107.0	-5.5
1981	93.9	20.3			

* 1985 index= 100.0

Source: Cho (1995), p. 53

Table 4.6 shows that the country experienced substantial levels of inflation until the early 1980s. It was only since the early 1980s that the change in wholesale price index was contained to single-digit levels.

However, the upward revaluation sanctioned on a voluntary basis has been criticised frequently for reducing the comparability and consistency of financial statements. Many companies abused the law to engage in manipulative accounting practices, reducing the quality of financial reporting in the country. In particular, business enterprises engaged in upward revaluation to minimise their tax liabilities and/or to facilitate bank borrowing provided on the basis of values of collateral assets. The detrimental impact of these discretionary asset revaluations led to heated discussions about their possible abolition (Nam 1994; Lee *et al.* 1994; Song and Yoon 1995; Cho 1995). Furthermore, upward asset revaluations do not appear to be necessary given the relatively lower levels of inflation experienced during the 1980s and 1990s, as indicated in Table 4.6. Recently, Cho (1995) proposed an improvement of the ARL by making the provisions mandatory and by strengthening disclosure requirements regarding revalued company assets.

Despite these criticisms of the use of discretionary asset revaluation, it is clear that an inflationary environment can influence the accounting treatment for company assets strongly. In hyperinflationary economies, a form of price index adjustment (i.e., general price-level adjustment) has been recommended to reflect the value of business assets and to facilitate investors' decision making (IAS 29). Korea's asset revaluation system uses a current cost accounting approach whose appraised values (i.e., as determined by the Korea Appraisal Board) becomes the new book value of assets owned.

4.6 INTERNATIONAL INFLUENCES

Financial reporting rules in Korea have been influenced heavily by foreign standards, mostly from Japan, the USA and the IASC. The strong Japanese influence, which was particularly acute during the colonial period, had continued in the 1950s and 1960s. For example, the 1958 BAP was patterned after the 1949 Japanese BAP. The Japanese influence continued until the mid-1970s and was reflected in the use of historical-cost valuation, accrual-basis accounting, all-inclusive income statement, and various other areas found in the 1976 BAP. In addition, a strong government involvement in financial reporting regulation is a legacy of the Japanese colonial period.

However, US accounting concepts and principles have been adopted increasingly since the mid-1970s (Koh 1988, p. 56), largely because of changes in Korea's capital market. The securities market has been playing a more important role in providing long-term financing to business enterprises. In particular, the increasing liberalisation and internationalisation of Korea's capital market since the 1980s has made the decision usefulness of financial statements an important factor in competing for capital in both the domestic and international markets. (Choi 1973; Gray *et al.* 1995). Second, the increasing use of US accounting concepts can be attributed also to a large influx of US-educated accounting practitioners and academics in the 1970s and 1980s, as evident in Table 4.7. This table shows the educational background of the members of accounting standard setting bodies.

Table 4.7
Educational Background of Accounting Standards-Setting Bodies

Educational Background	1958	1976	1981
Pre-war Japanese education	6 (60%)	3 (27%)	1 (7%)
Pre-war Japanese and post-war US education	1 (10%)	1 (9%)	1 (7%)
Post-war Korean education	2 (20%)	4 (37%)	4 (26%)
Post-war Korean university/US education	1 (10%)	3 (27%)	8 (53%)
Post-war Korean university/Japanese	-	-	1 (7%)
Total	10	11	15

Source: Koh (1988), p. 41

The proportion of US-educated members has increased from 20% in 1958 to 60% in 1981, while the percentage of Japanese-educated members has decreased from 70% in 1958 to 14% in 1981.

The IASC's influence has increased since the 1980s, particularly following the active participation of KICPA in the IASC (Koh 1988; Choi 1995). As an IASC member since 1988, the KICPA has participated actively in international efforts to harmonise accounting standards. The need to be in conformity with the IAS has been enhanced to meet the needs of diverse information users, especially foreign investors, who have called for increased comparability of financial information provided by Korean companies. The 1996 amendment of FAS introduced numerous accounting standards in accord with IAS, including asset valuation, revenue recognition and income tax allocation. In regard to asset valuation, market valuation for marketable securities and lower of cost and market valuation for inventory are in conformity with IAS. The adoption of revenue recognition for long-term instalment sales on the delivery of goods is another example. Deferred income tax allocation was introduced also in 1996. The similarities and differences between current FAS and IAS are presented in detail in Appendix 4, which shows a high degree of conformity in many areas.

Despite their convenience and apparent cost-effectiveness, the unquestioning adoption of foreign accounting standards by developing countries has been criticised for the incompatibility of these standards with the national environments of those countries (Briston 1978; Ndubizu 1984; Hove 1986; Rivera 1989). For example, the adoption of US criteria for consolidation has been found to be inappropriate to the Korean business context because of the unique control structure of Korean companies, particularly *chaebols* (McKinnon 1984b; Chun 1995). The widespread transfer of developed countries' accounting standards to LDCs has proved also to be counter-productive to the development of sound accounting standards in LDCs (Ndubizu 1984; Hove 1986; Wallace and Briston 1993). Because of such detrimental effects, it is important that Korea considers whether foreign and international accounting standards are appropriate to its particular business environment.

4.7 THE INFLUENCE OF CULTURE

Culture is often considered to be one of the most powerful environmental factors affecting a country's financial accounting system (Jaggi 1975; Hofstede 1987; Gray 1988; Salter and Niswander 1995). Accounting is an activity involving both technical and social aspects. Because of the "social" aspect of accounting, accounting constructs social reality and cannot be culture free (Chua 1986; Hines 1988).

Members of a given culture share common frameworks of meanings and social understandings. These common understandings, values and norms play an important role in shaping the three essential elements of a country's financial reporting system. Culture-specific broad aims, institutional arrangement of financial reporting regulation and specific rules and practices are created, maintained and changed.

4.7.1 Culture, Religion and Korea's Financial Reporting System

One of the principal dimensions of culture is religion. Korean culture has been influenced strongly by five religious systems: Confucianism, Buddhism, Christianity, Shamanism, and Taoism (Chang and Chang 1994). Emphasising the importance of the family system, the practice of Shamanism is integrated fully into the Confucianist teachings. Taoism, which stresses a distaste for worldly affairs and a life in harmony with nature, is not the mainstream religion in Korea. The first three religions are relevant to this study in view of their potential influences on Korea's financial reporting system. Table 4.8 shows the distribution of people in Korea according to religious belief.

Table 4.8
Distribution of Religious People
(1991)

Religion	Number of Believers (000s)	Proportion (%)
Christianity	10,514	24.3
Buddhism	11,941	27.6
Confucianism	433	1.0
Others	476	1.1
Total Religious People	23,364	54.0
Total Population	43,268	100.0
Proportion of Religious people	54.0	

Source: Song (1994), p. 49

As indicated in Table 4.8, religious people in Korea comprise 54% of the whole population in 1991. Two major religions, Buddhism and Christianity, and one philosophical thought, Confucianism, have played a significant role in the life of Korean people. Like any other East Asian country, Korea was influenced traditionally by Buddhism and Confuciansim. Christianity has played an important role in Korea's modernisation also by establishing modern schools and by instilling in Koreans the Western values including democracy, attitudes and civilisation (Song 1994, pp. 47-48). The potential impact of these three religious systems on Korea's financial reporting system is discussed below.

(a) Confucianism

As mentioned briefly in Chapter III, Confucianism is a moral philosophy with moral teachings. It is not emphasising an afterlife, but is a set of moral teachings and ethical values to guide the relationship between human beings.

Korean culture has been influenced most profoundly by the Confucian ethic. This became the officially sanctioned state philosophy during the *Yi* dynasty (1392-1910) and has remained dominant ever since (Eckert *et al.* 1990; Chiu 1992; Chang and Chang 1994; Song 1994; Simone and Feraru 1995; Haskins *et al.* 1996). The teachings and the value system of Confucianism have prevailed in the minds of Koreans. The Confucian ethic emphasises the following values: (1) filial piety and family loyalty; (2) a perception and acceptance of the state as an active, moral agent in the development of society; (3) a respect for status and hierarchy; (4) self-cultivation and education; and (5) concern with social harmony.

These deep-rooted Confucian values have significantly affected Korea's economic and financial reporting system in several ways. First, financial reporting has been regulated heavily by government or government agencies (i.e., MOFE and KSEC). State bureaucrats have been accorded a comparatively higher degree of respect and recognition in Korea. The state has been perceived also as an active, moral agent in the development of society as shown in most late industrialisers like Japan and Germany (Amsden 1989).

Second, corporate resistance to financial disclosures can be understood in the context of Korean group consciousness and interdependence. These traits are manifested in an individual's perception of him/herself as part of a group. Korea scores very low (i.e., 10) on Hofstede's (1980) individualism dimension and is perceived to be a 'collectivistic' and 'particularistic' society. Accordingly, the concept of accountability in the country carries contextual meanings different from that of 'individualistic' societies (i.e., Anglo-American countries). Corporate information including financial data tends to be considered company property and to be held in confidence. This tendency in 'collectivistic' countries is supported by Jaggi (1975), McKinnon and Harrison (1985), and Gray (1988). Corporate managers tend to retain responsibility for, and knowledge of, corporate activity within the organisation or group.

Third, group consciousness and interdependence has implications also for audit independence and quality in Korea, as in Japan (McKinnon 1984a). Under the CC, Korean corporations are subject to a statutory audit. However, the statutory auditor need not be independent of the corporation being audited and is frequently an employee of the company. Interdependence, rather than independence, characterises the relationship between the statutory auditor and corporate directors in which mutual loyalty and interests are emphasised.

Following the enactment of the SEL in 1963, an independent audit by external CPAs became a requirement for listed companies and was imposed on any stock corporations subject to the EAL (1980). An independent audit has long been considered by corporate directors as a legal requirement of little or no benefit to the corporations. The group consciousness and interdependence, which deeply permeates Korean business organisations, has had a negative impact on corporate directors' perception of external auditors. The sense of group membership, of who is an 'insider' and who is an 'outsider' looms significantly in Korean culture. Independent auditors are perceived to be outsiders by corporate directors. Moreover, external auditors may be compelled to compromise their independence to gain a favourable relationship with their audit clients and to further maintain their job security, particularly in a competitive audit environment in which the power of audit clients (e.g., *chaebols*) is increasing significantly.

(b) Buddhism

In contrast to Confucianism, Buddhism has been understood and practised as a pure religion in Korea. It emphasises the importance of "honest" and "virtuous" life in this world to achieve "enlightenment" and "salvation" in afterlife. It also stresses tolerance, modesty, adaptation, and moderation in everyday life.

The influence of Buddhism on accounting in Korea is reflected in two areas: institutional mechanisms of accounting regulation and detailed accounting rules. First, despite the government-directed accounting regulation, Korea has always incorporated private-sector participation in standard setting, as observed in increasing private-sector representation on the ASAC. Second, the country has borrowed US accounting concepts and standards which are micro-user oriented as well as Japanese concepts and principles, a typical macro-user oriented system. The Korean system has both micro-user and macro-user oriented components even though it has been shifting increasingly to a micro-user oriented system.

(c) Christianity

The impact of Christianity on Korea's modernisation has been enormous since the arrival of Roman Catholic Church missionaries in the late 18th century (Song 1994). However, the Christian teachings are contradictory to the population's long-cherished *Yin-Yang* concept through which Koreans perceive differences in the universe but also perceive the complementary nature of these differences (Lee 1984). The dualism of God and the evil is an alien and unfamiliar perception to Korean Christians. Christianity in Korea has been developed to embrace the traditional *Yin-Yang* concept along with its fundamental doctrine of dualism. Korean Christians are *Yin-Yang* Christians who have to reconcile their Korean cultural heritage with Christian doctrines (Chang and Chang 1994).

In 1991, Korean Christians comprised approximately half of the country's religious population, as shown in Table 4.8. Coupled with the country's history of economic and cultural invasions from neighbouring countries, the Christian influence made Koreans more receptive to foreign systems, particularly Anglo-American systems. This is reflected in the country's growing Anglo-Americanisation of its economy and furthermore, its financial reporting system (Amsden 1991). The adoption of US accounting concepts and principles has been particularly pronounced since the early 1980s, shifting Korea's financial reporting system toward a more micro-user oriented system. Long-cherished values of group harmony and interests are being challenged by free market principles which emphasise individual freedom and competition enshrined also in Christian doctrines.

4.8 CONCLUSION

The explanatory analysis shows that distinctive features of Korea's financial reporting system (i.e., broad aims, institutional environment for financial reporting regulation and detailed financial reporting rules and practices) are influenced strongly by six key environmental factors identified in the theoretical framework of Chapter II. These key environmental variables are found to have exerted various influences on the country's financial reporting system which is characterised by a government-directed legalistic approach to regulation, coupled with an increasing adoption of a micro-user oriented view of accounting.

It is difficult to clearly identify the degree of influence each variable has played in shaping Korea's financial reporting system. However, different environmental factors have played roles of varying degrees of importance in its development. Prior to the 1980s, it appears to have been dictated by the government and its macroeconomic policies, especially tax policies. Especially in the 1960s and 1970s, financial reporting rather served as a means to achieve the government's "economic growth-first" policies. Various financial and tax privileges were awarded to business enterprises involved in government-promoted activities and accounting was often used to protect these businesses from gaining unfavourable accounting treatment, as indicated in *Cheung-Yi*. Consequently, a macro-user view of accounting prevailed prior to the 1980s.

In contrast, Korea's financial reporting system since the 1980s shows a stronger capital market orientation. As Korea's capital market has become more sophisticated, business enterprises began to rely on direct financing through the equity market as a source of capital. A more diffuse ownership structure has resulted and consequently, a micro-user view of accounting is gaining in significance in the country. Independent audits are becoming increasingly important for ensuring reliable information is provided by companies to external users. Accordingly, the status of the accounting profession has improved substantially. Thus the role of government in financial reporting regulation has diminished to some degree, as evidenced by the increasing private-sector participation in accounting standard setting and by the market-based audit environment.

Despite these changes in the national environment, government involvement in financial reporting regulation is expected to continue as a means to maintain its influence on policy making and to control the increasing political and economic power of *chaebols*. However, with further internationalisation of financing and business activities expected, domestic and international capital markets will continue to play a most influential role in shaping Korea's financial reporting system towards a more micro-user oriented system. In addition, changes in the Korean population's long-cherished Confucianist values will coalesce with the country's fast-changing economic environment to effect continuous changes on Korea's financial reporting system.

CHAPTER V

DISCLOSURE PRACTICES OF SELECTED KOREAN LISTED COMPANIES

5.1 INTRODUCTION

The importance of corporate disclosure practices has been increasing with the internationalisation of capital markets and business activities (Saudagaran and Biddle 1992; Wallace and Nasser 1995). The most recent revision of the FAS in Korea reflects the importance of comparable financial statements in raising needed capital on both national and international capital markets. With Korea's admission into the OECD, the Korean capital market is expected to undergo substantial further liberalisation, necessitating more comparable disclosure practices of Korean companies to attract foreign capital (Kim and Paik 1996).

This chapter analyses the third element of the framework proposed in Chapter II: disclosure practices in Korea. This chapter provides empirical evidence regarding the current state of corporate disclosure practices, particularly the extent of financial disclosure. It further relates the extent of disclosure practised by Korean companies to their company-specific characteristics. The impact of specific company variables on disclosure levels is examined.

A disclosure index is used to examine the degree of disclosure. Then, a relationship between the disclosure level and each company-specific variable is drawn, as examined in prior single-country and comparative studies on disclosure practices (Cerf 1961;Buzby 1975; Belkaoui and Kahl 1978; Firth 1979; Chow and Wong-Boren 1987; Wallace 1988; Cooke 1989, 1991, 1992; Diga 1995).

The chapter is organised as follows. Section 5.2 reviews prior research on disclosure practices and develops hypotheses to be tested in Section 5.3 which deals with research design of this empirical study. Section 5.4 provides evidence regarding the disclosure level of Korean publicly-listed companies. The section also examines the relationship between disclosure level and company-specific financial characteristics. The limitations of this study are provided in Section 5.5. Finally, Section 5.6 provides some conclusions regarding the current state of disclosure practices evidenced by Korean companies.

5.2 LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

This section reviews major literature on corporate disclosure practices, identifying the relevant theories and research methods used in the study undertaken here. Prior research dealing with corporate disclosure practices is divided broadly into two categories: single-country studies and comparative studies involving two or more countries. This section focuses on single-country studies that examine the extent of disclosure practised by individual companies and relates it to company-specific factors within a country. However, this study also incorporates the relevance of comparative studies to the Korean situation.

5.2.1 Prior Research

Starting with Cerf (1961), various studies were conducted to examine any potential relationship between the degree of disclosure and specific company factors. Findings from these studies are provided in Table 5.1.

Table 5.1
Studies on Corporate Disclosure Practices using Disclosure Indices

Author	Data Used	Method	Factors	Results
Cerf (1961): USA	Annual reports 527 firms Financial analysts	Class means Least squares regression	Size (total assets) No. of shareholders Profitability (net income/net worth) Listing status	Positive Positive Positive Mixed
Singhvi and Desai (1971: USA)	Annual reports 155 firms Financial analysts	Chi-square Regression	Size (total assets) No. of shareholders Profitability - Return on S.E.** - Earnings margin Listing status Audit firm size	Positive, not sig. Positive, not sig. Positive, not sig. Positive, signif.* Positive, signif. Positive, not sig.
Buzby (1975: USA)	Annual reports 88 firms Financial analysts	Kendall rank corr. Wilcoxon matched-pairs, signed-ranks test	Size (total assets) Listing status	Positive, signif. No effect
Stanga (1976: USA)	Annual reports 80 firms Financial analysts	Regression	Size (net sales) Industry	Positive, not sig. Effect, signif.
Belkaoui and Kahl (1978: Canada)	Annual reports 200 firms Char. accountants Financial analysts	Kendall rank corr.	Size - total assets - net sales Profitability Liquidity Capitalisation ratio Industry	 Positive, signif. Positive, signif. Negative, signif. Positive, signif. Negative, signif. Effect
Firth (1979: UK)	Annual reports 180 firms Financial analysts	Kendall rank corr.	Size (sales+capital) Listing status Audit firm size	Positive, signif. Positive, signif. No effect
Chow/Wong-Boren (1987: Mexico)	Annual reports 52 firms Loan officers of banks	Regression	Size (equity+debt) Leverage Fixed assets ratio	Positive, signif. Positive, not sig. Positive, not sig.
Wallace (1988: Nigeria)	Annual reports 47 firms No specific focus	Regression	Foreign equity	Positive, signif.
Cooke (1989: Sweden)	Annual reports 90 firms No specific focus	Regression	Listing status Size - total assets - net sales No. of shareholders Parent company	Positive, signif. Positive, signif. Positive, signif. Positive, signif. Positive, not sig.
Cooke (1992: Sweden)	Annual reports 35 firms No specific focus	Factor analysis Regression	Size (8 variables) Listing status Industry	Positive, signif. Positive, signif. Significant
Ahmed/ Nicholls (1994: Bangladesh)	Annual reports 63 firms Annual reports	Regression (stepwise)	Size(assets or sales) Total debt Multinational owner Accounting officer qualification Audit firm size	Mixed, not sig. Positive, not sig. Positive, signif. Positive, signif.* Positive, signif.
Diga (1995: ASEAN)	Annual reports 145 firms No specific focus	Kruskall-Wallis ANOVA Principal component Regression	Size (assets or sales) Leverage Industry Ownership Country of origin	Positive, signif. Positive, not sig. Significant Significant for foreign-owned Significant

* significant at a range of between 0.05 and 0.10
** denotes shareholders' equity

As indicated in Table 5.1, the explanatory variables tested include: size (assets, sales, or other similar measures), listing status, industry type, profitability, financial leverage, financial liquidity, size of auditing firm, foreign ownership, and origin of country. However, a strict comparison of these findings between studies is difficult because different measuring instruments were used. For example, a disclosure checklist was made based on the opinions of financial analysts and weighting systems were employed in earlier studies (Cerf 1961; Singhvi and Desai 1971; Buzby 1975; Stanga 1976; Belkaoui and Kahl 1978; and Firth 1979). In contrast, other studies used a disclosure checklist constructed with no specific user-group focus and consequently no weighting was used in those studies (Wallace 1988; Cooke 1989, 1992; Ahmed and Nicholls 1994; Diga 1995).

Despite comparison difficulties, the studies reviewed highlight the importance of various company characteristics in explaining the levels of disclosure of individual companies. Among the several variables, both size and listing status have been found to be the most powerful in explaining the disclosure extent consistently in countries of widely diverse national backgrounds.

However, mixed evidence concerning the effects of other variables suggests that national environments where companies operate may actually affect the importance of specific company attributes in determining the disclosure level. For example, audit firm size was found to have no effect on the disclosure level of British companies, whereas it was found to be related positively to disclosure level of Bangladesh companies. Building upon these mixed results, Diga (1995)[81] incorporated country of origin in addition to other commonly used company-specific factors in his study of disclosure practices in ASEAN countries. He found a positive relationship (significant at $p \leq 0.01$ or 0.05) between country of origin and disclosure level of ASEAN companies.

It is recognised that these mixed results regarding the effects of some variables on disclosure practices pose an obstacle to the development of a contingency framework that would explain the theoretical linkages between company-specific variables and reporting practices within a country. However, coupled with

[81] Diga (1995) included five original members of ASEAN only: Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Brunei and Vietnam, which joined in 1995, were excluded mainly because they did not have a functioning market for long-term corporate securities at the time the study was conducted.

comparative studies on disclosure practices, findings from these single-country studies are potentially useful in uncovering the basis for the "contingent" relationships.

5.2.2 Hypotheses Development

Among the several variables included in prior studies, the following variables are viewed important in the context of the Korean business environment: size (measured in terms of total assets, sales turnover, and number of employees), profitability (i.e., net income to net worth; net income to net sales; ordinary income to total assets) and degree of financial leverage (i.e., debt to equity).

In addition, two new variables are included in this study: affiliation with *chaebols* given the increasing regulatory and public attention to the power of *chaebols* in Korea and audit firm (i.e., affiliation with any of multinational “Big-Six”[82] audit firms) because of the unavailability of audit firm size. The effects of both industry type and listing status are controlled because all the companies sampled here are listed companies engaging in manufacturing as of December 31, 1994. The following section discusses the relevance of each independent variable included in this study to Korea's environment.

(a) Affiliation with *Chaebols*

As discussed earlier, big business groups called *chaebols* have been exposed to the attention of the public and regulatory bodies in Korea because of their rapidly increasing political and economic power, particularly since the early 1980s. This attention has led to calls for more stringent financial reporting requirements for *chaebols*. Currently, listed companies (mostly large companies) are required to provide sufficient information on their control structure in their affiliated companies. In 1996, the current Kim government (1993-1998) announced three key pressing issues facing the country. One was the issue of *chaebols* whose corporate disclosure requirements have been strengthened further. The distinction between *chaebol* and *non-chaebol* companies is made here to identify any differences in disclosure levels between the two groups. Affiliation with *chaebols* like size and industry type may be a strong determinant in explaining the disclosure level of Korean companies. *Chaebol*

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[82] Big-Six accounting firms are: Coopers &Lybrand, Deloitte Tohmatsu Touche International; Klynveld Peat Marwick Goerdeler (KPMG), Arthur Andersen, Ernst & Young, and Price Waterhouse.

companies tend to be more threatened by adverse regulatory action, as advanced by political cost theories (Watts and Zimmerman 1978).

> *H1: There is a difference in disclosure level between chaebol companies and non-chaebol companies. Chaebol companies are expected to disclose more to reduce political costs than non-chaebol companies.*

(b) Size

Size was found to be associated positively with the extent of disclosure in various studies (Cerf 1961; Buzby 1975; Belkaoui and Kahl 1978; Firth 1979; Chow and Wong-Boren 1987; Cooke 1989, 1992; Diga 1995). One plausible reason is that large firms, in general, have resources and expertise to produce and disseminate more sophisticated financial information for their internal management purposes. In addition, management of large corporations are likely to realise the benefits of quality disclosure, especially in capital-raising. In contrast, smaller firms generally lack both resources and expertise to produce the information and more importantly, feel more than larger firms that their competitive position might be threatened by disclosing quality information. Secondly, agency costs may be another explanation because managers of larger firms tend to increase their disclosure level in an attempt to reduce agency costs that increase with the size of firms and are ultimately borne by them (Chow and Wong-Boren 1987). Finally, political cost theorists would assert that larger firms tend to disclose more information because they are more subject to adverse government control or regulation (Watts and Zimmerman 1978). These political costs, however, were found to be linked to industry type, rather than the sheer size of individual companies (Ball and Foster 1982).

> *H2: There is a positive association between the extent of disclosure and firm size.*

(c) Profitability

Profitable companies are hypothesised to have higher disclosure levels because those firms can be differentiated from poorly performing firms through disclosing more. When a company is profitable, managers may disclose more detailed information in order to support the continuance of their positions and compensation arrangements, especially in a competitive labour-market environment. In addition, minimisation of political costs may be applicable in a sense that the more profitable a company is, the more exposed the company is to regulatory attention.

H3: There is a positive association between the extent of disclosure and profitability of a firm.

(d) Financial Leverage

Studies of the relationship of financial leverage (i.e., debt to equity) with the extent of disclosure have shown mixed results (Belkaoui and Kahl 1978; Chow and Wong-Boren 1987). Despite this, a company with a higher leverage ratio is expected to disclose more to provide greater assurance about its ability to pay. However, this expectation should be refined in a country's peculiar environment. In Korea, for example, firms with higher leverage ratios have been viewed traditionally as safer companies because most of their corporate debt has been guaranteed by government. That is, government has supported companies traditionally through guarantees because the government viewed them as capable of undertaking government-promoted business activities. These government guarantees, however, are not as relevant to the current business environment of Korea as they used to be in the 1960s and 1970s.

H4: There is a positive association between leverage and extent of disclosure.

(e) Affiliation with Big-Six Accounting Firms

The primary responsibility for preparing annual reports rests with company directors. However, auditors of the companies may affect the quality of information disclosed in those annual reports significantly (Singhvi and Desai 1971; Firth 1979; Ahmed and Nicholls 1994). It may be argued that larger and better recognised accounting firms (e.g., multinational accounting firms) as auditors may exercise greater influence on companies' disclosure level. In the early 1980s with the enactment of the EAL, the government changed audit environment from government-directed allocation to market-based competition. Accordingly, corporatisation of audit firms and affiliation with multinational audit firms have become a common feature in Korea as a means to enhance audit independence and quality. Thus, it can be hypothesised that audit firms affiliated with multinational accounting firms have a positive relationship to disclosure level of companies being audited.

H5: There is a positive relationship between affiliation with Big-Six multinational accounting firms and disclosure level.

5.3 RESEARCH DESIGN

5.3.1 Sample Selection and Data Sources

Initially, a sample of 65 companies was selected from the total of 699 companies listed on the KSE as of December 31, 1994. Thirty one of those 65 companies were selected from *chaebol* groups while the remaining 34 were chosen from *non-chaebol* groups. All the *chaebol* companies were selected from the top 30 *chaebols.*[83] Four companies (3 from *chaebol* and 1 from *non-chaebol*) were deleted from the final sample because they were not in the manufacturing industry. All the companies in the final sample were thus in manufacturing and were listed on the KSE as at December 31, 1994 (Appendix 5).

This study focuses on financial information disclosed in the companies' financial statements, footnotes and supplementary schedules. The importance of financial statements with notes as a source of financial information was noted in Chang and Most (1981) and Baker and Haslem (1973). To examine the degree of disclosure provided in financial statements, notes and supplementary schedules, audit reports of those selected companies for the fiscal year ended December 31 1994 were obtained. Financial information is provided in audit reports in the most detailed and comprehensive manner in the country.

5.3.2 Variables

(a) Dependent Variable- Disclosure Level

This study focuses on the financial disclosure level which is measured by constructing a disclosure checklist. The disclosure checklist is based on the FAS and FAS Working Rules effective as of December 31, 1994 (see Appendix 2). Disclosure requirements of Korean listed companies are influenced also by various other legislation, *viz.* the CC, the SEL and the EAL; however, the FAS and FAS Working Rules comprehensively

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[83] The top 30 are the groups whose borrowings from financial institutions were strictly controlled in order to minimise economic concentration in *chaebols* and monopolistic competition and to improve financial structure of the *chaebols*. However, there was an announcement to reduce the number of *chaebols* whose borrowings are controlled to the top 10 in 1996.

prescribe specific disclosure requirements that should be provided in financial statements, notes and supplementary schedules.

Instead of selecting disclosure items subjectively, the disclosure requirements mandated by the FAS and FAS Working Rules were used for construction of a disclosure checklist. The requirements for consolidation were deleted because consolidated statements were unavailable in the audit reports collected for this study. Excluding 27 disclosure items relating to consolidation, the final 338 items are included in this study.

The 338 disclosure items are classified into 39 groups as below:

1. General disclosures
2. Supplementary schedules
3. Cash
4. Marketable securities
5. Receivable-current
6. Inventories
7. Other current assets
8. Investments (long-term)
9. Other assets (long-term)
10. Tangible fixed assets
11. Intangible fixed assets
12. Research and development costs
13. Deferred charges
14. Current liabilities
15. Long-term liabilities
16. Capital stock
17. Capital surplus
18. Retained earnings (or deficits)
19. Capital adjusting accounts
20. Income statement
21. Appropriations
22. Dispositions
23. Leases
24. Accounting changes
25. Prior period adjustment
26. Transactions with related parties
27. Contingencies
28. Post balance sheet events
29. Revenue recognition
30. Extraordinary or unusual items
31. Segment reporting
32. Business combinations
33. Foreign currency translations
34. Earnings per share
35. Severance and retirement benefits
36. Income taxes
37. Asset revaluation
38. Insurance coverage
39. Cash flow statement

Following Wallace (1988), Cooke (1989, 1992) and Diga (1995), each item was scored in a dichotomous way; that is, a disclosure item scored one if disclosed and zero if it was not disclosed in the financial statements with notes and supplementary schedules included in audit reports. The individual scores were treated as additive, such that the total disclosure score of a company is:

$$D = \sum_{i=1}^{338} d_i$$

where $d_i = 1$ if the ith item is disclosed

$= 0$ if the ith item is not disclosed.

The disclosure items were not weighted because of a number of methodological problems associated with the weighting system, such as scaling problems and scoring bias. More importantly, this study examines general-purpose financial statements which are prepared to provide information to a diversity of user groups, not any specific user group, as used in some prior research (Cerf 1961; Singhvi and Desai 1971; Buzby 1975; Stanga 1976; Belkaoui and Kahl 1978). Equal weighting to disclosure items was supported by prior research (Firth 1979; Chow and Wong-Boren 1987; Wallace 1988; Cooke 1989, 1992; Ahmed and Nicholls 1994; Diga 1995). The unweighted index permits analysis independent of perceptions of a particular user group (Chow and Wong-Boren 1987, p. 536) and allows an evaluation of financial statements in a 'general-purpose' context because all disclosure items are treated as equally important to the average user. Additionally, the items of information processed are extensive (i.e., 338 items) such that they would even out the differing preferences of different user groups.

Every mandatory requirement was considered relevant to each company included in the sample even though the advantage of a researcher's judgement on the item's applicability after reading annual reports was acknowledged by Cooke (1989, 1991, 1992). It was extremely difficult to determine the applicability of each disclosure item to a company because financial statements and the notes did not contain much qualitative information. To determine if items were relevant to companies requires information which may be contained in various company documents as well as annual reports, *viz.* prospectuses, statements of management at annual general meetings, press releases, and reports filed with regulatory authorities preceding and following the related fiscal year (i.e., 1994). The assumption that all disclosure items are equally relevant to the sample companies may be justified by the fact that all the companies in the sample are listed manufacturing companies.

The scores were not converted into an index (that is, ratio of actual score to total possible score) because of the same problems raised by Ahmed (1993), Ahmed and Nicholls (1994), and Diga (1995). Instead, the total disclosure score obtained by adding each disclosed item was used to indicate the degree of disclosure. Therefore, constraints on using the Ordinary Least Square (OLS) regression do not exist in this study.

(b) Independent Variables

Affiliation with Chaebols (H1)

One was assigned to companies that were selected from *chaebol* groups, while zero was assigned to companies from *non-chaebol* groups.

Size (H2)

A variety of size variables has been employed in prior research. Among the various alternatives, total assets, sales turnover, shareholders' equity, and number of shareholders have been used most commonly as proxies for size. The problem of using these accounting numbers is noted because of the availability of alternative asset valuation methods or revenue recognition methods in different countries (Diga 1995). In the Korean setting, upward revaluation of fixed assets has been allowed under certain circumstances since 1965. Due to the discretionary characteristic of the asset revaluation, total asset figures across companies may not be comparable. For this reason, a non-financial figure, i.e., the number of employees was used in addition to total assets and annual sales to proxy for size.

Profitability (H3)

Profitability can be measured in a number of different ways. Rate of return (i.e., net profit to net worth) and earnings margin (i.e., net profit to net sales) were used in several studies (Cerf 1961; Singhvi 1968; Singhvi and Desai 1971; Belkaoui and Kahl 1978). In addition to these two variables, another profitability variable, ordinary income to total assets, was included. Because of potential multicollinearity among these three profitability variables, stepwise regression was employed to include the most powerful explanatory profitability variable in the final model. Profitability in the financial regression model was measured by a company's net income-to-net sales ratio.

Leverage (H4)

The degree of leverage was measured by a company's debt-to-equity ratio (DE ratio). It is the proportion of total book liabilities to total shareholders' equity.

Affiliation with Big-Six (H5)

Companies whose audit firms are affiliated with the Big-Six were assigned 1, while the companies not affiliated with the Big-Six were assigned zero.

5.3.3 Statistical Methods

(a) Univariate Tests for Group Differences

Both non-parametric and parametric tests were used to test whether statistically significant differences in *chaebol* and *non-chaebol* companies exist in terms of their disclosure scores and continuous independent variables, *viz.* total assets, sales, number of employees, profitability, and leverage. First, a non-parametric test, the Mann-Whitney U test, was used for untransformed variables since this non-parametric test does not require normality assumption of the variables. Results from this test provide information regarding the possible effects of affiliation with *chaebols* (i.e., big business groups) on the variables under study. The statistically more robust two-sample t-test was used also for the log-transformed variables which satisfy the normality assumption.

(b) Multivariate Tests

In order to determine the impact of multiple company characteristics on disclosure level of individual companies, multiple regression analysis was used because the relationship between the dependent variable and a number of independent variables is of a multiplicative nature. By taking natural logs of both sides of the multiplicative model, the following simpler linear regression model was generated.

$$\log Y = \alpha + \beta_1 \log X_1 + \beta_2 \log X_2 + \beta_3 \log X_3 + \log \varepsilon$$

The transformed model was analysed using OLS regression. Before applying statistical tests on the multiple regression model, diagnostic tests were conducted to determine if all the assumptions underlying the regression model hold. The tests were multicollinearity, non-constant variance of residuals (i.e., heteroscedasticity), non-normal distribution of residuals, outliers or influential observations.

Multicollinearity among continuous explanatory variables was detected by correlations, variance inflation factors (VIF), and tolerance (Weisberg 1985, pp. 196-200; Maddala 1992, pp. 274-276). Table 5.2 presents the correlation matrix among the log-transformed dependent and continuous explanatory variables, including VIFs and tolerance level of each explanatory variable.

Table 5.2
Pairwise Pearson Correlation Coefficients Among Dependent and Continuous Explanatory Variables

	Scores (ln)	Assets (ln)	Sales (ln)	Employees (ln)	Leverage (ln)	Profit2 (ln)
Scores (ln)	1.0000					
Assets (ln)	.6313**	1.0000				
Sales (ln)	.5756**	.9297**	1.0000			
Employees (ln)	.5800**	.8379**	.8101**	1.0000		
Leverage (ln)	.2775*	.3338**	.3609**	.2934*	1.0000	
Profit2 (ln)***	.2728*	.0640	-.0202	.0637	-.2780*	.6356**
VIF^		10.037	8.142	3.858	1.783	1.260
Tol.^^		.0996	.1228	.2592	.5610	.7936

* significant at or below .05 (two-tailed)
** significant at or below .01 (two-tailed)
*** profit2 denotes net income to net sales.
^ variance inflation factor
^^ tolerance level

Statistically significant correlation between the dependent and individual explanatory variables provides an overall evidence of relationship among them. In particular, as anticipated, potential size variables (assets, sales, and number of employees) were found to be highly correlated (r= more than 80%).

Even though multicollinearity may not be a problem as discussed in Maddala (1992, pp. 269-270), various methods have been applied in prior studies to address the problems it poses. They include factor analysis, principal component analysis, stepwise regression and ridge regression. Cooke (1989, 1991) and Ahmed and Nicholls (1994) used stepwise regression by including each of the highly-correlated variables separately in the proposed model until they found the model providing the greatest explanatory power. However, with this method, the explanatory power of variables dropped from the final model may be lost, especially when the correlation is not perfect (Diga 1995). Cooke (1992) and Diga (1995) employed factor analysis and principal component analysis, respectively, to avoid multicollinearity among potential size variables included in their studies.

There is "no overwhelming theoretical reason to prefer one size variable to another because each variable may contain an interesting and possibly unique aspect of size" (Cooke 1992, p. 532). Instead of dropping variables used in the stepwise regression, therefore, this study used the factor analysis which decomposes the information content inherent in the original size variables into information about an inherent set of meaningful factors (Aczel 1993, p. 804). Unlike the principal component analysis, the factor analysis is not always interested in orthogonality of the factors. Both principal component analysis and factor analysis maintain the information content in the original variables while removing the multicollinearity problem.

Prior to performing the analysis, other diagnostics of multicollinearity were employed also to determine whether the leverage ratio (i.e., debt to equity) should be included in the size variable. The VIF for leverage was very low (VIF= 1.783), which means that the correlation between leverage and any of the remaining explanatory variables is very low (*n.b.* VIF=1 means that the variable is not collinear with any of the remaining explanatory variables). In addition, the tolerance level for leverage was comparatively high (Tol.= 0.561006) showing that the variable is not correlated significantly with any of the remaining explanatory variables (*n.b.* tolerance=1 means that the variable has no correlation with any of the remaining variables at all.)

Factor analysis was applied to the above size variables (i.e., total assets, sales, and number of employees) by following three steps. Initially, the Bartlett's test of sphericity was undertaken to test the hypothesis that the correlation matrix of the five variables is an identity matrix. The test statistic of 180.9 is significant at less than 0.01, which provides statistical justification for the use of factor analysis.

Secondly, preliminary (initial) factors were extracted by principal component analysis, which also computes both eigenvalues and percentage of variance explained by each factor. Any factors with an eigenvalue less than 0.7, as discussed in Jolliffe

(1972) and Diga (1995), were not used in this study. Only the first factor satisfies this condition, as shown in Table 5.3 below.

Table 5.3
Factor Analysis

Factors	Eigenvalue	% Variation Explained	Cumulative % Variation
First factor	2.71882	90.6	90.6
Second factor	0.21179	7.1	97.7
Third factor	0.06939	2.3	100.0

The analysis shows that the three size variables load highly on the first component which accounts for approximately 90.6% of the variance of the original variables. All the three new variables (components) account for all the variance of the original variables; however, the application of all the three variables may not guarantee better coefficient estimates in the original regression model and may also lack economy (Aczel 1993, p. 806).

Thirdly, factor loadings between the first factor and the original variables were computed by varimax rotation which is designed to find the best distribution of the factor loadings in terms of the meaning of the factors (Aczel 1993, p. 808). Only one factor was found to be meaningful in explaining the original variables. They are shown in Table 5.4.

Table 5.4
Factor Loadings of Original Variables

Variable	Factor 1
Assets (ln)	.96988
Sales (ln)	.96015
Employ (ln)	.92535

The factor loadings represent correlations between each factor and each original variable. Based on the factor loadings, the first factor was used as a proxy for size to incorporate the three original size variables. The new size variable is written as below:

Size= 0.96988 Assets + 0.96015*Sales + 0.9 2535*Employ.*

The original multiple regression model incorporating the new size variable is as follows:

$$D = c + a_1 S + b_1 P + c_1 L + \sum_{i=1}^{1} x_i A_i + \sum_{i=1}^{1} y_i B_i + \varepsilon$$

where

D= disclosure level (ln)

S= size measures derived using factor analysis

P= profitability measured by net income-to-net sales ratio (ln)

L= leverage measured by the debt-to-equity ratio (ln)

A_i= affiliation with *chaebols*
0= *non-chaebol* companies (default level)
1= *chaebol* companies

B_i= affiliation with Big-Six accounting firms
0= not affiliated with Big-Six
1= affiliated with Big-Six

$c, a_1, b_1, c_1, x_i, y_i$= coefficients to be estimated

ε= stochastic error term which is part of disclosure level not explained by the explanatory variables in the model.

5.4 ANALYSIS OF RESULTS

5.4.1 Descriptive Statistics

Descriptive statistics for the untransformed dependent and explanatory variables are provided in Appendix 6A. Results show that skewness and kurtosis are significant for all variables, except for disclosure scores and profitability (i.e., profit1). Frequency histograms also support high skewness and kurtosis. Data transformation using natural logs was made because the range of values is dispersed widely.

The descriptive statistics for the log transformed variables are presented in Appendix 6B. Appendix 6B indicates that both kurtosis and skewness of the log-transformed variables are much smaller than those of the untransformed variables. Histograms of log-transformed variables also approximate normal distribution. The normality distribution of the variables implies that parametric tests can also be used to analyse those variables.

5.4.2 Univariate Tests

The untransformed variables were used for the non-parametric Mann-Whitney U test. Results of this test are provided in Table 5.5.

Table 5.5
Results of Mann-Whitney U Test for Group Differences (Two-Tailed)

Variable	Mean Ranks		Z-statistic	P-value
	Chaebol (n= 28)	Non-chaebol (n=33)		
Disclosure scores	39.41	23.86	-3.4132	.0006**
Assets	44.89	19.21	-5.6300	.0000**
Sales	45.29	18.88	-5.7892	.0000**
Employees	39.88	21.08	-4.1972	.0000**
Leverage	37.04	25.88	-2.4459	.0144*
Profit1^	28.30	33.29	-1.0927	.2745
Profit2^^	29.61	32.18	-0.5645	.5724
Profit^^^	31.36	30.70	-0.1447	.8849

** significant at $p \leq .01$ (two-tailed probability)
* significant at $p \leq .05$ (two-tailed probability)
^ denotes ordinary profit to total assets
^^ denotes net profit to net sales
^^^denotes net profit to net worth

The results support the existence of highly statistically significant (at $p \leq .01$) differences between *chaebol* and *non-chaebol* companies in Korea in terms of all the variables except profitability variables. *Chaebol* companies tend to rank much higher than *non-chaebol* companies, in particular, in assets, sales, and number of employees. Z-scores are used because of larger sample size ($n \geq 30$) with p-value denoting the percentage we can observe the difference of this magnitude in rankings when the two population mean ranks are equal.

Second, for the parametric two-sample t-test, the log-transformed variables were used because the normality assumption holds for those transformed variables. Results of this parametric test are given in Table 5.6.

Table 5.6
Results of Two-Sample T-Test for Group Differences (Log-Transformed)

Variables	Chaebol (n= 28)		Non-chaebol (n= 33)		Df^	T-score	P-value
	Mean Rank	Standard Deviation	Mean Rank	Standard Deviation			
Disclosure scores	5.2545	.065	5.1926	.059	59	-3.89	.000**
Assets	20.3722	1.040	18.5868	.724	59	-7.87	.000**
Sales	20.1213	1.078	18.3727	.638	42.30	-7.54	.000**
Employees	7.8016	1.048	6.5331	.845	57	-5.14	.000**
Leverage	5.6610	.630	5.2934	.612	59	-2.31	.025*
Profit1	.4411	1.188	.8296	1.233	51	1.16	.251
Profit2	.6044	.981	.7170	1.020	55	.42	.674
Profit	1.7227	1.142	1.6353	.879	55	-.33	.745

** significant at $p \leq .01$ (two-tailed probability)
* significant at $p \leq .05$ (two-tailed probability)
^ denotes degree of freedom

The results are consistent with the Mann-Whitney U test results reported earlier. The *chaebol* and *non-chaebol* group companies show statistically significant differences in all the variables indicated above, except for the profitability variables. Thus, both parametric and non-parametric tests indicate that the *chaebol* and *non-chaebol* groups have different firm characteristics (i.e., financial) which may, in turn, affect their disclosure practices. *Chaebol* companies tend to disclose more than *non-chaebol* companies. However, higher level of disclosure by *chaebol* companies may result from their inherent characteristics, including larger asset size, sales figure, and other characteristics. Thus, the influence of affiliation with *chaebols* was tested using the multiple regression model after controlling for the remaining independent variables.

5.4.3 Multivariate Tests

Results of the multiple regression model discussed previously are provided in Table 5.7.

Table 5.7
Results of Korean Disclosure Model

Variable	Estimated Coefficient	Standard Error	t-Statistic	p-value
Constant (c)	5.132354	.070245	73.064	.0000**
Chaebol	.011972	.019353	.619	.5390
Size (S)	.035804	.009891	3.620	.0007**
Profitability	.018776	.007532	2.493	.0161*
Leverage	.013083	.012472	1.049	.2993
Audit Firm	-.002655	.015219	-.174	.8622
F-value: 9.267 ($p \leq .01$)	Adjusted $R^2 = 0.43357$			

** significant at $p \leq .01$ (two-tailed probability)
* significant at $p \leq .05$ (two-tailed probability)

Stepwise regression[84] was employed on the three profitability variables. It was found that profit2 (i.e., net profit/net sales) was the most powerful explanatory variable (Appendix 7A). Adjusted R^2 (i.e., 0.43357) approximates the results obtained from similar studies dealing with disclosure indices such as Singhvi (1968) (i.e., 0.42) and Singhvi and Desai (1971) (i.e., 0.43). The adjusted R^2 of 0.43357 is lower than Cooke (1989) and Ahmed and Nicholls (1994), which were 0.60 and 0.52, respectively. Lower adjusted R^2 may be due to the fact that two important explanatory variables, industry effect and listing status, are excluded from the study. Cooke (1989) incorporated additional variables such as listing status, number of subsidiaries owned by parent company, and number of shareholders.

Various diagnostic tests were undertaken to examine if the assumptions underlying the multiple regression model hold. All of them support the assumptions underlying the model. First, a histogram and normal probability plot of the standardised residuals show that the distribution of the residuals appears to be fairly normal (Appendices 8A, 8B). Second, a plot of the standardised residuals against the predicted

[84] There are three profitability variables used in this study. Because of the high collinearity among these variables, stepwise regression was used. Among them, profit2, i.e., net income to net sales, has been found to be the most powerful explanatory variable, resulting in adjusted R^2 of 0.43357 (Appendix 7A). The multiple regression model including profit1 (i.e., ordinary income to total assets) has adjusted R^2 of 0.35008, while the model including profit (i.e., net income to net worth) has 0.40210 for adjusted R^2 (Appendices 7B, 7C).

values shows the constant variance of residuals (i.e., homoscedasticity) (Appendix 8C). Third, potential outliers were detected by a casewise plot of standardised residuals which shows no significant outliers. (Appendix 8C).

H1: Affiliation with Chaebols Affiliation with *chaebols* appears to exert a positive impact on financial disclosure level. This positive relationship may be attributable to higher political costs of companies affiliated with *chaebols* because of enormous economic concentration in a small number of *chaebols* (i.e., 30 largest *chaebols*). Their combined sales comprised approximately 75 per cent of Korea's GNP in 1995 (Haskins *et al.* 1996). The result is statistically significant only at the 54% level (p= .54), suggesting that other factors are more important in explaining levels of disclosure in Korea. However, more stringent reporting regulations, which have been and will be placed upon *chaebols* by government as a means of control, will enhance the level of disclosure of *chaebol* companies compared to *non-chaebol* companies. That is, *chaebol* companies would increase their disclosure level to minimise political costs resulting from affiliation with *chaebols*.

H2: Size A statistically significant positive relationship (i.e., p= .0007) between company size and disclosure level was found for the sampled Korean companies at the level of $p \leq .01$. This result strongly supports the findings of prior disclosure studies in the USA, the UK, India, Sweden, and Japan. As discussed previously, the positive relationship can be explained in various ways. Two widely accepted explanations are operational complexity and political costs associated with large companies. Large Korean companies tend to engage in complex operations which are, in turn, related to high disclosure levels. Similarly, large Korean companies have been exposed to more public attention and regulatory scrutiny because of the enormous economic concentration in them. The lending of financial institutions to the top 30 *chaebols* made on the basis of each *chaebol*'s aggregate asset size is controlled by the Bank of Korea.

H3: Profitability Profitability was found to be associated positively with disclosure level at the level of p= .0161. Prior studies show mixed results on the profitability variable: a positive relationship in Cerf (1961) and Singhvi and Desai (1971) and a negative relationship in Belkaoui and Kahl (1978). The positive relationship between profitability and disclosure level can be explained by incentives of profitable companies to disclose more to differentiate themselves from poorly performing companies. Similarly, more profitable companies may be subject to stricter regulatory scrutiny, leading to greater political costs in Korea. The positive relationship obtained in this study supports the hypothesis that companies with higher profitability tend to disclose more information than less profitable companies to minimise political costs arising from their higher profitability.

H4: Degree of Financial Leverage The sign of the coefficient for the degree of leverage is positive as expected in the model. However, the relationship is statistically significant only at the 30% level (p= .2993) which implies that disclosure level of companies in the country is explained better by other important variables, rather than the degree of financial leverage. The result may be explained by the unique relationship between major debt providers (i.e., financial institutions) and borrowing firms. The main-bank system that was launched in 1976 to monitor bank credit to major *chaebols* has allowed each group's main bank to participate in management decision making of its borrowing firms. More importantly, the monitoring role allows the main bank to obtain access to significant financial and business information (Park and Kim 1994). Therefore, financial information provided for external purposes may not be as significant as expected.

H5: Affiliation with Big-Six Contrary to initial expectation, affiliation with a Big-Six multinational accounting firm is related negatively to the level of disclosure but not statistically significant (p= .8622), suggesting that the affiliation with the Big-Six is not an important explanatory variable in determining the disclosure level of Korean companies. The statistical insignificance may be related to the fact that all but one company in the sample not affiliated with the Big-Six were audited also by one of the 9 largest audit firms in Korea, as shown in Table 5.8.

Table 5.8
Audit Firms of Sample Companies

Korean Big-9 Audit Firms	*International Affiliation*	*No. of Sample Companies Audited*
1. Samil	Coopers & Lybrand	12
2. Ahnkun-Sewha	Deloitte Tohmatsu Touche International	9
3. Sandong	Klynveld Peat Marwick Goerdeler	8
4. Anjin	Arthur Andersen	1
5. Youngwha	Ernst & Young	7
6. Sedong	Price Waterhouse	3
7. Samduck	NEXIA International	8
8. Chungwoon	Howarth International	7
9. Shinhan	RSM International	5
Samkyung Hapdong*		1
Total		61 firms

* not a member of Korean Big-Nine

5.5 LIMITATIONS

There are several limitations in this study. First, it is limited to profit-seeking listed companies in Korea. So, findings may not be generalisable to unlisted companies, government or 'not-for-profit' organisations in the country. As discussed in Singhvi and Desai (1971) and Cooke (1989, 1992), listing status was associated with level of disclosure in the USA, Sweden and Japan. Even though the advantages of including unlisted companies in the study is recognised, there are some advantages of limiting the study to listed companies only. Both domestic and international attention has been paid mostly to listed companies because of their economic importance in Korea. This importance is reflected in growing regulation and control over those companies, particularly the *chaebol* companies. The effects of listing status (i.e., differences between listed and unlisted companies) on disclosure level are controlled by including listed companies only. In addition, access to the financial reports of unlisted companies is extremely difficult because those companies are not required to file their reports with the country's regulatory bodies, with the exception of the ones subject to the EAL.

Second, unlike most prior disclosure studies which used annual reports, only financial statements with notes and supplementary schedules are examined. The study of financial information only is limited under current circumstances in which non-financial information such as social responsibility accounting has been steadily growing in its significance. However, the regulation of non-financial information in the country has not been systematic until recently, when disclosure requirements on the impact of economic transactions on environment and employees were adopted. A separate study of *Operating Report* including non-financial as well as financial information will generate more comprehensive findings of disclosure practices of listed companies and also enhance comparability with other disclosure studies, which examined not only financial information but also non-financial information disclosed in annual reports.

Third, the study of unconsolidated statements rather than consolidated statements limits the findings. Consolidation is an important area which has been continuously strengthened in financial reporting regulation in Korea. With consolidated statement items excluded, it is difficult to measure the compliance level of those companies with mandatory requirements.

Last, the cross-sectionality is in contrast with the overall thrust of this thesis, i.e., focus on historical evolution of financial reporting in Korea. Even though cross-sectionality may provide a useful picture of disclosure practices at a specific point in time (i.e., the 1994 fiscal year), study of longitudinal nature would be useful in identifying general trends and problem areas which may provide policy implications for accounting standard setters and regulatory organisations.

5.6 CONCLUSION

This chapter has identified company-specific characteristics that may influence the disclosure level of Korean publicly-listed companies, using research methods employed previously by various accounting studies. The findings support prior disclosure studies in the size variable. A composite of three different size variables (i.e., total assets, net sales, and number of employees) shows a statistically significant positive relationship to disclosure level. This may be related to higher political costs associated with corporate size in Korea where government has taken measures to control rapidly increasing economic power of the private business sector, especially large business conglomerates. Interestingly enough, however, rather than an affiliation with *chaebols*, size appears to be the most powerful explanatory variable in determining the corporate disclosure level in Korea. The terseness of financial information disclosure by *chaebols* is noted in Haskins *et al.* (1996). To rectify these poor reporting practices of *chaebols*, the government announced its *chaebol* policy in 1996 which requires 30 leading *chaebols* to bring in outside auditors to their boards and allows minority shareholders to scrutinise their financial statements.

With respect to the degree of profitability, the result is consistent with the initial expectation. The degree of profitability (i.e., net income-to-net sales) is found to be associated positively with disclosure level at the level of $p \leq .05$. This finding is supported by the following argument. Companies with higher profitability tend to engage in disclosure practices to minimise political costs arising from their higher profits.

The sign of the coefficients for the affiliation with *chaebols* and the degree of financial leverage is also positive as expected, while the negative association between the affiliation with the Big-Six accounting firms and the extent of disclosure is contrary to the initial expectation. However, results regarding these three variables are found not to be statistically significant at conventional levels. These results suggest that there are other more important variables in explaining the disclosure level of companies in the country.

This study focuses on quantitative company-specific factors. Qualitative firm-specific characteristics including organisational culture, management attitudes towards disclosure practices, and founder's philosophy may play significant roles also in determining the level of financial disclosure. This approach may involve more in-depth studies of individual companies; however, it will enhance an understanding of disclosure practices of Korean companies.

Despite the limitations, the findings suggest the importance of national environments as well as company-specific variables in influencing disclosure practices of individual companies within a country. Findings concerning the effects of financial leverage and profitability on the extent of disclosure by Korean companies add to the mixed results in prior studies. Thus it can be drawn that company-specific characteristics play differential roles in influencing disclosure practices of individual companies depending on national environments where companies operate. Disclosure practices in a country appear to be contingent upon both organisational and national environmental contexts where individual companies operate.

CHAPTER VI

MEASUREMENT PRACTICES OF SELECTED KOREAN COMPANIES

6.1 INTRODUCTION

This chapter examines the degree of uniformity and conservatism practised by Korean publicly-listed companies by analysing part of the third element of the framework proposed in Chapter II, i.e., measurement practices. There is a broad dichotomisation between micro-user oriented and macro-user oriented reporting systems in terms of measurement practices. In countries that adopt a micro-user perspective to accounting, companies are allowed ample discretion in choosing accounting methods from a wide range of accounting options that capture economic reality. In contrast, in macro-user oriented systems, in general, emphasis is placed on complying with requirements prescribed by government or government agencies, such that greater uniformity is achieved in measurement practices (Craig and Diga 1996b).

Countries differ also in the degree of conservatism employed in financial accounts of individual enterprises (Abel 1969; Choi *et al.* 1983; Choi and Hiramatsu 1987; Weetman and Gray 1991; Bloom *et al.* 1994; Norton 1995; Nobes and Parker 1995). A greater degree of conservatism prevails in countries with a macro-user perspective to accounting, as evidenced by asset valuation methods adopted and maintenance of various types of reserves. In comparison, micro-user oriented systems allow less conservative approaches to asset valuation and profit measurement.

This study is motivated by the need to locate accounting measurement practices of Korean companies in an international context. Whereas Korea used to adopt conservative approaches, it is now shifting to less conservative approaches as it undergoes changes in its accounting orientation from a macro-user to a micro-user perspective. In particular, findings obtained from analysis of the impact of company-specific factors on the degree of conservatism provide information useful to foreign investors who have been burgeoning since January 1992. The findings also provide useful insights to the harmonisation process that has been pursued at national, regional and international levels.

Section 6.2 reviews prior research regarding measurement practices, i.e., uniformity and conservatism. Section 6.3 contains an empirical study of publicly-listed Korean companies. The section deals with data selection, hypotheses, and statistical methods to be employed to test the hypotheses developed. Analysis of results is provided in Section 6.4. Section 6.5 provides some policy implications and conclusions regarding measurement practices of Korean companies.

6.2 PRIOR RESEARCH

6.2.1 Harmony/Uniformity

Van der Tas (1988) and Tay and Parker (1990) distinguished between formal or *de jure* harmony and material or *de facto* harmony. Formal or *de jure* harmony refers to harmony of accounting rules, while material or *de facto* harmony refers to harmony of the actual accounting practices of companies. Only the degree of *de facto* harmony is examined because this thesis deals with measurement practices of companies within a country. The findings could be compared with those derived from studies of other countries.

To determine the degree of harmony within a country and between countries, van der Tas (1988) developed three indices: H-index, C-index and I-index. H-index and C-index were used to measure national harmony, with the latter incorporating multiple reporting. In comparison, I-index was devised to measure international harmony, as applied subsequently to three European countries (France, Germany and the UK) by Emenyonu and Gray (1992). The first two indexes are relevant to single-country studies, specifically with the C-index being used for this study because the C-index considers multiple reporting. However, one of the principal drawbacks of using these indexes is the absence of statistical significance tests for observed variations in index values (Tay and Parker 1990, pp. 82-83).

To address this problem, use of chi-square tests was suggested by Tay and Parker (1990). Chi-square tests were employed subsequently by Emenyonu and Gray

(1992) and Archer *et al.* (1995) to find out significant differences among selected countries with respect to selected individual measurement practices. Measurement items chosen because of their significant effects on asset and profit figures include inventory valuation, depreciation method, goodwill, research and development, valuation of fixed assets, extraordinary items, deferred income taxation, and consolidated goodwill. Overall, countries included in their study show statistically significant differences in their measurement practices, with the highest degree of harmony (i.e., 0.6079) for the valuation basis for fixed assets and the lowest being in depreciation methods (i.e., 0.0076). One implication of the findings is that the measurement provisions of the EC Fourth Directive are sufficiently flexible to allow ample discretion for managers. Given the flexibility, a study of underlying reasons for choosing one method over alternative accounting methods will help enrich an understanding of current observed variations among nations.

6.2.2 Conservatism

Conservatism is defined generally as the deliberate understatement of profits and assets and overstatement of losses and liabilities. The extent to which companies adopt conservative approaches to measurement varies across countries. Accounting rules and practices in some countries emphasise conservative approaches to asset valuation and profit measurement. For example, reported profits in France, Sweden, West Germany, and the Netherlands were consistently lower than those of the UK (Abel 1969). Using Gray's (1980) conservatism index introduced, Weetman and Gray found that UK and Dutch accounting practices are less conservative than US practices. Korean and Japanese companies were found to use more conservative approaches than their US counterparts (Choi *et al.* 1983), while Australian companies used less conservative approaches to reporting of shareholders' equity than US companies (Norton 1995).

The differences in the degree of conservatism across nations are attributable to various factors. Nobes (1991) related the high degree of conservatism in Germany to the heavy dependence of companies on banks for their financing. Because bankers are more interested in the collectibility of their long-term loans rather than profitability of companies, more conservative approaches to profit measurement are called for in countries where major providers of capital to business enterprises are creditors, including banks.

Thus the varying degree of conservatism is explained by the business environment from which accounting numbers are derived (Choi *et al.* 1983). Similarly, company-specific characteristics are useful also in explaining the difference in the degree of conservatism adopted by individual companies within a country, as evidenced by Watts and Zimmerman (1978), Hagerman and Zmijewski (1979), Bowen *et al.* (1981), Dhaliwal *et al.* (1982), Daley and Vigeland (1983), and Zmijewski and Hagerman (1981). These studies tested firms' choice of a single accounting measurement method and a portfolio of methods, using an agency theory framework. The economic theory of agency was used to predict and explain the behaviour of parties involved with a firm, with respect to specific accounting methods.

The most commonly tested hypotheses in these studies are debt-to-equity, political cost, and bonus plan hypotheses. Studies produced evidence generally consistent with debt-to-equity and political cost hypotheses but mixed results regarding the bonus plan hypothesis (Watts and Zimmerman 1986). Larger firms were found to use income-decreasing accounting methods, whilst highly-leveraged firms adopted income-increasing methods. However, mixed results regarding the bonus hypothesis imply that managers' choice of accounting methods may be related more to the actual bonus arrangements than to the existence of bonus plans. Healy (1985) argued that managers are more likely to "take a bath" in the current period instead of increasing reported profits when their profit-increasing technique does not maximise their utility. The evidence on the influence of bonus plans on accounting choices is generally weak and contradictory.

Findings from these empirical studies are relevant for analysing accounting choices of Korean companies. Drawing upon the findings, potential relationship between specific company factors and degree of conservatism adopted by Korean publicly-listed companies is hypothesised and examined. Any relationship between them suggests the importance of company factors as well as overall national business environment in determining measurement practices in Korea.

6.3 RESEARCH METHODS

6.3.1 Sample Selection and Data Sources

The same sample of 61 companies used in the empirical study of disclosure practices in Chapter V was used for this study. They are all manufacturing companies listed on the Korea Stock Exchange (KSE) as of December 31, 1994. The sample was divided into *chaebol* and *non-chaebol* groups to identify any differences between these two groups in terms of degree of uniformity and conservatism.

Data for this study were collected from financial statements and the notes contained in the 1994 audit reports submitted to regulatory bodies. With respect to the degree of uniformity, items that are considered significant in determining magnitude of assets and profits were examined in order to measure the degree of uniformity in the country. The items included are inventory valuation, fixed assets valuation, depreciation method, goodwill, research and development, foreign-currency translation, leases, and marketable securities. The first five items were used also in Emenyonu and Gray (1990). As for the degree of conservatism, the following 12 items[85] affecting the amount of current reported profits were examined: market-value changes in investments; inventory cost assignment method; depreciation method; basis of depreciation charges; interest capitalisation; research and development costs; pension and retirement expenses; income tax accounting; foreign exchange translation gains or losses; non-specific or discretionary reserves; leased assets; and recognition of "extraordinary" losses.

6.3.2 Hypotheses

The following hypotheses were tested. First, the null hypothesis for the degree of uniformity is that no significant differences exist in methods used by Korean publicly-listed *chaebol* and *non-chaebol* companies with respect to each of the eight accounting policies discussed in Section 6.3.1. Each null hypothesis is shown in the Analysis of Results section (Section 6.3.4).

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[85] Four items deleted from this study mainly because of high rate of non-disclosure or inapplicabillity are: equity accounting profit or loss, business start-up or/and exploration expenditures, business combinations, and goodwill on acquisition.

Second, on the basis of findings from prior research on accounting choices, the following hypotheses were developed to test the relationship of company-specific factors to the degree of conservatism.

H1: Larger Korean firms are expected to adopt a portfolio of accounting methods that decrease current period reported earnings.

H2: Korean firms with a higher debt-to-equity ratio are more likely to use a portfolio of accounting methods that increase current reported earnings.

H3: Chaebol companies are more likely to employ a portfolio of accounting methods that decrease current reported earnings than non-chaebol companies.

Hypotheses 1 and 3 have been proposed because large and *chaebol* companies in Korea are, in general, subject to more regulatory scrutiny and public reaction. Political costs associated with these companies tend to be higher in the country's economy which is dominated heavily by the *chaebols*. It is expected, therefore, that these companies engage in measurement practices which reduce current period profits. In contrast, as proposed in Hypothesis 2, companies with a higher debt-to-equity ratio are expected to use accounting methods that increase current period profits to provide assurance regarding their ability to pay to creditors. This hypothesis is relevant to the Korean environment considering the heavy reliance of most Korean companies on debt financing.

6.3.3 Methods of Analysis

Two statistical methods were used to test the degree of *de facto* accounting measurement harmony in Korea: C-Index and Chi-square test. With respect to the degree of conservatism, the Mann-Whitney U test and multiple regression analysis were used for analysing group differences between *chaebol* and *non-chaebol* companies and for identifying the relationship between the degree of conservatism and three company-specific characteristics (i.e., size, degree of leverage, and *chaebol* affiliation), respectively. All these methods are discussed further below.

(a) Degree of Uniformity

C-Index

The C-index was employed to assess the degree of uniformity in measurement practices of the sample companies. The C-index first developed by van der Tas (1988) is written as follows (pp. 167-168):

$$\text{C-index}=\frac{\left(\sum_{t=1}^{i} a_t^2\right)-n}{n^2-n}$$

where a_i= the number of companies applying accounting method i;
i= the number of alternative accounting methods; and
n= the total number of companies.

In words, it is expressed as "Pairwise comparisons between companies using the same method" divided by "Maximum pairwise comparisons between companies disclosing method." Unlike the H-index, the C-index takes into account multiple reporting practices, thereby providing additional information to enable comparison. The index provides a basis for evaluating the degree of inter-firm uniformity in the measurement practices in Korea. Furthermore, sampled companies are all in the manufacturing industry. Consequently, the index provides an estimate of the degree of uniformity of accounting practices within the manufacturing industry in Korea.

Chi-square (X^2) Test

Chi-square (X^2) test was used to evaluate the null hypotheses that the proportion of *chaebol* companies and *non-chaebol* companies using a particular measurement method is the same (Aczel 1993). Rejection of the null hypotheses indicates a statistically significant lack of measurement harmony in the two groups with respect to the particular accounting measurement method. Because of the possibility of small expected cell frequencies, cells are combined if any of the expected cell frequencies is less than the threshold,[86] as used in Emenyonu and Gray (1992).

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[86] The threshold defined here is: (i) 20% of expected cell frequencies are less than five; or (ii) if any one expected cell frequency is less than one.

(b) Degree of Conservatism

In regard to the degree of conservatism, three plausible accounting methods were identified (i.e., 1 was assigned to the least conservative with 3 to the most conservative approach) for each measurement item (Appendix 9). Individual scores were treated as additive, such that the total conservatism score (C) of a company is:

$$C = \sum_{i=1}^{12} c_i$$

where c_i= 1 if a company adopts the least conservative approach for the ith item;
3 for the most conservative approach for the ith item; and
2 otherwise.

Then, the conservatism index was obtained by dividing the total score by maximum possible score. If all of the 12 items are applicable or available to a company, the maximum possible score of the company is 36 points. Otherwise, the maximum score is less than 36. It is written as follows:

$$\textit{Conservatism Index} = \frac{\sum_{i=1}^{12} c_i}{3n} \quad \text{where } n \leq 12,$$

with 0= the least conservative and 1= the most conservative.

Univariate Test for Group Differences

A non-parametric Mann-Whitney U test was used to test whether statistically significant differences in *chaebol* and *non-chaebol* companies existed in terms of the conservatism index.

Multivariate Tests

To determine the impact of multiple company characteristics on the degree of conservatism of individual companies, multiple regression analysis was undertaken because the relationship between the dependent variable (i.e., degree of conservatism) and the independent variables (i.e., size, degree of leverage and affiliation with *chaebols*) is of a multiplicative nature.

Because of multicollinearity among three size variables (i.e., assets, sales and number of employees) as discussed in Chapter V, factor analysis was applied to derive a composite variable that accounts for the variance of the original three size variables. The same new size variable was used also in Chapter V (Table 5.4).

As shown earlier, the conservatism index is bounded at or between 0 and 1. To eliminate the statistical problems (OLS regression) related to the use of a bounded index, the conservatism index was normalised using the logarithm of the odds ratio, as employed in Ahmed (1993). The transformation is expressed as follows:

$$DOC = \log\left(\frac{d}{1-d}\right)$$

where DOC = logistically transformed conservatism index;
d = computed conservatism index (actual score over total possible score).

This transformation ensures that for any value of *DOC, d* will lie in the range between 0 and 1 (i.e., $0 \le d \le 1$). In addition, the two independent variables (size and degree of leverage) were log-transformed to satisfy the normality assumption of the regression analysis.

The multiplicative regression model incorporating the new size variable is as follows:

$$DOC = c + aS + bL + xA + \varepsilon$$

where

DOC = logistically transformed conservatism index;

S = size measures derived using factor analysis;

L = degree of leverage measured by the debt-to-equity ratio (ln);

A = affiliation with *chaebols*;
0= *non-chaebol* companies (default level)
1= *chaebol* companies

c, a, b, x = coefficients to be estimated; and

ε = stochastic error term which is part of the degree of conservatism not explained by the explanatory variables in the model.

Then, Ordinary-Least Square (OLS) regression was applied for the transformed model.

6.4 ANALYSIS OF RESULTS

This section presents results on the degree of uniformity and conservatism practiced by selected Korean companies listed on the KSE as of December 31, 1994.

6.4.1 Uniformity

(a) Inventory

Article 93 (FAS 1994) requires that inventories be valued at purchase or production cost, plus incidental expenses determined on any of the following methods: FIFO, LIFO, specific identification, average, retail method, or other reasonable method. However, inventories may be recorded at market value if the market value is below cost. Market value is defined as the average wholesale price for one month preceding balance sheet date, determined by a price survey index published by a reputable price survey institute. However, if not available, it should be net realisable value, which is the estimated selling price less normal selling expenses. Thus, two categories were identified: cost and lower of cost and market (LCM).

The following null hypothesis was tested:

Ho1: *There is no significant difference in the inventory valuation method adopted by publicly-listed chaebol and non-chaebol companies.*

Table 6.1
Inventory Valuation Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Cost	27 (96.4%)	33 (100%)	60 (98.3%)
Lower of Cost and Market	1 (3.6%)	0 (0%)	1 (1.7%)
Total	28	33	61
X^2= 1.198	p-value= .274	C-Index= 0.9672	

As shown in Table 6.1, all the companies except one *chaebol* company valued their inventories at cost. Even the only company adopting LCM reported its inventory at cost because market value did not actually decline below cost. The computed chi-square statistic indicates that there is no statistically significant difference between *chaebol* and *non-chaebol* companies in the proportion of companies using each method. The C-index (0.9672) shows a very high degree of uniformity in the inventory valuation adopted by Korean companies. This almost perfect convergence may be related to the fact that LCM did not become a mandatory requirement until the 1996 amendment.

A test on cost-determination methods was not undertaken because most companies used a combination of methods depending on the nature of inventories. The difficulty of testing cost-determination methods was noted in Emenyonu and Gray (1992, p. 52). More than 90% of companies (i.e., 55 companies) used a combination of methods prescribed by tax rules under the CTL. Strong tax influences are found in the determination of cost of inventories.

(b) Tangible Fixed Assets

FAS (Art. 94) stipulates that tangible fixed assets be valued at production cost or purchase cost plus incidental expenses. However, revaluation is allowed for certain categories of tangible fixed assets pursuant to the Asset Revaluation Law. So historical cost and modified historical cost (i.e., revaluation) were used for the tests.

The following null hypothesis was tested:

Ho2: There is no significant difference in the valuation method for tangible fixed assets adopted by chaebol and non-chaebol publicly-listed companies.

Table 6.2
Tangible Fixed Assets Valuation Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Historical Cost	1 (3.6%)	6 (18.2%)	7 (11.5%)
Modified Historical Cost	27 (96.4%)	27 (81.8%)	54 (88.5%)
Total	28	33	61
X^2= 3.18	p-value= .074	C-Index= 0.7934	

Table 6.2 shows that the majority of sample companies (88.5%) used a modified method in valuing tangible fixed assets at a specific point in time, resulting in a higher degree of uniformity (i.e., 0.7934). However, because of its voluntary nature under the

ARL, the revaluation has been a controversial issue in Korea since its promulgation in 1965. One of the criticisms cited most frequently is the lack of comparability of financial reports across companies and over time because of the discretionary nature of asset revaluation. The computed chi-square statistic (p= .074) indicates that the difference between *chaebol* and *non-chaebol* companies in the proportion of companies using each method is not statistically significant at conventional levels (at p≤.01 or p≤.05).

(c) Depreciation Method

Article 96(4) prescribes that straight-line (S-L), declining balance, units of production or other reasonable method be used for depreciation of tangible fixed assets. The three methods were used for the C-index computation.

The following null hypothesis was tested:

> *Ho3: There is no significant difference in the depreciation method adopted by chaebol and non-chaebol publicly-listed companies.*

Table 6.3
Depreciation of Tangible Fixed Assets Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Declining Balance	7 (25%)	25 (75.8%)	32 (52.46%)
Straight-Line	21 (75%)	8 (24.2%)	29 (47.54%)
Units of Production	0 (0%)	0 (0%)	0 (0%)
Total	28	33	61
X^2= 15.648	p-value= .00008	C-Index= 0.4929	

As shown in Table 6.3, no companies in the sample used units of production method. Approximately even distribution among straight-line (32 companies) and declining balance (29 companies) was found and was reflected also by the relatively lower degree of uniformity (i.e., 0.4929). Differences among *chaebol* and *non-chaebol* companies were sufficient to reject the null hypothesis *Ho3* (p= .00008). That is, a significant difference existed in the depreciation method adopted by *chaebol* and *non-chaebol* publicly-listed companies. Seventy-five per cent of *chaebol* companies used the straight-line method, whilst approximately 76 per cent of *non-chaebol* companies applied the declining balance method. This result is surprising and contrasts with conventional wisdom, particularly since *chaebol* companies are expected to adopt income-decreasing depreciation methods to avoid adverse regulatory scrutiny and public reaction. However, the effect of adopting a depreciation method on a company's income really depends upon the age structure of assets involved and the growth phase the company is in.

One notable feature is that all the companies in the sample employed the depreciation methods in accordance with provisions of the Corporation Tax Law (CTL). The CTL stipulates that all the tangible fixed assets be depreciated by declining balance or straight-line except for those which are used directly in mining. Fixed assets that are used directly in mining should be depreciated through units of production method under the CTL.

(d) Goodwill

Goodwill (Art. 97 (2)) is to be capitalised and amortised over no more than five years, starting from the date of acquisition. As shown in Table 6.4 below, only three companies disclosed their valuation method-- all three adopted the capitalisation method. The high degree of non-disclosure (95.1%) may be attributed to the following two reasons: first, non-disclosing companies may not have any goodwill or second, they may not disclose even if they have goodwill to be disclosed.

The following null hypothesis was tested with respect to goodwill:

Ho4: There is no significant difference in the measurement of goodwill adopted by chaebol and non-chaebol companies.

Table 6.4
Goodwill Accounting Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Capitalise	3 (10.7%)	0 (0%)	3 (4.9%)
Writeoff to reserves	0 (0.0%)	0(0%)	0 (0%)
Not disclosed	25 (89.3%)	33 (100%)	58 (95.1%)
Total	28	33	61

Because of the high degree of non-disclosure (95.1%), C-index calculation was not undertaken. The chi-square statistic also could not be computed because the number of non-empty rows or columns is one.

(e) Research and Development

Research and development costs should be expensed unless prescribed criteria[87] for capitalisation are met (FAS Working Rules on R&D Costs). Due to this provision, two categories were used for testing: expensed only and capitalised.

In regard to research and development costs, the following hypothesis was tested:

Ho5: There is no significant difference in the method of accounting for research and development costs adopted by chaebol and non-chaebol companies.

Table 6.5
R & D Expenditure Accounting Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Capitalised	18 (64.3%)	22 (66.7%)	40 (65.6%)
Expensed only	8 (28.6%)	3 (9.1%)	11 (18.0%)
Not disclosed	2 (7.1%)	8 (24.2%)	10 (16.4%)
Total	28	33	61
X^2= 2.654	p=.1032	C-Index= 0.6549	

As indicated in Table 6.5, sampled companies converged towards capitalisation of their R & D expenditure, resulting in the relatively high C-Index (0.6549) . Some caution should be undertaken in interpreting this finding because of relatively high non-disclosure (i.e., 16.4%). The non-disclosers could be construed as follows: first, they did not engage in any R&D activities or second, they were not willing to disclose its treatment, possibly for proprietary reasons. However, of those companies that disclosed their policy, approximately 84% chose to capitalise these expenditures.

Non-disclosers were excluded in applying the statistical tests. The computed chi-square statistic (p= .1032) indicates that the proportion of companies either

[87] See Section 3.6.3.

capitalising or expensing their R & D costs does not vary significantly between *chaebol* and *non-chaebol* companies at conventional levels (i.e., p≤.01 or p≤.05).

(f) Translation of Transactions Denominated in Foreign Currency

Article 103 of FAS (1994) stipulates that monetary assets and liabilities denominated in foreign currency be translated using the exchange rate at balance sheet date. The hypothesis in regard to translations of foreign-currency transactions was:

> *Ho6: There is no significant difference in the method used to translate foreign-currency transactions adopted by chaebol and non-chaebol publicly-listed companies.*

Table 6.6
Translation of Transactions Denominated in Foreign Currency Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Rate- balance sheet date	26 (92.9%)	29 (87.9%)	55 (90.2%)
Rate- date of transaction	0 (0.0%)	0 (0.0%)	0 (0.0%)
Not disclosed	2 (7.1%)	4 (12.1%)	6 (9.8%)
Total	28	33	61
C-Index= 1			

As shown in Table 6.6, all the companies other than the six non-disclosers used the balance-sheet-date rate in translating transactions denominated in foreign currencies. For those companies that disclosed their policy, 100% used the rate applicable at the balance sheet date. The perfect convergence is reflected in the C-index (i.e., 1). Excluding the non-disclosers, the chi-square statistic could not be computed because the number of non-empty rows or columns is one. Likewise, all the 55 companies (except for the six non-disclosing companies) reported translation differences as profits or losses in the current period. Perfect convergence existed among the sample companies also in the treatment of translation differences.

(g) Leases by Lessees

FAS for the Leasing Industry stipulates that leases be treated as expenses unless criteria[88] are met for capitalisation. Like research and development costs, two categories were made for the sample companies in this study: operating lease only and capital/finance lease (including operating lease).

The following hypothesis was tested:

Ho7: There is no significant difference in the method of accounting for leases adopted by chaebol and non-chaebol publicly-listed companies.

Table 6.7
Accounting for Leases Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Operating only	12 (42.9%)	18 (54.5%)	30 (49.2%)
Capital/Finance	16 (57.1%)	7 (21.2%)	23 (37.7%)
Not disclosed	0 (0.0%)	8 (24.3%)	8 13.1%)
Total	28	33	61
X^2= 4.567	p= .0326	C-Index= 0.4993	

As shown in Table 6.7, a relatively lower C-index value of 0.4993 shows that the sample companies were approximately evenly distributed over operating and finance lease method. Excluding the 8 non-disclosing companies, the chi-square statistic was computed. The statistic (p= .0326) indicates that the proportion of companies using either method differed significantly across *chaebol* and *non-chaebol* companies. Presumably, *non-chaebol* companies were reluctant to adopt the finance method of accounting for leases since this method would increase the reported financial leverage and decrease reported earnings, which may adversely affect their ability to borrow. In contrast, *chaebol* companies, through their own sources, had less difficulty in financing and showed less reluctance to adopt the finance method.

(h) Marketable Securities

Under the 1994 FAS (Art. 92), marketable securities should be valued at purchase cost plus incidental expenses determined on the weighted average or moving average

[88] See Section 3.6.3.

method. If their market value has declined below cost, however, they should be recorded at market value. The following null hypothesis was tested:

Ho8: There is no significant difference in the valuation method for marketable securities adopted by chaebol and non-chaebol publicly-listed companies.

Table 6.8
Marketable Securities Valuation Practices in Korea

Methods	*Chaebol*	*Non-chaebol*	*Total*
Cost	14 (50.0%)	15 (45.5%)	29 (47.5%)
Lower of cost and market	14 (50.0%)	18 (54.5%)	32 (52.5%)
Total	28	33	61
X^2= .125	p= .7232	C-Index= 0.4921	

Table 6.8 shows a relatively lower degree of uniformity (0.4921) in the measurement of marketable securities. Despite the LCM requirement, approximately 48% of sampled companies valued marketable securities at cost. The use of the cost method can be attributed to the transition provision which deferred the implementation of LCM until further determination by the KSEC. In April 1996, however, the transition provision was lifted and LCM became an official requirement. The chi-square statistic (p= .7232) supports the null hypothesis that there is no statistically significant difference between *chaebol* and *non-chaebol* companies in the proportion of companies using each method in the valuation of marketable securities.

6.4.2 Conservatism

Differences in *chaebol* and *non-chaebol* companies were examined using a non-parametric Mann-Whitney U test. The test was used to check any statistically significant difference between these two groups in terms of the total degree of conservatism (i.e., Conservatism Index) in selected measurement items.

Table 6.9
Results of Mann-Whitney U Test for Group Differences (Conservatism)

Group	*Number of Companies (n)*	*Mean Rank*
Chaebol	28	30.27
Non-chaebol	33	31.62
Total	61	
Z-statistic= -.2986 p-value= .7653		

Table 6.9 does not support the existence of statistically significant (at p≤.01 and ≤.05) differences between *chaebol* and *non-chaebol* companies in terms of the overall degree of conservatism adopted for the fiscal year 1994. It also shows that *non-chaebol* companies adopted more conservative approaches than *chaebol* companies even though the result is not statistically significant (p= .7653).

Results from the regression analysis show the relationship between the overall degree of conservatism and each company-specific factor (Table 6.10).

Table 6.10
Results of Korean Measurement Model (Conservatism)

Variable	Estimated Coefficient	Standard Error	t-Statistic	p-value
Constant	1.50666	0.31336	4.808	<.001**
Size	0.05556	0.04864	1.142	.2583
Leverage	-0.02201	0.05661	-0.389	.6989
Chaebol	-0.07131	0.09441	-0.755	.4532
F-value= 0.44223 (p= .7237)	Adjusted R^2= -0.0297			

The adjusted R^2 (-0.0297) shows that the model does not have any power to explain the proportion of variation in the dependent variable (degree of conservatism). However, the multiple regression analysis here is concerned with the potential relationship between the dependent variable and each independent variable. The inclusion of additional variables in the model may account for better explanatory power.

Table 6.10 shows that the signs of the coefficients for both the size and the debt-to-equity variables are as expected (i.e., positive and negative, respectively), while the negative relationship between affiliation with *chaebols* and degree of conservatism is contrary to the initial expectation. However, the relationship between the degree of conservatism and each company-specific variable has been found not to be statistically significant at conventional levels (i.e., at $p \leq .01$ or $p \leq .05$).

6.5 LIMITATIONS

There are several limitations in this study of measurement practices. First, the C-index has no significance tests. However, this weakness is remedied to some extent by the chi-square test. Second, regarding the conservatism index, this study assumes equal spacing between categories and does not consider actual financial effects of applying each measurement item on profits. It is acknowledged that each measurement item has a varying degree of impact on reported profits. However, these measurement items are unweighted because of potential problems of scoring bias. Instead, each item is considered to carry the same weight in determining a company's reported earnings. Third, potential offsetting effects of combinations of accounting measurement items on reported profits are not considered. Fourth, non-disclosure items which are excluded for statistical tests may affect the findings significantly. Finally, the cross-sectional nature of this study provides only a limited understanding of Korean companies' measurement practices. For example, a company may engage in conservative approaches for the current year but non-conservative approaches in the future years. The trends obtained from a longitudinal study will provide useful insight into policy-making regarding harmonisation of measurement practices at both national and international levels.

6.5 CONCLUSION

The purpose of this chapter was to provide an overall picture of measurement practices of selected publicly-listed Korean companies in terms of uniformity and conservatism. The degree of uniformity was relatively high in all the areas covered, with the highest of 0.97 in inventory valuation and the lowest of 0.49 in marketable securities. Statistically significant differences between *chaebol* and *non-chaebol* companies (at $p \leq 0.01$ or 0.05) did not exist except in two measurement areas: depreciation method and accounting for leases.

As mentioned in Chapter III, FAS and Related Working Rules allow flexible accounting methods in various areas, including inventory cost determination and depreciation methods. However, most companies in the sample adopted uniform accounting methods in these areas. As for the inventory cost determination, only one company used the LIFO method with the remaining 60 companies employing a combination of cost flow methods strictly in accordance with the CTL. With respect to depreciation methods, all the companies adopted depreciation methods in accordance with the CTL. The study shows that accounting practices in Korea are still largely tax-driven.

With respect to the degree of conservatism, the Mann-Whitney U test reveals that *chaebol* companies have been found to adopt less conservative approaches than *non-chaebol* companies, contrary to the initial expectation. This result could be construed to mean that the *chaebol* companies, as active participants in international capital markets, adopted less conservative approaches to compete favourably for scarce capital. However, this result is not statistically significant ($p = .7653$) at conventional levels. The regression analysis shows results consistent with the initial expectations with respect to the size and degree of financial leverage, that is, positive and negative, respectively. In contrast, the negative relationship between the affiliation with *chaebols* and the extent of conservatism is contrary to the initial expectation. This result is consistent with the finding obtained from the Mann-Whitney U test. However, it should be noted that the relationship between the degree of conservatism and each company-specific factor is not statistically significant, suggesting that there may be other variables more important in determining measurement practices of Korean companies, such as philosophy of company founders, bonus plans for top management, and tax incentives.

The impact of different measurement practices on financial reports of individual companies is noted in international accounting literature (Choi *et al.* 1983). The relatively high degree of uniformity and conservatism in measurement practices has been essential in accomplishing government policy of economic development at an earlier stage and is still a common feature in Korea. However, with the inevitable shift towards a more micro-user oriented financial reporting system, less adherence to strict conservatism is expected, as realised already to some degree in the 1996 FAS. Measurement practices that are in conformity with IAS and US standards will continue to be emphasised and even be required to enhance the comparability and usefulness of financial reports of Korean companies in international capital markets.

CHAPTER VII
SUMMARY AND CONCLUSIONS

7.1 INTRODUCTION

The diversity revealed by prior research in comparative international accounting is captured by three essential elements comprising a country's financial reporting system, i.e., broad aims, institutional environment of financial reporting regulation, and detailed financial reporting rules and practices. It has been suggested that differences and similarities in these three elements are influenced by various national environmental factors.

This thesis sought to analyse the extent to which the above assertion was supported in the case of Korea's financial reporting system. Factors in Korea's national environment that influenced the three elements of its financial reporting system were a particular focus of attention. The ways these factors shaped the Korean financial reporting system and their likely impact on the future development of Korea's financial reporting system were studied also.

A twofold methodology was employed. First, the historical development and current state of financial reporting in Korea were described comprehensively (Chapter III, V, and VI) to identify distinctive features of its financial reporting system and furthermore, to facilitate comparisons, presumably with those of other NIEs, OECD members, or LDCs. Second, Korea's financial reporting system was analysed in relation to the company- and nation-specific factors perceived to be important in shaping the country's financial reporting system (Chapter IV, V, and VI) to provide evidence regarding how and why a peculiar system has evolved in Korea as it has.

This chapter summarises findings of the descriptive and explanatory analyses of Korea's financial reporting system (Section 7.2). Contributions to accounting research, theory and practices and policy implications are discussed (Section 7.3). This chapter also suggests areas for future research (Section 7.4) and provides an overall conclusion of this thesis (Section 7.5).

7.2 SUMMARY OF FINDINGS

7.2.1 Broad Aims

The first modern Korean financial reporting system (1958) adopted a macro-user orientation. This orientation was evidenced in the strong influences of tax laws on accounting practices and in the emphasis on accountability as the objective of financial reporting under accounting standards promulgated by government agencies. However, this macro-user perspective to accounting is shifting to a micro-user view of accounting adopted in most Anglo-North American countries. Particularly since the 1980s following the increasing internationalisation of financing activities, a "decision-usefulness" objective of financial reporting has been emphasised. This "decision-usefulness" objective adopted in FAS will continue to gain increasing significance with further liberalisation and internationalisation of Korea's capital market.

The development and sophistication of Korea's capital market has been influential in engendering the shift to a micro-user oriented view of accounting. Korean companies traditionally relied on indirect financing (debt financing), but it did not provide sufficient capital to continue the country's rapid economic growth. Consequently, the equity market has been promoted by government since the late 1960s through financial and tax support for listed companies. This government policy has resulted in the second largest stock market in Asia in terms of number of listed companies. As such, adequate disclosure of corporate information useful for investors' decision making is becoming increasingly important in enhancing the competitiveness of Korean companies in seeking capital in domestic and international capital markets.

7.2.2 Institutional Environment

Since the first modern accounting standards were promulgated in 1958, financial reporting regulation has always been government-dominated. Government agencies (MOF and KSEC) have been responsible ultimately for promulgating and enforcing accounting standards in the country. Prior to the early 1980s, government representation on accounting standards-setting bodies was pronounced, comprising 75 per cent of the body in 1958. Government agencies also had powers to allocate audit jobs among CPAs.

Strong government involvement in financial reporting regulation was possible because of Korea's unique environment. First, the nature of domestic capital markets and the scarcity of capital shifted the balance of power toward the government. Through control over capital allocation, the government clearly enjoyed its superior relationship with the private sector. Second, deep-rooted Confucian values shared by the Korean population provided a basis for government involvement. The government has been perceived as an active, moral agent in the country's development.

Despite the ultimate authority of government agencies, private-sector participation (i.e., academia, industry and KICPA) in accounting standard setting began to grow from the early 1980s, with current private-sector representation on ASAC comprising 75 per cent. The audit environment also changed to a market-directed system from government allocation.

Most importantly, increasing private-sector participation can be attributed to the change in the power relationship between the government and the business sector. Following the liberalisation of the country's capital market in the 1980s, Korean enterprises increasingly relied on direct financing through the securities market and consequently, the role of government as a financier lessened substantially. Second, the huge influx of US-educated economists and accounting scholars also created a group with a vested interest in maintaining their influence on policy making process. A market-based economy rather than a heavily regulated economy was advocated by these US-educated technocrats and scholars for sustainable further industrialisation of the country.

7.2.3 Detailed Rules and Practices

(a) Disclosure rules and practices

The ownership structure of business enterprises, particularly *chaebols*, has influenced Korea's financial reporting system in regard to disclosure of financial information to external users. Financial reporting has been regarded by most *chaebols* just as a legal formality to preclude further scrutiny and adverse government regulation, rather than as a means to provide information useful to external users.

With more diffuse ownership following the development of Korea's capital market, the demand for adequate information disclosure has been heightened. Especially, disclosure requirements stipulated by the KSE comprise detailed non-financial and financial information. The growing importance of social responsibility and employee accounting is reflected in the 1996 amendment.

The analysis of disclosure practices of selected publicly-listed companies indicates that the extent of disclosure is influenced by various corporate factors. Among the variables under study, only size and the degree of profitability have been found to show a statistically significant relationship (positive) to the disclosure level. The sign of the coefficients for the degree of financial leverage and the affiliation with *chaebols* is positive as expected, while the negative relationship between the affiliation with the Big-Six and the extent of disclosure is contrary to the initial expectation. However, the results regarding these three variables (i.e., degree of financial leverage, affiliation with *chaebols*, affiliation with Big-Six) are not statistically significant at conventional levels ($p \leq .01$ or $p \leq .05$). Overall, size has been found to be the most powerful explanatory variable in determining the level of disclosure by Korean companies, which is supported also by prior studies.

(b) Measurement

Conservative approaches to asset valuation and profit measurement have been a predominant feature in Korea. The emphasis on conservative and prudent accounting methods is linked closely to providers of capital. When the country's capital market was less developed, bank loans guaranteed by government were a major source of capital for business enterprises, so protection of creditors was considered an important function of financial reporting. Tax influences on measurement practices have been strong also. Accounting practices have been motivated frequently to minimise tax liabilities.

However, since the 1980s, increasing demand for "comparable" information has resulted in vigorous adoption of US standards and IAS in Korea. Accordingly, less conservative approaches are allowed in order to reflect the economic reality of business transactions better. Continuous efforts to bring Korean accounting standards into harmony with IAS have been made by Korea's regulatory bodies even though Korea has still its country-specific accounting provisions, such as upward revaluation of tangible fixed assets.

Korean companies have been found to use quite uniform accounting methods, with the highest degree of uniformity being 0.9672 in inventory valuation and the lowest of 0.4921 in marketable securities. The study of measurement practices of selected publicly-listed companies indicates that there is no statistically significant relationship between each company-specific variable and the degree of conservatism. These results suggest that there may be other variables (possibly, non-financial) more important in determining the degree of conservatism of Korean companies. However, the direction for the two variables (i.e., size and degree of financial leverage) is positive and negative, respectively, as expected even though the sign of the coefficient for the affiliation with *chaebols* is negative, contrary to the initial expectation.

7.3 CONTRIBUTIONS AND POLICY IMPLICATIONS

7.3.1 Contributions

(a) Accounting Theory and Research

Contributions to accounting theory emerging from this thesis relate to enhancing extant understanding of accounting development in different national contexts. The theoretical framework proposed for describing and explaining Korea's financial reporting system facilitates comparative study in accounting because the framework provides a comprehensive description and explanation of national financial reporting systems.

To provide explanations regarding how and why a particular financial reporting system has evolved in Korea, this thesis draws primarily from a functional research paradigm which has been adopted by most current research in comparative international accounting. So the findings obtained could be used as a benchmark against which findings from studies of other countries' financial reporting systems (e.g., NIEs, OECD members, and LDCs) could be compared. This comparison helps to identify environmental factors equally important in shaping national financial reporting systems.

(b) Accounting Practice

Information users, particularly foreign investors could benefit from knowledge regarding the nature and extent of financial reporting practices in Korea. Since 1992, foreign investors have been allowed to invest directly in stocks of Korean companies. The findings from this study could help these investors interpret Korean financial statements better because the interpretation of financial statements requires understanding of the environment from which accounting numbers are derived. This thesis discusses the institutional and environmental context which engenders specific accounting rules and practices in the country.

7.3.2 Policy Implications

(a) Continued Government Support for Financial Reporting Regulatory Process

In contrast to suggestions by Gonedes and Dopuch (1974), Benston (1980) and Dye (1985), government intervention has been effective in improving the quality of financial reporting and is still suggested to improve compliance with reporting requirements because financial reporting practices have been influenced frequently by individual companies' tax and investment motives. It is essential that government agencies continue to be given explicit authority to enforce financial reporting standards and relevant legal requirements because it is insufficient merely to specify reporting requirements of companies (Craig and Diga 1996a, p. 249).

(b) More Transparent Standard Setting Process

Despite the advantage of enhancing compliance with regulatory requirements, government-directed financial reporting regulation in Korea has been easily subject to political pressures from interest groups with power. To mitigate these political pressures, more transparent standard setting processes similar to the due process adopted in the US and Australia are suggested so that diverse interest groups, including the information user group can participate in the process directly or indirectly. This due process can increase industry acceptance of, and compliance with, reporting standards in Korea. Increasing Western influences, especially US influences on Korean society, have brought changes in cultural values. Individual freedom and competition are replacing long-cherished values of group harmony and interests. These changes appear to make the adoption of more transparent standard setting processes appropriate in Korea's extant environment.

(c) Active Private-Sector Participation

Active participation in financial reporting regulation by the professional accounting body may be inevitable to respond to the needs of rapidly-changing capital markets. With the increasing importance of audit quality and independence, the social status of the professional accounting body in Korea will be improved. The accounting profession is expected to further expand in size and expertise and to evolve as a well-organised private organisation to which responsibility for formulating and implementing financial reporting standards can be delegated to some degree.

(d) Continuous Legislative Support

Legislative influences have played a significant role in moulding financial reporting in Korea. The SEL, EAL and other pertinent laws specify financial reporting requirements and also provide a legal status to financial reporting standards promulgated by government agencies (i.e., KSEC) to enhance the quality of financial reporting. Continuous legislative support is needed to improve the quality of Korea's financial reporting. However, the consistency and harmony among pertinent laws and regulations need to be considered to improve financial reporting practices of Korean companies.

(e) Adoption of International Accounting Standards (IAS)

Increasing interdependence with the world economy has prompted Korea to bring Korean reporting standards into harmony with IASC pronouncements (Yoo 1995). However, to the extent that accounting is culture-specific, careless and uncritical adoption of IAS primarily consistent with developed Anglo-North American countries may create practical difficulty in implementing them, as indicated in Chun (1995) concerning the adoption of IAS consolidation rules in Korea. Careless and unsolicited intervention in the Third World accounting system often causes more problems than the current level of development in these countries can deal with (Ndubizu 1984; Goodrich 1986). The appropriateness of IAS to Korea's social, cultural, political, economic, and technological environment, therefore, should be considered for their efficient implementation in Korea.

7.4 SUGGESTIONS FOR FUTURE RESEARCH

This study provides both descriptive and explanatory analyses of Korea's financial reporting system using the framework comprising three essential elements of the system. The study is quite comprehensive in that it has taken a historical approach to identify the characteristics of the country's system and to relate them to the country's unique national environmental factors.

Starting from this comprehensive study, a logical and promising area for future research would be a study of specific areas, such as on financial reporting of *chaebols*. In spite of the significant concentration of wealth and economic power in a small number of *chaebols*, very little attention has been paid to their financial reporting practices. Considering the role of the *chaebols* in Korea's stunning economic growth, a study of financial reporting of the *chaebols* will provide useful insight to future policy making regarding Korea's financial reporting regulation. As part of such a study, the historical emergence and development and the unique management system of the *chaebols* may be discussed. In addition, their international management control could be studied because the exchange of information (including financial information) between head office and subsidiary management plays a crucial role in co-ordinating and controlling multinational operations. This international management control is particularly important with increasing direct investment of the *chaebols* in a range of host countries, especially in developing countries. Results obtained from this study may provide policy suggestions which will contribute to sustainable economic development in Korea.

Another area for future research would be a comparative study of North East Asian economic powers (Japan, Korea and Taiwan) to identify any differences and similarities in financial reporting systems and the roles of accounting in those countries' economic success. The initial economic, cultural and geographical proximity between these countries will provide both interesting and informative theories to the existing literature of international accounting. Particularly, findings on the roles of accounting in those countries' remarkable economic achievement will present useful benchmarks against which developing countries' policies can be compared. Similar approach could be applied to a comparative study of financial reporting of four NIEs (i.e., Korea, Taiwan, Hong Kong, and Singapore).

7.5 OVERALL CONCLUSION

The assertion that Korea's financial reporting system is a product of its distinctive political, economic and socio-cultural environment is supported strongly by evidence provided in this thesis. The country's financial reporting system currently contains both macro-user and micro-user orientation, with an increasing shift towards a micro-user oriented view of accounting. The shift to a micro-user orientation has occurred as a response to the changing needs of domestic and international capital markets which demand corporate information useful for investors' economic decision making.

Despite the change in user orientation, government-directed financial reporting regulation is likely to continue in Korea to improve the quality of financial information given the unique tax-driven financial reporting practices. Government regulation should be used as a means to control rapidly increasing political and economic power of the private business sector, particularly *chaebols*. National environmental factors as well as international influences will continue to shape the country's financial reporting system. It is hoped that this thesis enhanced extant understanding of accounting development in different national contexts.

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Appendix 1A

Differences between Tax Rules and Accounting Rules in Korea

REASONS	ACCOUNTING	TAXATION
LEGISLATION	**Fair presentation for information users**	**Promotion of or restriction on business activities**
i) Reserves (eg. reserves for overseas market development, export losses and technology development; investment by a small- and medium-sized firms; emergency risk; securities transaction loss)	i) not recognised as expenses	i) recognised as expenses
ii) Contributions and Entertainment expenses	ii) Entire amount recognised as expenses	ii) recognised as expenses within prescribed limits
TIMING DIFFERENCES	**Realisation and Accrual Basis**	**Settlement of Rights and Obligations Basis**
i) Bad debts	i) Estimated based on past experience, etc; applicable to any types of receivable	i) 2% of total outstanding for finance industry; 1% for other industries; limited to receivable from operations
ii) Construction-type contracts (long-term)	ii) Completed method, in principle; percentage of completion, allowed	ii) Percentage of Completion method required
iii) Instalment sales	iii) Recognised when goods delivered or services rendered except for long-term sales	iii) Recognised when instalment is made
CONCEPT OF PROFITS	**Distinction between Capital and Operating Transactions**	**No distinction between Capital and Operating Transactions**
i) Gains on donated assets and Gains on forgiven liabilities (capital nature)	i) Treated as capital surplus when used for capital recovery; otherwise, revenue	i) Gains from capital transactions left after recovery of carried-over losses treated as revenue
ii) Government subsidies, Contributions for construction and Gain on insurance settlement of capital nature	ii) Treated as capital surplus	ii) Included in income but immediate write-off allowed when received under the Subsidy Management Law
SOCIAL JUSTICE IN ECONOMIC CALCULATION	**No emphasis on social justice**	**Emphasis on social justice**
i) Unfair transactions (eg. gains from transactions with related parties)	i) Not included in income	i) Included in income and taxed
ii) Fines, interest on late payment of taxes	ii) Treated as expenses	ii) Not deductible as expenses
OTHERS		
i) Allowance for severance benefits	i) Entire liability for severance benefits are deductible	i) Only 50% of total liability deductible; 100% allowed for group severance benefits
ii) Fixed assets acquired through long-term instalment payment	ii) Present value allowed; interest excluded from acquisition cost; interest exp. incurred after acquisition is recognised as interest expense	ii) Present-value not allowed; interest added to acquisition cost; interest incurred after acquisition cost and then depreciated
iii) Allowance for special repairs	iii) Entire amount deductible	iii) Deductible within limits

Source: FAS and FAS Working Rules (1994), Nam (1994), Kang (1995), and CTL (1994)

Appendix 1B

Connections between Tax Rules and Accounting Rules in Korea

AREAS	ACCOUNTING	TAXATION
Depreciation	Method: straight-line, declining balance; units of production and other reasonable method Special depreciation under the Tax Exemption and Reduction Control Law (TERCL) and the CTL was incorporated in FAS; however, special depreciation under the TERCL was deleted from 1994 FAS	Method: specific method for each category of fixed assets Useful life, residual value, depreciation rates are specified Depreciation expenses should be recorded in financial statements to be deductible for tax purposes
Fixed asset valuation	Revaluation allowed pursuant to the Asset Revaluation Law when criteria are met; otherwise, historical cost basis Revaluation increment not included as income	Revaluation allowed based on the Asset Revaluation Law when criteria met; otherwise, historical cost basis Revaluation increment not included as income
Inventory Valuation	Valuation: cost or lower of cost and market (LCM) Flow assumptions: several methods available	Valuation: cost, market, or LCM Several flow assumptions allowed
Research and Development	Expensed or Capitalised depending on nature (when capitalised, amortised within 5 yrs.)	If non-recurring, then deferred and amortised within 5 years; otherwise, expensed.
Other deferred charges (e.g., org. costs, new stock issue costs, etc.)	Deferred and amortised within certain period in equal amounts	Deferred and amortised within certain period in equal amounts
Foreign currency translation/transactions	Included in current income/loss	Included in current income or loss
Leasing	Expensed or capitalised depending on nature	Expensed or capitalised depending on nature
Interest on borrowings for construction of assets	Not treated as expense; should be added to the cost of relevant assets and depreciated	Not treated as expense; added to relevant assets and depreciated

Source: FAS and FAS Working Rules (1994), CTL(1990), and CTL (1994)

Appendix 2

FINANCIAL REPORTING REGULATION
Disclosure Requirements Checklist- FAS and FAS Working Rules

BROAD REQUIREMENTS
General Disclosures
General information of business enterprises
Information on operations
Major business segments
Significant changes in management environment and policies
Balance sheet
Consolidated balance sheet
Income statement
Consolidated income statement
Statement of appropriations of retained earnings (or disposition of deficits)
Consolidated statement of appropriations of RE (or disposition of deficits)
Cash flow statement
Consolidated cash flow statement
Comparative statements
Overall valuation policy
Footnotes and parenthetical disclosure
Supplementary Schedules
Schedule of retained earnings
Schedule of cost of goods manufactured
Schedule of marketable securities
Schedule of assets and liabilities relating to affiliated companies
Schedule of receivable and payable from/to stockholders, directors and employees
Schedule of inventories
Schedule of investments in real estate
Schedule of tangible fixed assets
Schedule of intangible fixed assets
Schedule of short-term fixed assets
Schedule of long-term fixed assets
Schedule of debentures
Schedule of allowances
Schedule of depreciation
Schedule of income taxes
Schedule of sales
Schedule of selling and general administrative expenses
Schedule of cost of goods sold
REQUIREMENTS ON SPECIFIC ACCOUNTS
Cash
Amount- Cash and Bank deposits
Nature of restrictions on cash and bank deposits
Marketable Securities
Amount- Cost (acquisition)
Amount- Market value
Amount- Marketable securities
Amount- Allowance for marketable securities valuation
Amount- Loss from securities valuation
Amount- Reversal of allowance for securities valuation (applies also to long-term)
Amount- Gain (loss) on disposal of marketable securities
Amount- Interest income on securities
Valuation method (cost, LCD, market value, etc.)
Policy on determining cost
Details on the difference between cost and market value

Appendix 2 (Continued)

Receivable- Current
Amount- Receivable (trade)
Amount- Factoring (with recourse)
Amount- Notes discounted or endorsed
Amount- Short-term loans
Amount- Loans represented on notes
Amount- Other receivable
Amount- Allowance for doubtful accounts
Amount- Bad debts
Amount- Reversal of allowance for doubtful accounts
Amount- Unusual bad debt expense
Amount- Interest and discount income (expense)
Amount- Income from recoveries of bad debts
Amount- Accrued income
Policy on valuation
Policy on computing allowance
Description of discounted or endorsed notes
Inventories
Amount- B/S amount
Amount- Fair market value or net realisable value
Amount- Major classes (finished goods, semi-finished, work-in-process, raw materials, supplies, etc.)
Amount- Loss from valuation of inventories
Amount- Loss from inventory obsolescence
Amount- Gain (loss) from disposal
Policy on valuation (e.g. cost, market or LCD)
Policy on flow of costs
Other current assets
Amount- Advance payments
Amount- Prepaid expenses
Amount- Other current assets
Amount- Treasury debentures acquired for resale
Amount- Total current assets
Reason for the acquisition of treasury debentures and other relevant information
Investments (long-term)
Amount- Long-term deposits
Amount- Investment securities
Amount- Investments other than joint-stock companies
Amount- Equity securities of affiliated companies (joint-stock)
Amount- Bond securities (Debentures) of affiliated companies (joint-stock)
Amount- Investments in affiliated non-joint stock companies
Amount- Investments in real estate
Amount- Other investments
Amount- Allowance for investment securities valuation
Amount- Cost (acquisition cost)
Amount- Market value
Amount- Loss from valuation of investments
Amount- Dividend income (cash)
Amount- Stock dividend income
Amount- Gain on disposition of preemptive rights to new shares
Amount- Loss (gain) on disposal of investments
Policy on valuation basis
Policy on determining cost
Details on investment in real estate
Details on the difference between historical cost and market value

Other Assets (long-term)
Amount- Loans
Amount- Receivable (trade)
Amount- Discount to present value
Amount- Loans to stockholders, directors, and employees
Amount- Loans to affiliated companies
Amount- Restricted cash and bank deposits
Amount- Rights (by categories)
Amount- Guarantee deposits (by categories)
Amount- Allowance for doubtful accounts
Amount- Dishonoured notes receivable
Amount- Other assets
Amount- Total investment and Other Assets
Policy on valuation
Policy on computing allowance
Tangible Fixed Assets
Amount- Land
Amount- Building
Amount- Accumulated depreciation
Amount- Depreciation expense
Amount- Machinery and equipment
Amount- Other categories of fixed assets
Amount- Construction in progress
Amount- Nominal value of assets acquired on instalment purchases
Amount- Present value of assets acquired on instalment purchases
Amount- Capitalised borrowing costs
Amount- Gain (loss) from disposal of fixed assets
Amount- Depreciation expense
Amount- Special depreciation
Context in which borrowing costs are capitalised
Discount rate, period, accounting method for long-term instalment transactions
Policy of depreciation
Policy on valuation
Intangible Fixed Assets
Amount- Goodwill
Amount- Major categories
Amount- Total fixed assets
Amount- Amortisation of intangibles
Amount- Total fixed assets
Policy on valuation
Policy on depreciation
Research and Development Costs
Amount- R&D costs (unamortised)
Amount- Amortisation of R&D
Amount- Regular R&D expenses
Amount- Development expenses
Amount- R&D of fixed assets when schedule of fixed assets is prepared
Schedule of R&D expenditures
Policy on capitalisation of R&D expenditures
Policy on method of amortisation
Deferred Charges
Amount- Major categories (organisation, preoperating, bond/stock issue costs)
Amount- Amortisation by categories
Amount- Total deferred charges
Amount- Total assets
Policy on amortisation
Valuation of deferred charges

Current Liabilities
Amount- Bank overdrafts Amount- Accounts and notes payable (trade) Amount- Borrowings Amount- Borrowings represented on notes Amount- Accounts payable (other) Amount- Payable represented on notes Amount- Advance receipts (unearned revenues) Amount- Withholdings Amount- Accrued expenses Amount- Income taxes payable Amount- Borrowings from affiliated companies Amount- Borrowings from stockholders, executives and employees Amount- Current portion of long-term debt Amount- Reserves for liability in nature Amount- Other current liabilities Amount- Interest/discount Amount- Total Current Liabilities Policy on liabilities reserves (accrued severance pay, reserve for repairs/maintenance, product warranties, and guarantees)
Long-Term Liabilities
Amount- Bonds (by type) Amount- Discount or premium on bonds issued) Amount- Long-term debt Amount- Long-term borrowings from affiliated companies Amount- Long-term borrowings from stockholders, executives, and employees Amount- Long-term notes payable Amount- Discount to present value Amount- Reserves for liability in nature Amount- Other long-term liabilities Amount- Gain (loss) on redemption of debentures Amount- Interest expense on debentures Amount- Total long-term liabilities Amount- Total liabilities Type of debentures Terms of debentures
Capital Stock
Amount- Categories (common, preferred) Amount- Par value Amount- Credit to capital surplus from stock subscriptions Amount- Payments received for stock subscriptions Amount- Total capital stock Number of shares authorised, issued and outstanding Changes in capital stock (additional stocks issued, retired capital stock, stock dividends, etc) Due date for payment of stock subscriptions Number of shares to be issued through stock subscriptions Details on interlocking shares and other shares which carry voting right restrictions
Capital Surplus
Amount- Paid-in capital in excess of par value Amount- Excess of par value over amount paid of retired capital Amount- Excess of business combination value over par value Amount- Other capital surplus (includes government subsidies and aids for capital expenditures; gain from insurance settlements of fixed assets, capital contributions in kind and liabilities condoned; gain on sale of treasury stocks; and consideration for convertible rights or stock warrants if exercised) Amount- Capital reserves Amount- Revaluation surplus Amount- Total capital surplus

Appendix 2 (Continued)

Retained Earnings (or Deficits)
Amount- Legal reserve
Amount- Other statutory reserves (includes reserve for industry rationalisation, financial structure improvement, etc)
Amount- Voluntary reserves (include reserve for business expansion, sinking funds, dividend equalisation, deficit recovery, etc)
Amount- Reserve for others
Amount- Unappropriated retained earnings applicable to prior years before adjustment of prior period gain or loss (undisposed deficit applicable to prior years before adjustment of prior period gain or loss)
Amount- Gains from prior period adjustment
Amount- Loss from prior period adjustment
Amount- Unappropriated retained earnings (or undisposed deficit) applicable to prior years after adjustment
Amount- Net income for the year (on net loss for the year)
Amount- Unappropriated retained earnings at the end of year (or undisposed deficit)
Capital Adjusting Accounts
Amount- Discounts on stock issued (to be subtracted)
Amount- Prepaid dividends during preoperating period (to be subtracted)
Amount- Treasury stock (to be subtracted)
Amount- Consideration for conversion rights (if not exercised)
Amount- Consideration for stock warrants (if not exercised)
Amount- Foreign-based operations translation debit (credit)
Amount- Total stockholders' equity
Reason for the acquisition of treasury stocks
Management's future plans for such treasury stocks
Income Statement
Amount- Sales
Amount- Cost of sales
Amount- Gross Profit (or Loss)
Amount- Selling and general administration
Amount- Officers salaries and allowances
Amount- Operating income (loss)
Amount- Non-operating income
Amount- Non-operating expenses
Amount- Ordinary income (loss)
Amount- Special gains
Amount- Special losses
Amount- Income before income taxes
Appropriations
Amount- Transfers from voluntary reserves
Amount- Legal reserve
Amount- Other statutory reserves
Amount- Cash dividends
Amount- Stock dividends
Amount- Proportion of common (and preferred) stock
Amount- Voluntary reserves (include business expansion, redemption of debts, dividend equalisation)
Amount- Reserve for others (amortisation of discount on capital stock or preoperating dividends)
Amount- Unappropriated retained earnings to be carried forward to next year
Amount- Capital surplus or retained earnings appropriated to reduce accumulated operating loss within two years prior to deficit reduction
Description o appropriate appropriation used for deficit reduction
Date of shareholders' approval of appropriation for deficit reduction
Details on computation of dividends

Appendix 2 (Continued)

Dispositions
Amount- Transfers from voluntary reserves Amount- Transfers from other statutory reserves Amount- Transfers from legal reserve Amount- Transfers from assets revaluation surplus Amount- Transfers from capital reserves Amount- Deficit to be carried forward to next year
Leases
Amount- Operating leases Amount- Next five-year payments (annual) Amount- Payments over the remaining period after five years Amount- Capital or finance-type leases by asset classes Amount- Minimum lease payments (annual- for the next five years) Amount- Minimum lease payments over the remaining period after five years Amount- Lease liabilities under capital lease Amount- Depreciation expense for assets under capital lease Amount- Future lease payments for operating leases denominated in foreign currency Amount- Exchange rate at the lease recognition rate Amount- Exchange rate at the B/S date Amount- Difference in lease payments due to exchange rate fluctuation Amount- Disposal price and book value of leases after sales (sales-leaseback) Amount- Future lease payments for sales-leaseback Amount- Related assets and liabilities Accounting for leases Nature of related assets and liabilities Contents for sales-leaseback Significant financing restrictions (dividends, additional lease, etc)
Accounting Changes
Amount- Effect of change in accounting principles on current period financial statements Amount- Effect of change in accounting estimates on current period financial statements Description of change in accounting principles Description of change in accounting estimates Reason for change in accounting principles Reason for change in accounting estimates
Prior Period Adjustment
Amount- Net income (loss) for prior period after adjustment Nature of adjustment Reason for adjustment
Transactions with Related Parties
Amount- Significant transactions with related companies Amount- Transactions with directors, officers and stockholders Names of affiliated companies Assets and liabilities related to affiliated companies Nature of transactions with affiliated companies Names of related companies Nature of significant transactions with related companies Nature of transactions with directors, officers and stockholders
Contingencies
Amount- Possible outcome of pending obligations Amount- Contingent liabilities Nature of pending obligations Description of contingent liabilities Collateral provided by company, affiliates, third parties, vice versa Guarantees issued by company, affiliates, third parties, vice versa
Post Balance Sheet Events
Nature of significant events occurring after B/S date
Revenue Recognition
Accounting policies on revenue recognition

Appendix 2 (Continued)

Extraordinary or Unusual Items
Amount- Effect of natural disasters, strikes, accidents, etc.
Amount- Gain from donated assets, condoned liabilities, insurance settlement
Nature of natural disasters, strikes, accidents, etc.
Segment Reporting
Amount- Sales by business segment
Amount- Cost of sales by business segment
Business Combinations
Amount- Price for combination and ownership interest
Name, executive director, operations, and relationship of combined company with combining company
Number of interlocking shares and percentage of ownership in each other
Comparative summary balance sheet and income statement of combined company
Date of decision, shareholders' approval, and actual (effective) combination
Method of valuation of assets and liabilities of combined company
Description of difference between book value of assets and liabilities of combined company and their fair value
Descriptions on computing goodwill or gain on business combinations
Other important issues
Foreign-Currency Translations
Amount- Gain (loss) from foreign exchange conversion (transactions)
Amount- Gain (loss) from foreign currency translation
Amount- Overseas translation debits (credits)
Currency translation method
Details of foreign-currency assets and liabilities
Details of gain (loss) on foreign currency translation
Details of translation gain (loss) of foreign operations (i.e., overseas translation debits (credits))
Earnings Per Share
Amount- Earnings per share
Basis of calculation
Severance and Retirement Benefits
Amount- Legal liability for severance and retirement benefits
Amount- Book balance of severance and retirement benefits
Amount- Payment of severance liability
Amount- Provision for severance indemnities
Accounting treatment of severance and retirement benefits for directors

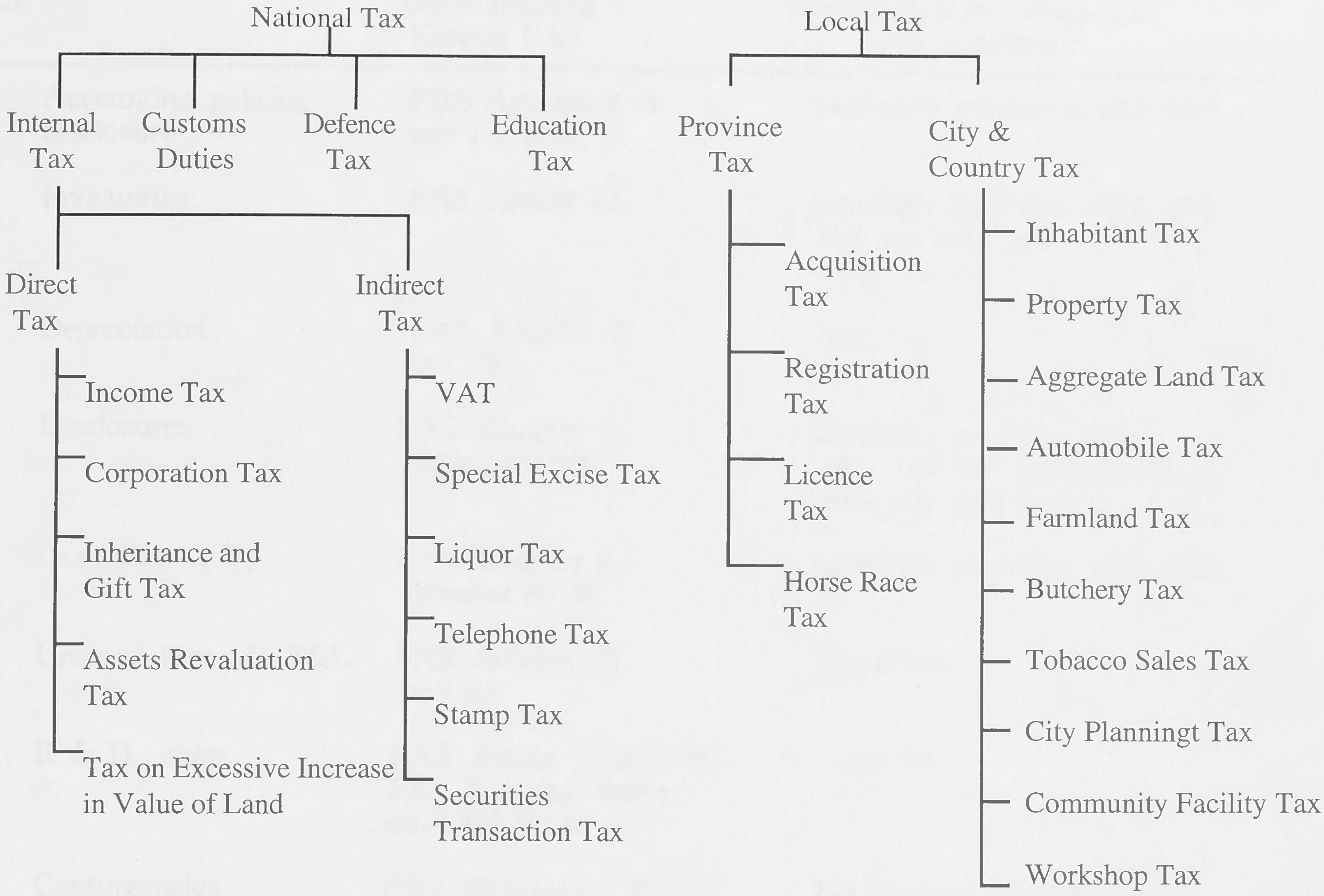
Appendix 2 (Continued)

Consolidated Financial Statements
Amount- Investment in each class of share capital of subsidiaries
Amount- Minority interest in equity of consolidated companies
Amount- Minority interest in group income (income and loss)
Amount- Material intercompany balances not eliminated
Amount- Subsidiary interest in equity in parent company
Amount- Amortisation (reversal) of consolidation debits (credits)
Amount- Effects of changes in accounting policies
Amount- Consolidated net income (loss)
Amount- Consolidated EPS
Subsidiary financial statements (if fiscal periods are different; however, if the difference is less than 3 months, then not required)
Details of consolidated subsidiaries (name, executive director, ownership interest, activities, reasons included etc.)
Details of unconsolidated subsidiaries
Changes in entities included for consolidation (names and contents)
Description of operations of subsidiaries and parent and transactions between parent and subsidiaries
Reasons for and effects of changes in accounting policies on consolidated financial statements
Policy on eliminating intercompany balances
Contents of amortisation and reversal of consolidation debits (credits)
Policy on eliminating unrealised gain/loss on intercompany transactions
Contents of changes in both parent and subsidiaries' statements
Collateral/Guarantees between consolidated companies
Changes in consolidated capital surplus
Significant transactions between consolidated companies
Important events occurring until the date of consolidation after the B/S date of subsidiaries
Income Taxes
Amount- income taxes
Schedule of income taxes
Asset Revaluation
Amount- Net book value by asset category before revaluation
Amount- Revalued amount
Amount- Revaluation increment
Accounting for revaluation increments
Date of revaluation
Approval date by authorities
Accounting date by authorities
Date of revaluation
Insurance Coverage
Amount- Respective insurance coverage
Assets insured
Cash Flow Statement
Amount- net cash from operating activities
Amount- net cash from financing activities
Amount- net cash from investing activities
Amount- net effect on cash and cash equivalents
Amount- beginning balance of cash
Amount- ending balance of cash
Details on non-cash transactions
Difference in and content of cash & cash equivalents and cash & bank deposits
Items to be added to or deducted from net income or loss when direct method is used (or)
Items to be added to or deducted from net income or loss when indirect method is used

Sources: FAS and FAS Working Rules (1994)

Appendix 3

CURRENT KOREAN TAX SYSTEM



Source: Kim and Kim (1990), pp. 6-7.

Appendix 4

CONFORMITY OF KOREAN FAS WITH IAS

IAS		Corresponding Korean FAS	Non-conforming items and other comments
1	Accounting policies disclosure	FAS Articles 3, 5 and 84, para. 3	Generally conforms with IAS.
2	Inventories	FAS Article 67	Generally conforms with IAS, but see note (a).
4	Depreciation	FAS Articles 21 and 70	Note (b).
5	Disclosures	FAS, Chapter 7, Articles 92-94	Generally confoms with IAS, but see Appendix B. Also see note (c).
7	Cash flow	FAS, Chapter 6, Articles 85-91	Generally conforms with IAS.
8	Unusual items in P&L	FAS Articles 60 and 84	Note (d).
9	R & D costs	FAS Article 72 item 5 FAS Working Rules on R&D Costs	Note (e).
10	Contingencies	FAS, illustration 98-140	No national requirement on subsequent event, but practice generally conforms with IAS.
11	Construction contract	FAS Article 42 FAS for Construction Industry	Note (f).
12	Taxes	FAS Article 61	Note (g).
13	Current assets	FAS Articles 14-17 and Article 26	Generally conforms with IAS.
14	Segments	-	No national requirement and practice generally does not conform with IAS.
15	Changing prices	FAS Article 65	Note (h).
16	Property, plant & equipment	FAS Articles 64-65 and Article 70	Generally conforms with IAS.
17	Leases	FAS on Leases	Generally conforms with IAS.
18	Revenue recognition	FAS Article 42	Generally conforms with IAS.

19	Retirement benefit costs	FAS Article 47-2	FAS differs in many respects with IAS due to differences in pension system. See note (i).
20	Government grants	FAS Article 79	Generally conforms with IAS.
21	Exchange rate change	FAS Articles 76 and 77	FAS conforms in all material aspects with IAS.
22	Business combinations	FAS Working Rule on Business Combination	FAS conforms in all material aspect with IAS. However there is a difference in accounting for negative goodwill. Note (j).
24	Related party	-	No explicit FAS is available, but practice generally conforms with IAS.
25	Investments	FAS Article 68	Note (k).
26	Retirement plans	-	There is no FAS on retirement plans.
27	Consolidation	FAS on Consolidation, FAS Working Rules on Consolidation	FAS conforms in all material aspects with IAS.
28	Associaties	FAS Article 68 and FAS on Consolidation	Note (l).
29	Hyperinflationary economies	-	There is no FAS on hyperinflationary economies.
30	Banks	Guidelines on Accounting for Financial Instititutions	Practice generally conforms with IAS.
31	Joint ventures	-	There is no FAS on joint ventures.

Notes:

(a) FAS requires that the loss arising from inventory valuation using the lower-of-cost-of-market rule should be recorded as a direct reduction of inventory book values.

(b) FAS requires that the useful life of a depreciable asset should be estimated, but service life as specified in the Tax Law is commonly used for accounting purposes.

(c) FAS proposes a particular format for the primary financial statements, which should be prepared in a report form. The balance sheet, however, may be in a T-account form.

(d) IAS permits the effect of accounting changes to be applied retrospectively. FAS requires that changes in accounting policy should only be applied prospectively. Therefore, financial statements of prior periods are not restated, nor is the cumulative effect on prior years of retroactive application of new principles or estimates presented in the current year statements.

(e) IAS permits capitalization of development cost if cost recovery is probable. FAS requires R&D expenditures to be treated as deferred charges if certain conditions specified in the Working Rule on R&D costs are met. Recurring R&D costs for improvement of present techniques cannot be capitalized and should be expensed as incurred.

(f) IAS permits only percentage-of-completion method. FAS allows both percentage-of-completion and completed contract methods.

(g) FAS Article 61 requirs interperiod income tax allocation effective from April 1, 1996. Application is suspended for a certain time period to avoid sudden impact of tax allocation.

(h) There are no accounting standards on treatment for inflation . However, certain categories of assets may be revalued permanently under the Asset Revaluation Law of 1965. Under the Law, current cost as of revaluation date becomes the new book value of the revalued asset.

(i) The retirement pension system is different from that of many western countries. Korean companies are required to pay lump-sum severence pay to retiring or leaving employees. For financial accounting purposes companies establish a reserve account for the severence pay as liability reserves. The amount is calculated assuming that all employees would leave the company on the balance sheet date.

(j) The alternative treatment under IAS 22 allows the entire negative goodwill to be treated as deferred income. FAS requires the entire negative goodwill to be treated as gain on business combination..

(k) FAS does not permit investment classified as current assets to be valued on an individual investment basis. When revalued amounts are used for investments classified as long-term assets, FAS does not require a policy for the frequency of revaluations to be adopted.

(l) FAS does not permit the equity method to be used in unconsolidated financial statements and the cost method is generally used. However, if the long-term investment has marketability and its market price is less than the cost, the market price should be used.

Source: Jang (1996)

Appendix 5

Korean Companies Selected for Analysis

	CHAEBOL	NON-CHAEBOL
1	Asia Automobile	Chongkeun Dang
2	Daerim Yo Up	Chosun Naewha
3	Daewoo Chungmil	Chungsan
4	Dongkook Jekang	Daehan Joongsuk
5	Dongyang Cement	Daewoo Keumsok
6	Dongyang Jekwa	Dongsuh Sanup
7	Dongyang Maekjoo	Dongsung Whahak
8	Dongyang Nylon	Hanchang
9	Doosan Yuri	Handok Pharmaceuticals
10	Goldstar	Hankook Cosmetics
11	Hanwha Energy	Hankook Koa
12	Hyundai Kangkwan	Heungchang
13	Hyundai Mokjae	Jinwoong
14	Jeil Mojik	Kabul
15	Kia Teuksookang	Keukdong Jehyuk
16	Kohap Sangsa	Kunsul Whahak
17	Kolon	Kwangdong
18	Kookje Junsun	Kyeyang Electric
19	Kumho	Kyemongsa
20	Kumho Petroleum	Kyungnong
21	Lotte Samkang	Maxon
22	Mando Kikye	Namsun Aluminium
23	Miwon	Paekkwang Sanup
24	Sammi	Pyungwha Sanup
25	Samsung Junkwan	Samrip
26	Samsung Jungmil	Sepoong
27	Ssangyong Yanghoe	Sewon
28	Yukong	Suhkwang
29		Suhtong
30		Taeil Jungmil
31		Woongjin
32		Youngwon
33		Yuwha

Appendix 6A

Descriptive Statistics of Dependent and Explanatory Variables (Untransformed Variables)

Parameter	*Min*	*Max*	*Mean*	*Standard Deviation*	*Skewness*	*Kurtosis*
Disclosure Scores						
All groups	159	220	185.557	12.820	0.299	0.502
Chaebol	170	220	191.821	12.614	0.488	0.030
Non-chaebol	159	200	180.242	10.509	-0.409	-0.498
Assets (*)						
All groups	21431812	6453272480	614981269	1053727433	3.834	17.589
Chaebol	98688506	6453272480	1164951629	1369808144	2.728	8.532
Non-chaebol	21431812	391720334	148339752	97372271	0.923	0.241
Sales (*)						
All groups	24619506	5865699176	508912940	1007273317	4.294	19.948
Chaebol	35499530	5865699176	974107588	1354483686	2.968	8.740
Non-chaebol	24619506	284916172	114202329	66241861	0.686	-0.238
Employees						
All groups	131	30621	2495	4352	5.021	30.648
Chaebol	411	30621	4242	5849	3.662	15.940
Non-chaebol	131	2714	918	638	0.835	0.453
Leverage (%)						
All groups	53.1	1067.2	288.810	205.554	2.079	5.351
Chaebol	53.1	1054.0	343.826	217.917	1.641	3.254
Non-chaebol	63.7	1067.2	242.131	185.096	2.952	11.963
Profit1(%) (**)						
All groups	-5.8	11.5	2.393	3.665	0.150	0.408
Chaebol	-5.8	7.0	1.668	3.421	-0.310	0.118
Non-chaebol	-5.1	11.5	3.007	3.804	0.348	0.342
Profit2(%) (***)						
All groups	-13.1	11.5	2.310	3.703	-0.895	5.498
Chaebol	-13.1	11.2	1.910	4.169	-1.466	6.339
Non-chaebol	-7.2	11.5	2.648	3.284	0.222	3.085
Profit (%) (****)						
All groups	-28.4	42.9	6.799	11.397	0.494	3.442
Chaebol	-28.4	42.9	7.495	14.386	0.286	2.197
Non-chaebol	-13.7	32.9	6.208	8.255	0.784	3.563

(*) in Korean currency, *won* (000s)
** profit1 denotes ordinary profit to total assets
*** profit2 denotes net profit to net sales
**** profit denotes net profit to net worth

Appendix 6B

Descriptive Statistics of Dependent and Explanatory Variables (Log-Transformed Variables)

Parameter	*Min*	*Max*	*Mean*	*Standard Deviation*	*Skewness*	*Kurtosis*
Disclosure Scores						
All groups	5.07	5.39	5.221	0.069	0.065	0.326
Chaebol	5.14	5.39	5.255	0.065	0.323	-0.073
Non-chaebol	5.07	5.30	5.193	0.059	-0.427	-0.521
Assets (*)						
All groups	16.88	22.59	19.406	1.253	0.400	-0.284
Chaebol	18.41	22.59	20.372	1.040	0.004	-0.384
Non-chaebol	16.88	19.79	18.587	0.724	-0.145	-0.419
Sales (*)						
All groups	17.02	22.49	19.175	1.230	0.577	0.076
Chaebol	17.39	22.49	20.121	1.078	0.017	0.915
Non-chaebol	17.02	19.47	18.373	0.638	-0.749	-0.322
Employees						
All groups	4.88	10.33	7.135	1.135	0.238	0.168
Chaebol	6.02	10.33	7.802	1.048	0.229	-0.244
Non-chaebol	4.88	7.91	6.533	0.845	-0.686	-0.541
Leverage (%)						
All groups	3.97	6.97	5.462	0.643	0.015	0.071
Chaebol	3.97	6.96	5.661	0.630	-0.450	1.234
Non-chaebol	4.15	6.97	5.293	0.612	0.386	0.331
Profit1(%) (**)						
All groups	-2.30	2.44	0.654	1.217	-0.657	-0.380
Chaebol	-2.04	1.95	0.441	1.188	-0.448	-0.607
Non-chaebol	-2.30	2.44	0.830	1.233	-0.923	0.220
Profit2 (%) (***)						
All groups	-1.90	2.44	0.666	0.995	-0.443	-0.160
Chaebol	-1.51	2.41	0.604	0.981	-0.220	-0.500
Non-chaebol	-1.90	2.44	0.717	1.020	-0.645	0.337
Profit (%) (****)						
All groups	-0.80	3.76	1.675	0.999	-0.071	0.014
Chaebol	-0.80	3.76	1.723	1.142	-0.170	0.100
Non-chaebol	-0.12	3.49	1.635	0.879	0.006	-0.393

(*) in Korean currency, *won* (000s)
** profit1 denotes ordinary profit to total assets
*** profit2 denotes net profit to net sales
**** profit denotes net profit to net worth

Appendix 7A

SPECIFICATION ANALYSIS- KOREAN DISCLOSURE MODEL
Multiple Regression Analysis (Profit2)

```
* * * *   M U L T I P L E   R E G R E S S I O N   * * * *

Equation Number 1   Dependent Variable..   LSCORES

  Descriptive Statistics are printed on Page  113

Block Number  1.  Method:  Enter

Variable(s) Entered on Step Number
   1..    FACT1      REGR FACTOR SCORE   1 FOR ANALYSIS    1
   2..    LPROFIT2
   3..    AUDIT
   4..    LGEAR
   5..    CHAEBOL
   6..    LQUID

Multiple R           .70305
R Square             .49428
Adjusted R Square    .43106
Standard Error       .05117

Analysis of Variance
                     DF      Sum of Squares      Mean Square
Regression            6              .12284           .02047
Residual             48              .12569           .00262

F =        7.81899        Signif F =  .0000
------------------ Variables in the Equation ------------------

Variable              B          SE B         Beta         T   Sig T

FACT1           .034105       .010097      .505603     3.378   .0015
LPROFIT2        .018544       .007553      .274155     2.455   .0178
AUDIT           .002737       .016424      .019590      .167   .8683
LGEAR           .005973       .014857      .054126      .402   .6894
CHAEBOL         .007446       .020058      .055303      .371   .7121
LQUID          -.020203       .022818     -.132499     -.885   .3804
(Constant)     5.264714       .165239                 31.861   .0000
End Block Number   1   All requested variables entered.
```

Appendix 7B

Multiple Regression Analysis (Profit1)

```
* * * *   M U L T I P L E   R E G R E S S I O N   * * * *

Equation Number 1    Dependent Variable..   LSCORES

  Descriptive Statistics are printed on Page  106

Block Number  1.  Method:  Enter


Variable(s) Entered on Step Number
   1..     FACT1      REGR FACTOR SCORE   1 FOR ANALYSIS    1
   2..     LPROFIT1
   3..     AUDIT
   4..     LGEAR
   5..     CHAEBOL
   6..     LQUID


Multiple R             .65513
R Square               .42920
Adjusted R Square      .35136
Standard Error         .05430

Analysis of Variance
                      DF      Sum of Squares      Mean Square
Regression             6              .09755           .01626
Residual              44              .12974           .00295

F =       5.51402       Signif F =  .0003
------------------ Variables in the Equation ------------------

Variable               B          SE B        Beta          T  Sig T

FACT1            .036380       .011023     .539245      3.300  .0019
LPROFIT1         .010347       .006523     .188150      1.586  .1199
AUDIT       -8.10313E-04       .017791    -.005926      -.046  .9639
LGEAR           -.001056       .015848    -.009658      -.067  .9472
CHAEBOL          .004388       .021640     .032805       .203  .8403
LQUID           -.025650       .024581    -.172435     -1.043  .3024
(Constant)      5.337739       .176263                 30.283  .0000
End Block Number   1   All requested variables entered.
```

Appendix 7C

Multiple Regression Analysis (Profit)

```
**** MULTIPLE REGRESSION ****

Equation Number 1    Dependent Variable..   LSCORES

  Descriptive Statistics are printed on Page   120

Block Number  1.  Method:   Enter

Variable(s) Entered on Step Number
   1..   FACT1      REGR FACTOR SCORE    1 FOR ANALYSIS     1
   2..   LPROFIT
   3..   LGEAR
   4..   AUDIT
   5..   CHAEBOL
   6..   LQUID

Multiple R           .68509
R Square             .46934
Adjusted R Square    .40301
Standard Error       .05242

Analysis of Variance
                    DF       Sum of Squares       Mean Square
Regression           6               .11665            .01944
Residual            48               .13189            .00275

F =       7.07564       Signif F =  .0000
------------------ Variables in the Equation ------------------

Variable              B          SE B         Beta          T  Sig T

FACT1           .035155       .010331      .521183      3.403  .0014
LPROFIT         .014157       .007579      .211525      1.868  .0679
LGEAR          -.007400       .014939     -.067063      -.495  .6226
AUDIT           .003298       .017211      .023600       .192  .8489
CHAEBOL         .006045       .020527      .044896       .294  .7697
LQUID          -.024248       .023386     -.159032     -1.037  .3050
(Constant)     5.345111       .166175                  32.166  .0000
End Block Number   1   All requested variables entered.
```

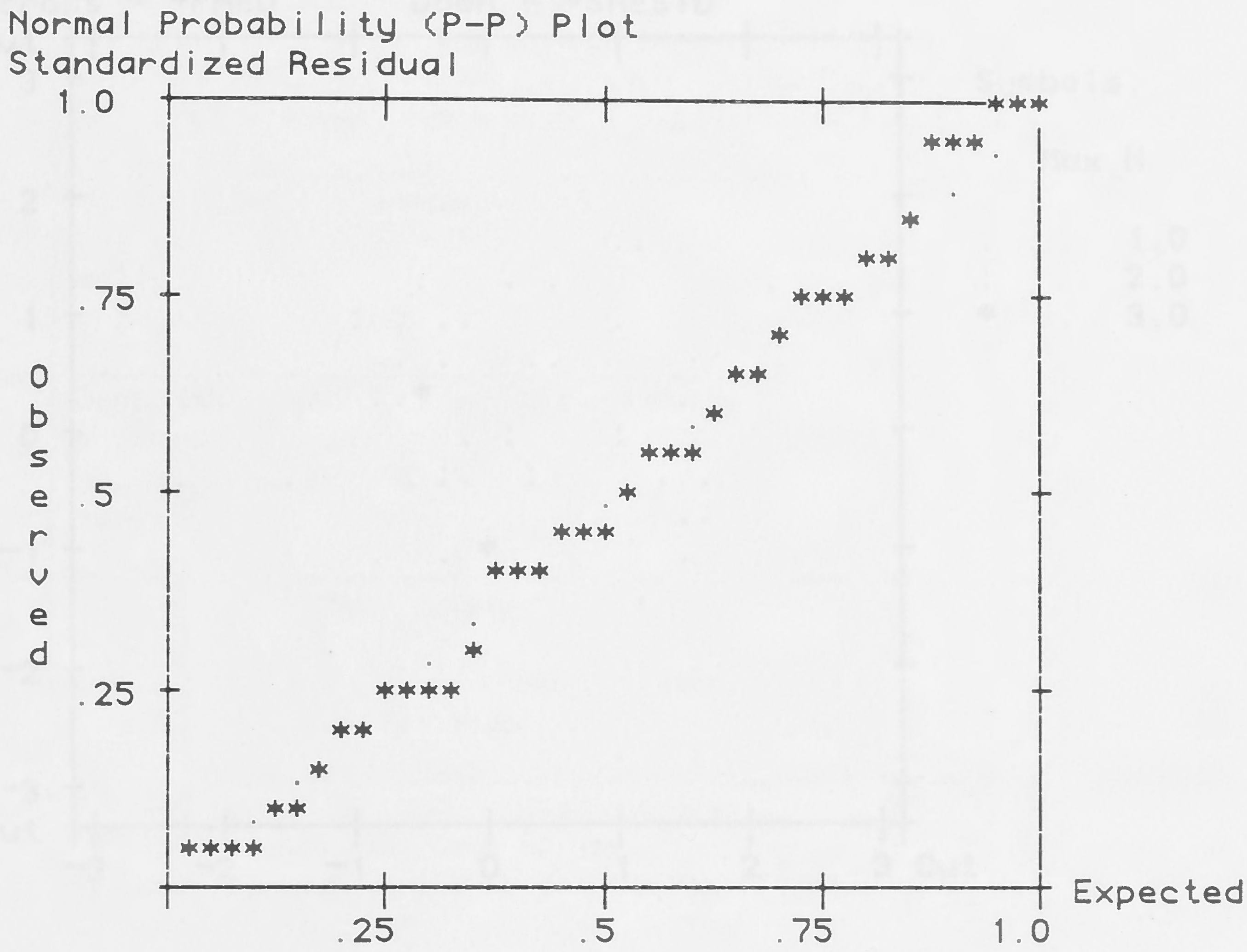
Appendix 8A

HISTOGRAM OF STANDARDISED RESIDUALS
(Test of Normal Distribution of Residuals)

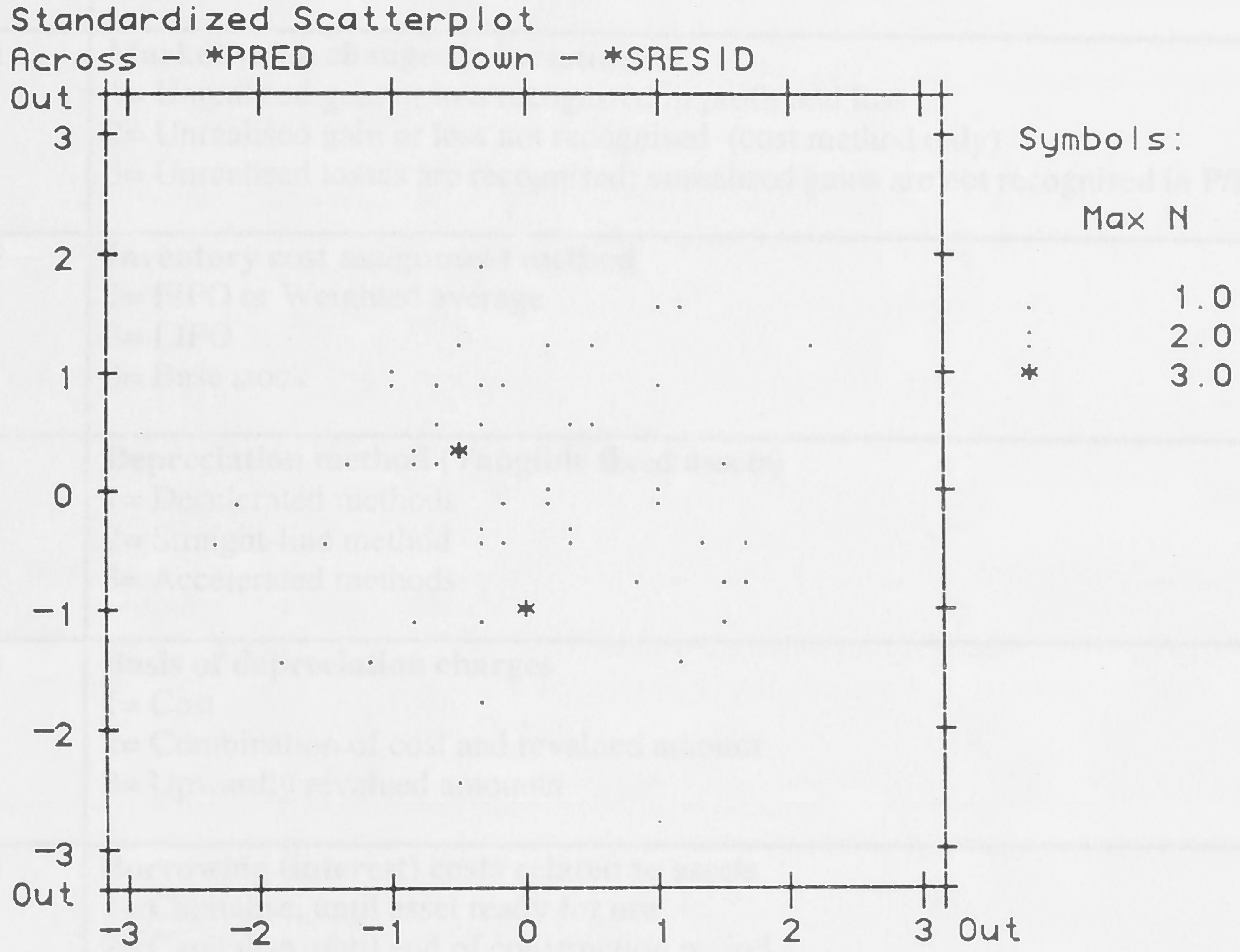
```
Histogram - Standardized Residual

NExp N    (* = 1 Cases,     . : = Normal Curve)
0  .04    Out
0  .08   3.00
0  .21   2.67
0  .49   2.33
1 1.00   2.00 :
1 1.84   1.67 *.
2 3.02   1.33 **.
8 4.44   1.00 ***:****
4 5.84    .67 ****  .
9 6.89    .33 ******:**
6 7.28    .00 ******.
9 6.89   -.33 ******:**
3 5.84   -.67 ***     .
6 4.44  -1.00 ***:**
4 3.02  -1.33 **:*
0 1.84  -1.67   .
0 1.00  -2.00 .
1  .49  -2.33 *
1  .21  -2.67 *
0  .08  -3.00
0  .04    Out
```

NORMAL PROBABILITY (P-P) PLOT OF STANDARDISED RESIDUALS
(Test of Normal Distribution of Residuals)



PLOT OF STANDARDISED RESIDUALS AGAINST PREDICTED VALUES
(Test for Homoscedasticity)



Appendix 9

KOREAN FINANCIAL ACCOUNTING
Conservatism Index - Reported Profits

	Profit and Loss Treatment
1	**Market value changes in investments** 1= Unrealised gain or loss recognised in profit and loss 2= Unrealised gain or loss not recognised (cost method only) 3= Unrealised losses are recognised; unrealised gains are not recognised in P/L
2	**Inventory cost assignment method** 1= FIFO or Weighted average 2= LIFO 3= Base stock
3	**Depreciation method (Tangible fixed assets)** 1= Decelerated methods 2= Straight-line method 3= Accelerated methods
4	**Basis of depreciation charges** 1= Cost 2= Combination of cost and revalued amount 3= Upwardly revalued amounts
5	**Borrowing (interest) costs related to assets** 1= Capitalise, until asset ready for use 2= Capitalise, until end of construction period 3= Expense immediately
6	**Research and Development Expenditures** 1= Capitalise and carry indefinitely as assets 2= Capitalise and amortise over useful life 3= Expense immediately
7	**Pension and retirement expenses** 1= No pension expenses recognised 2= Actual cash outlays 3= Projected or accrued benefit methods
8	**Income tax accounting** 1= Deferred tax (partial allocation) 2= Deferred tax (comprehensive allocation) 3= Income tax payable method
9	**Foreign exchange translation gains or losses** 1= Defer and show separately in shareholders' equity 2= Defer and amortise over life of related balance sheet items 3= Recognise in current period profit or loss
10	**Non-specific or discretionary reserves** 1= Not used 2= Used (only for specifically identifiable operating losses) 3= Used (management discretion or legal mandate)
11	**Leased assets** 1= Operating leases 2= Capital leases (but depreciation on leased assets not charged) 3= Capital leases (with interest and depreciation charged as expenses)

12	**Losses considered "extraordinary"** 1= Includes items related to ordinary operations 2= Only items clearly of unusual and infrequent nature (not related to ordinary operations) 3= None recognised
13	**Equity accounting profit or loss*** 1= Recognised in profit and loss account 2= Not recognised in profit and loss (but disclosed in notes) 3= Equity accounting method not used
14	**Business start-up and/or exploration expenditures*** 1= Capitalise and carry indefinitely as assets 2= Capitalise and amortise over useful life 3= Expense immediately
15	**Business combinations*** 1= Pooling-of-interests method only 2= Combination of pooling-of-interests and purchase method 3= Purchase method only
16	**Goodwill on acquisition*** 1= Immediate write-off (equity reserves)/Hold indefinitely as part of equity reserves 2= Amortise over designated period to income 3= Immediate write-off (income)

* deleted for analysis due to inapplicability or unavailability

BASIS FOR CONSERVATISM RANKINGS

1. Accounting policies that result in higher reported revenues or lower reported expenses *in the current accounting period* are less conservative than policies that have the opposite effect. For example, capitalisation of research and development expenditures is less conservative than immediately charging such expenditures to expense in the current period.

2. Accounting policies which allow expenditures to be charged against equity reserves rather than being reflected in the profit and loss statement are considered less conservative. For example, allowing goodwill to be written off immediately against capital reserves deemed less conservative than recognising such goodwill in the balance sheet and amortising the same.

3. It is assumed that the effects of accounting policies occur in an environment of rising general price levels (inflation). In this sense, inventory valuation for balance-sheet purposes using FIFO is less conservative than using LIFO since the LIFO method results in lower reported ending inventory amounts in inflationary periods.

4. Accounting policies that allow either upward adjustments of revenues or downward adjustments of expenses are less conservative than policies that do not allow such adjustments. For example, use of equity method of accounting for long-term investments is considered less conservative because it allows the results of investee firms to either reduce or increase reported profits.

5. Accounting policies that allow only a downward adjustment of revenues or upward adjustment of expenses are considered the most conservative. For example, use of discretionary reserves allows management to reduce reported profits.

6. Accounting policies that result in recognising an equal amount of asset and liability are considered more conservative than accounting policies that do not have this effect. The asset increase is offset by a corresponding increase in liability, resulting therefore in a higher financial leverage (debt-to-equity). For example, recognition of capital-type leases is considered more conservative than non-recognition of such leases. Furthermore, depreciation charges and interest expense recognised on leased assets often exceed lease payments made, particularly in earlier years.

Source: Diga (1996)