

# **Determinants of Financial Reporting System: The Case of South Korea**

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## **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; Doupanik and Salter 1995; Nobes 1998). The most frequently cited variables in the literature are government; business enterprises; accounting profession; economic factors; international influences; and culture.

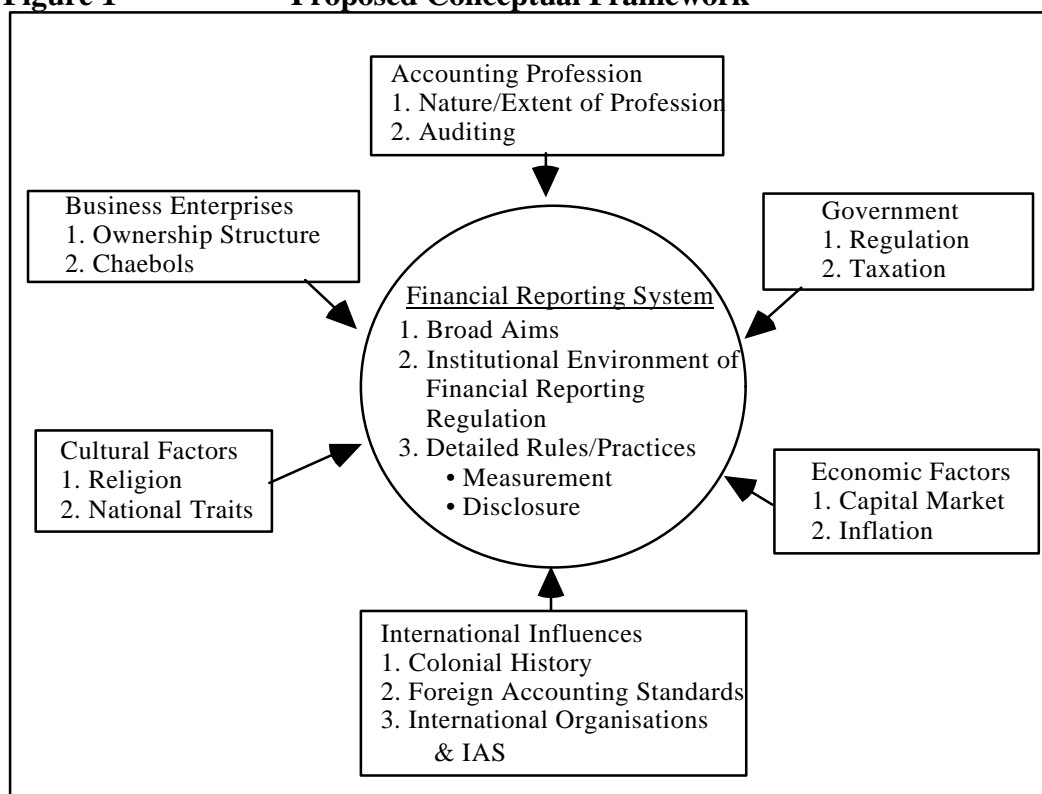
This study seeks to analyse the development of Korea's financial reporting system in relation to these key explanatory variables. The explanatory analysis explores how and why the unique financial reporting system arises, is maintained, and transformed over time in Korea. It enhances current understanding of the country's system and also helps to identify environmental factors equally important to other countries, thus facilitating the development of a comparative explanatory framework.

The remainder of this paper is organised as follows. Section 2 proposes a conceptual framework for analysing the evolution of Korea's financial reporting system by critically reviewing prior contingency theory-based research. The role of these six variables in shaping Korea's financial reporting system is discussed in Sections 3 to 8. Section 9 provides some conclusions regarding the contribution of this explanatory approach to understanding development and current features of Korea's financial reporting system.

## **2. CONCEPTUAL FRAMEWORK**

A conceptual framework (Figure 1) has been proposed for analysing Korea's financial reporting system. It has been derived from a critical review of prior contingency theory-based research (e.g., Mueller 1967; Radebaugh 1975; AAA 1977; Frank 1979; Nair and Frank 1980; Nobes 1983; Yang and Lee 1994; Nobes 1998).

**Figure 1 Proposed Conceptual Framework**



As indicated in the proposed framework (Figure 1), this study adopts a broader definition of financial reporting system. It encompasses broad aims, institutional environment of financial reporting regulation, and detailed financial reporting rules and practices. These three elements of a country's financial reporting system are depicted to be influenced by six key factors. They are: government, business enterprises, accounting profession, economic factors, international influences, and cultural factors. Each of these components is briefly discussed below.

## 2.1 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 also played a significant role in shaping a country's financial reporting system in situations where financial reporting systems are strongly influenced by state objectives (Mueller 1967; Meek and Saudagaran 1990; Radebaugh and Gray 1993; Doupanik 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

## 2.2 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.

### **2.3 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.

### **2.4 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 increasingly raised 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; Douppnik and Salter 1995). Countries with highly developed capital markets tend to adopt a professionally regulated, "true and fair" view audit system and disclose relatively large volume of information (Salter and Niswander 1995).

Inflation has also been 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).

### **2.5 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 (e.g., EU, NAFTA), foreign direct investment, multinational firms, the rapid growth of international financial markets, the expansion in business services, and the activities of international regulatory agencies (e.g., IOSCO).

### **2.6 Culture**

The influence of cultural factors on financial reporting has been studied and accepted 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; Douppnik and Salter 1995). In particular, Hofstede's (1980) four dimensions of culture have been widely tested to identify any potential linkage between cultural variables and characteristics of financial reporting systems. Strong bureaucratic involvement in financial reporting regulation in specific countries has also been found to be closely linked to underlying Confucianist-based belief in the "moral basis of government."

In sum, despite some limitations associated with any contingency theory-based research (see Kim 1997 for details), the proposed framework substantially contributes to current understanding of a country's financial reporting system.

### **3. THE ROLE OF GOVERNMENT**

The role of Korean government is discussed by addressing two aspects: financial reporting regulation and taxation.

#### **3.1 Financial Reporting Regulation**

Until the early 1980s, the Korean state had been pre-eminent in its relationship with the private business sector and with the accounting profession. The state as a major financier to the private sector had engendered a close, but superior relationship with the business sector (Jones and Sakong 1980; Chung and Lee 1989; Chen 1995). In addition, the state had controlled the accounting profession with respect to its examination, registration and practices.

The superior relationship with both sectors had enabled the state to play a pivotal role in regulating financial reporting in the country. Government agencies had been heavily involved in setting and enforcing accounting standards, with the Ministry of Finance (MOF) being given ultimate responsibility. Also prior to the enactment of the External Audit for Joint-Stock Companies Act (EAA) in 1980, government agencies had substantially controlled the accounting profession by allocating audit work among CPAs (Park 1990; KICPA 1992a).

Based on the discussions above, it can be argued that the institutional framework for financial reporting regulation prior to the 1980s had 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).

Since the early 1980s, the Korean government has accelerated its liberalisation policy by deregulating various economic sectors, especially the country's capital market. The private sector, *chaebols* in particular, has since been gaining both political and economic ascendancy in contrast to dwindling government intervention in the country's economic affairs (EWYB 1995, The Economist 1996).

The deregulatory trend of government has also been reflected in increasing private-sector participation in accounting standards setting process. Despite some deregulatory moves in the 1980s and 1990s, the ultimate authority in accounting standards setting and enforcement had still rested with government agencies, i.e., Korean Securities and Exchange Commission (KSEC) and Financial Securities Commission (FSC) until 1999 when an independent private-sector accounting standards-setting body was established. It seems therefore reasonable to argue that government-directed legalistic approach had been widely accepted by most stakeholders until 1999.

The government-directed regulation has often been criticised for its susceptibility to political pressures from special interest groups (Zeff 1978; Solomons 1978; Jang and Chun 1999; Kim 2000). For example, the fourth and the fifth amendments to Korean

Financial Accounting Standards (KFAS) were made in 1990 and 1992 mainly because financial institutions lobbied the government against the implementation of LOCOM (Lower of Cost or Market) for marketable securities and long-term investments.

Following the crisis, the Korean government has been particularly subject to increasing international pressures (e.g., IMF, World Bank) for establishing independent and transparent standards setting processes and for developing effective enforcement mechanisms. As a result, an independent private-sector accounting standards setting body, Korea Accounting Institute (KAI) and its umbrella organisation, Korean Accounting Standards Board (KASB) were established in 1999. Subsequently, the FSC revised the EAA to provide a legal basis for delegating its authority to formulate accounting standards to KAI and KASB. Despite the establishment of private-sector standards-setting bodies, government intervention may still be needed to an extent for some time to facilitate the implementation of its reform measures, given the current state of Korea's accounting profession. However, the role of the state should be limited to a supervisory role (Lee et al. 1994; Yoon et al. 1999).

### **3.2 Financial Reporting and Taxation**

As the Korean economy has developed, the country's tax system has changed too (see KICPA 1992a for details). 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).

Financial reporting rules and practices have been strongly influenced by national tax policies (Kim 1986; Nam 1994; Song and Yoon 1995; Kang 1995). First, most companies report on their financial statements the depreciation expenses prepared in accordance with the rules of the Corporation Tax Law (CTL) to minimise their tax liabilities (Kim and Kim 1990, p. 275). Second, a special provision called *Chueng-Yi* was allowed in 1975 by the government to prevent firms from being penalised by a "qualified" or "adverse" opinion because they engaged in accounting practices not allowed under KFAS to obtain government incentives. 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, most companies put aside statutory legal reserves and other types of reserves prescribed in the CTL and Commercial Code (CC).

Various attempts have been made, however, to minimise these tax influences on financial reporting since the late 1960s, as shown in the requirement of submission of tax reconciliations to regulatory bodies, the abolition of *Cheung-Yi* and special depreciation, and the recent introduction of tax accounting rules. Despite these continuous efforts to separate tax accounting from financial accounting, Korean firms still tend to prepare their financial statements in accordance with tax rules (Yoon et al. 1999). In particular, the increasing adoption of IAS will inevitably result in more gaps between accounting standards and tax rules. Albeit costly, it is suggested that Korean firms prepare two sets of financial statements for accounting purposes and for tax purposes separately to enhance the reliability and comparability of their financial information (Jang and Chun 1999).

#### 4. 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. Among the various types of business enterprises that have existed in Korea, joint-stock corporations have, in general, a broader ownership base than sole traders, partnerships and other types of companies. As the broader ownership base has more significant implications for the nature and extent of financial information provided, this section focuses on influences of joint-stock companies, particularly *chaebols*, on the country's financial reporting system. The focus on *chaebols* seems warranted in view of their economic significance in the country.

##### 4.1 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). 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 further discussed because of its relevance in financial reporting, especially disclosure.

Despite many varieties of ownership structures, *chaebols* are typically owned and controlled by founders and their immediate family members through direct and interlocking ownership among affiliated companies. Unlike Japanese pre-war *zaibatsu* or post-war *keiretsu* groups, *chaebols* without holding companies are strongly dominated by family members. For example, the ownership share of families amounted to 49.4 per cent (i.e., 13.7 per cent direct ownership and 35.7 per cent interlocking ownership) for top 10 listed *chaebol* companies in 1989. When unlisted companies of the *chaebols* had been considered, the proportion of family ownership in *chaebols* may have been 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 1).

**Table 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

With the increasing economic power of *chaebols*, new financial accounting standards were promulgated and enforced to monitor their activities. Regulations on consolidation were first introduced in 1974 to monitor and control the amount of credit allocated to large business groups. Separate KFAS on Consolidation and KFAS Working Rules on Consolidation were also 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 KFAS on Consolidation and KFAS Working Rules on Consolidation requiring independent audits of consolidated financial statements that consolidation rules were enforced relatively widely.

However, the 1992 and 1994 amendments were criticised for their incompatibility and inappropriateness in Korea's business environment (Chun 1995; Jang and Chun 1999). The criteria for consolidation (following US criteria on ownership and control) have resulted in only a smaller number of companies being subject to consolidation because of the unique control structure of Korean business groups. Few companies satisfied 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.

Furthermore, it has been argued that consolidated statements alone do not properly reflect the financial position and performance of *chaebols* because of their unique practices like interlocking shareholding and debt guarantees among affiliated companies. The particular nature and ownership structure of *chaebols* has been taken into account in the most recent amendment to KFAS (1998). *Chaebols* are now required to consolidate the accounts not just of the *chaebol's* subsidiaries but also of linked companies ('combined') with which they do business (Jang and Chun 1999; Yoon *et al.* 1999; Kim 2000; Economist 2000). *Chaebols* are thus expected to produce three sets of financial statements: individual, consolidated, and combined.

## 5. THE ROLE OF THE ACCOUNTING PROFESSION

Since the first post-war professional accounting body (Korean Institute of Registered Accountants) was established in 1954, the accounting profession in the country had been heavily regulated and at the same time highly protected by the government until the financial crisis (Kim 2000). As mentioned earlier, the state maintained close control over the profession with respect to its members' examination, registration, and allocation of audit assignments.

The degree of government control over the profession has decreased since the early 1980s, as reflected in more market-directed competition among CPAs. This change in the audit environment has had a substantial impact on the distribution of audit opinions rendered. The proportion of companies which obtained an "unqualified" audit opinion was relatively low, ranging from 15% to 40% in the 1970s, but it amounted to 88% in 1985 following the adoption of a market-based audit choice (Shin 1977; Park 1990). The remarkable improvement most likely resulted from audited firms' newly acquired power to retain or change their external auditors, which in turn deteriorated audit independence and quality substantially.

The poor audit independence and quality led to a few legal actions against audit firms in the 1980s. In particular, following the legal action against auditors of Heung-Yang Ltd. in 1991, audit quality and independence have been gaining increasing attention among investors and the public in Korea (Choe and Choi 1996, pp. 4-5). To maintain the independence of external auditors and the quality of audit work and reports, various regulatory measures and structural mechanisms were introduced (e.g., post-audit quality reviews, increased audit indemnity fund). Despite these various mechanisms in place, the external audit system largely failed to function effectively, as shown in a series of audit failures in the late 1990s surrounding the collapse of Hanbo Steel, Kia Motors, and Daewoo group (Kim 2000). The failure was partly due to the overwhelming power of audited firms in relation to their external auditors and a general lack of market response to audit failures.

To protect the independence of external auditors from audited companies, particularly the largest shareholder of these firms, the EAA recently included a new provision on the composition of the external auditor selection committee (Kim 2000). In addition, various regulatory and protective measures related to the external audit system in the country are being lifted to enhance the market mechanism and self-discipline of the accounting profession. Although the successful implementation of the proposed mechanisms remains to be seen, more market-based audit environment through self-discipline and self-regulation is expected to continue in the country.

## **6. THE EFFECTS OF ECONOMIC FACTORS**

The evolution of a country's financial reporting system is closely linked 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.

### **6.1 Modern Development of Korea's Capital Market**

Broadly, a capital market 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.

Korea's capital market has undergone several stages of development, consistent with the country's economic development. Korea's financial reporting has also changed to meet the needs of its evolving capital market. The current study specifically focuses on the development of Korean capital market and its influences on accounting since the late 1950.

**Table 2** **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 2, 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 from the Korean Development Bank (KDB). 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 were promulgated primarily 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 also began to be promoted through various legislation aimed at mobilising much needed domestic capital into government-promoted business activities and through various tax and financial privileges granted to publicly-held companies (e.g., Cheung-Yi). 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. Despite this growth in the equity market, the heavy reliance on debt financing was still 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).

Nonetheless, the Korean government's continuous efforts to boost the securities market saw a massive liberalisation of the market in the 1980s and 1990s (Cargill 1990; Chung 1994). The growth in securities market activity from 1980 to 1995 is evident in Table 3.

**Table 3** **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

Table 3 shows that the number of companies listed on the KSE increased substantially from the late 1980s, more than doubling from 342 in 1985 to 721 in 1995. Similarly, market capitalisation and trading value 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 .

The ownership structure of Korean enterprises is becoming even more diffuse with the liberalisation and internationalisation of the country's capital market. As such, adequate disclosure of "comparable" corporate information has become increasingly important in enhancing the competitiveness of Korean companies seeking foreign capital. 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 arising from information asymmetry and opportunism in the market (Pratt and Behr 1987; Lev 1988; Ray and Gupta 1993). The increasing significance of economic substance over legal form in enhancing the decision-usefulness of financial information has also shifted measurement rules towards less conservative approaches since the 1980s and particularly since the financial crisis.

The KFAS has continuously 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 most recent amendment adopts IAS substantially. The increasing adoption of IAS 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. To summarise, 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.

## **6.2 Inflationary Environment**

Korea has adopted predominantly conservative approaches to asset valuation and profit measurement. However, the upward revaluation of some categories of assets 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).

Despite the efforts to control hyperinflation in both years, the wholesale price index continued to rise, increasing 69% between 1962 and 1965. During these hyperinflationary 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 of permanent nature was instituted to provide a more equitable basis for taxation and to further develop a sound business environment.

However, the upward revaluation sanctioned on a voluntary basis has been frequently criticised 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, especially following the financial crisis (Nam 1994; Lee *et al.* 1994; Song and Yoon 1995; Cho 1995; Jang and Chun 1999; Kim 2000).

The asset revaluation was finally abolished in the 1998 amendment with a special provision that it is not to be allowed beyond 2000.

## **7. INTERNATIONAL INFLUENCES**

Financial reporting rules in Korea have been heavily influenced 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. 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 standards. 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 increasingly adopted since the mid-1970s (Koh 1988, p. 56), largely because of changes in Korea's capital market. 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). In addition, the increasing use of US accounting concepts can be attributed to a large influx of US-educated accounting practitioners and academics in the 1970s and 1980s. The representation of US-educated members on accounting standards setting bodies increased from 20% in

1958 to 60% in 1981, while the percentage of Japanese-educated members decreased from 70% in 1958 to 14% in 1981.

The IASC's influence has also increased since the 1980s. 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 1998 amendment of KFAS following the crisis, in particular, introduced numerous accounting standards in accord with IAS, including asset valuation, abolition of asset revaluation, present value accounting, and fair value accounting (see Kim 2000 for details). The comprehensive adoption of IAS was accelerated by international pressures from organisations like IMF and World Bank who provided bailout funds for the country during the crisis. They argued that one of the major causes of the financial crisis lay in the overall loss of international confidence in the reliability of financial statements provided by Korean business enterprises.

Despite the convenience and apparent cost-effectiveness of adopting foreign standards or IAS, the unquestioning adoption of foreign accounting standards may not be compatible with the Korean context, as argued in the international accounting literature (e.g., Briston 1978; Ndubizu 1984; Hove 1986; Rivera 1989). For example, the adoption of US criteria for consolidation was found to be inappropriate to the Korean business context because of the unique control structure of Korean companies, particularly *chaebols* (McKinnon 1984b; Chun 1995; Jang and Chun 1999).

## **8. 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). Among various cultural factors, this study specifically addresses the influence of Confucianism that has most profoundly influenced the Korean culture.

### **8.1 Confucianism**

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 deep-rooted Confucian values have significantly affected Korea's economic and financial reporting system in several ways. First, financial reporting has been heavily regulated by government or government agencies. The state has also been perceived 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 held in confidence.

Third, group consciousness and interdependence has also implications 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.

## **9. 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 proposed conceptual framework. 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. 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 a substantial degree, as evidenced by the recent establishment of independent, private-sector accounting standards-setting bodies and by the market-based audit environment.

In sum, 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.

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