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THE PROBLEM OF EARNINGS MANAGEMENT AND THE DIFFERENCES IN THE DEGREE OF IMPACT THAT EARNINGS MANAGEMENT CAUSES IN THE UNITED STATES AND SOUTH KOREA

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ABSTRACT

Companies engage in earnings management, the deliberate manipulation of financial statements, to enhance the financial position of the company. While there are a considerable number of problems arising from this earnings management all around the world, there is a noticeable difference in the degree of seriousness in terms of the earnings management in the United States and South Korea. On the other hand, since the early in 2000s, the United States has actively placed and implemented regulations on auditing standards. As a result of the efforts in the enactment of new regulation and serious repercussions of financial scandals such as publication of the scandals along with the severe punishments, accounting transparency has significantly improved in past years. On the other hand, the accounting transparency in South Korea has worsened despite intensified accounting regulations in 2006. In this paper, I present a comparison of the United States and South Korea's cultural differences, accounting regulations, fraudulent earnings management cases, and public perceptions of accounting transparency. In addition to the academic literature review, I also conducted a survey of professional auditors in both countries to assess the audit quality, effective communication methods, and ethical standards.

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Chapter 1

Introduction

Corporate frauds occurring between 2000-2002 had a significant impact on the global economy and many suffered from evictions, foreclosures, and prolonged unemployment as a result of these fraudulent acts. Enron, WorldCom, and Typo were highly publicized frauds cases that aroused questions about various conflicts of interest and earnings management. In order to prevent further unethical behavior in capital markets, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 to protect information users from corporate frauds and material misstatements on financial statements. This Act, also known as "Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002", includes additional provisions that increased requirements for U.S. public company boards, management, and public accounting firms.

Despite the enacted legislation, many public companies and public accounting firms have constantly engaged in earnings management, the manipulation of financial statements. It is evident that each party receives benefits from this misconduct. However, those benefits would generally last only for a short period of time and this may cause a high risk to both the company and the capital market. In this paper, I discuss the effects of earnings management in our society, including the effects on both the engaged parties and capital markets.

In addition to a brief introduction of earnings management, I also analyze the degree of impact of earnings management that occurred in the United States and South Korea. ChosunBiz, a South Korean newspaper company, conducted a survey of 290 professional auditors with career experience of less than 10 years in South Korea with a question of *"how much do you trust or rely on the audit report?."* The overall outcome of the survey was 3.3 out of 7 total points (with 7 indicating strong reliance), which raises questions about the accounting transparency in South Korea.

As a part of literature review, I have analyzed and compared the accounting regulations, earnings management cases, and the public perception of accounting transparency in both the United States and South Korea. For accounting regulations in both countries, I listed accounting regulations that legally prevent the misconduct of earnings management, and the punishments for breach of contract. This comparison of the two countries' regulations and sanctions helps to analyze whether the regulations are severe enough to avoid such consequences. In order to better understand the accounting regulations, I have included some previous cases that engaged in earnings management and summarized how each country's Accounting Boards responded to each case. I have also referred to previous academic studies to grasp an understanding of public perception towards accounting transparency.

In addition to the academic review on earnings management in both countries, I conducted a survey that is designed to analyze the public perception of accounting transparency in each country and to perceive how important audit quality is to the independent auditors in both countries. As one of the key factors that cause more earnings management in South Korea is a cultural difference that I would like to observe and compare how independent auditors in each country think about their own audit procedures, audit reports, and the work environment. All in all, my main focus for this paper is to thoroughly compare how each country reacts to the earnings management.

Chapter 2

Background Information

2.1 Purpose of Financial Statements

Every public company has responsibility to prepare annual or quarterly financial statements to be audited and released to the public. The objective of these statements is to provide financial information to a wide range of users from public to make the best financial decisions possible. Stakeholders in public companies have rights to know all important material information before making any decisions regarding the financial position, performance and changes in financial position of a company.

2.2 Purpose of Audit Report

Public accounting firms examine the financial statements and issue opinions in audit reports to provide reasonable assurance that the financial statements are stated fairly according to the generally accepted accounting principles and that these financial statements are free from any material misstatements. The auditors have responsibilities to inform their clients if the financial statements have not been prepared properly in conformity with generally accepted accounting principles before expressing an opinion on the report; the company may choose to correct the misstatements, agree to release the auditors' opinions regarding the financial statements, or switch to another auditor.

2.3 Responsibilities of the Management

The management is the party that prepares financial statements, which are subject to public audit under generally accepted accounting principles. Management is responsible for preparing the financial statements and accompanying footnotes in accordance to generally accepted accounting principles and for establishing and maintaining internal controls that are consistent with management’s assertions embodied in the financial statements. During the audit procedures, professional auditors may advise management to make adjustments in order to fairly state financial information. However, management is ultimately responsible for all decisions made regarding the formation and contents of the financial statements.

2.4 Responsibilities of the Independent Auditor

According to AU Section 110, the primary responsibility of an auditor is “to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.” The external auditors from public accounting firms need to maintain both independent attitudes and appearances in order to conduct audit work. Most importantly, it is critical to notice the fact that the auditors are not responsible for every company’s misstatement because they provide opinions under reasonable assurance; however, if the financial statements are misstated due to the auditors’ negligence or intentions, the auditors are accountable.

Chapter 3

Background of Earnings Management

3.1 Definition of Earnings Management

Earnings management occurs when management uses accounting techniques to change the "earnings" from that which should have been reported on the financial statements. The technique may be used to increase the net income of the company to show that the company has performed well throughout the fiscal year. Earnings management may also decrease the net income, resulting in the firm paying less tax for the fiscal year or to deferring earnings for the following years. As a result, since the primary goal of a company is to make a profit, there are times that management faces a temptation of abusively using earnings management. Regardless of the legality of earnings management, misleading financial information may adversely affect the decisions of the information users. According to the Securities and Exchange Commission (SEC) defines earnings management as: *"Abusive earnings management involves the use of various forms of gimmickry to distort a company's true financial performance in order to achieve a desired result."*

Many individuals may consider that earnings management is only subject to management's misconduct. However, as mentioned in the Auditor's Responsibilities, the professional auditors are also responsible for detecting any material misstatements and preventing the release of unreliable financial statements. Though it is impossible for the auditors to detect every single misstatement, the auditors will be subject to unfavorable situations in which the financial statements are misstated due to auditors' negligence or intentions. To clarify, the auditor's intention for this situation means that the auditor and the client have agreed to conceal the intended misstatements for their own benefits.

3.2 Earnings Management from a Client firm's Perspective

Earnings management includes various accounting techniques for a company to make its financial statements look appealing for the potential investors and creditors. As the ultimate goal for any business would be to make profit, use of earnings management may give company short-term gains such as a higher stock value, lower tax payments, increased funds from the investors, and an attractive reputation as a growing company.

There are circumstances when companies face the temptation of abusing earnings management. In most circumstances, a company wants to continue with its profitable trend that it has had in previous years, so that it attracts more investors to provide the capital for the following years. To give a specific example, when a company encounters a sudden decrease in revenue due to the economic difficulties or any other possible reasons, the earnings for the fiscal year would also decrease. If there is a sudden decrease in the company's growing trend, many shareholders and investors may review their investment decisions, which may cause an unfavorable situation for the company. In order to avoid such a situation, the company may choose to manipulate the revenue or expense account to come up with comparable amount of net income. Futher, a company may need to have profits during the fiscal year in order to earn loans from financial institutions. There are many other situations in which management may tend to make excuses of manipulating the financial statements but this is primarily to benefit the company in the short term.

3.3 Earnings Management from an Accounting Firm's Perspective

Mostly, earnings management does not successfully work if the auditors do not consent to it. An auditor is likely to notice a huge change in reporting method, and check if the management has reported the financial statements in accordance to generally accepted accounting principle. Also, if there is any change in reporting methods or any significant areas, such changes are required to be written on the disclosure notes to inform the users. Except when the auditor is not able to detect the concealed changes, the management needs auditor's consent to express an unqualified opinion, stating that there is no material misstatement.

In reality, from an accounting firm's perspective, the client company is considered as a business partner. Just like the client company, the accounting firm is also a company that cares about its profits and achievements because the accounting firm's profit comes from the connections that has with the client companies. When competition is intense among the companies (among big four accounting firms, for instance) each accounting firm is eager to raise its market share, increase the revenue, and maintain good relationships with the client companies. Although it is essential for the auditors to be independent and disregard any financial interests to express an opinion on the audit reports, auditors also have pressure to avoid any problems with the client companies. Accounting firms are eager to maintain long-lasting relationships with as many client companies as possible, and keep higher rankings and comparisons among the similar companies because after all, accounting firms are service companies.

3.4 Problems of Earnings Management

While the purpose of financial statements is to provide trustworthy information, whether or not earnings management is legal, it definitely has a potential to mislead. When it is misleading, earnings management may adversely affect three parties: clients, accounting firms, and, most importantly, information users.

For a client company, manipulation of the financial statements is burdening for the company itself. As a consequence of earnings management, the company is expected to make up for the concealed part, and needs to perform much better than it has performed in previous years.

When the company faces a downturn of economy, or unexpected demand trend, it would eventually face an even worse financial situation with the previous fiscal year's portion added. Also, if the company's use of earnings management is discovered, it will need to face the sanctions under regulations. Also many stakeholders will doubt the transparency of the company.

The illegal use of earnings management will cause legal liability to the CPA and also to the accounting firm because they both are responsible for independence and maintenance of transparency in the capital market. Most importantly, the information users (or stakeholders) become the victims of abusive use of earnings management because they are likely to have invested more, sincerely trusting the client and accounting firm's duties. In addition, if earnings management fraud repeats, the credibility of capital markets collapses and this could lead to a huge loss to the worldwide economy.

Chapter 4

Earnings Management in the United States

4.1 Earnings Management in the United States

United States has always been a strong country. However, this country that seems to never collapse, had a huge breakdown after going through corporate frauds. The unexpected collapse was the consequence of the earnings management that corporations engaged in to satisfy their greed. After the tragic financial scandals, the United States enacted even more laws that could solidify the auditing standards, one of them being the Sarbanes-Oxley Act. The purpose of this act was to build more sophisticated standards regarding the audit report, and to prevent further financial scandals. Also, if the entities catch employers or employees conducting inappropriate behaviors intentionally, they are likely to be given more severe punishments. By doing so, the United States has reduced the number of earnings management cases.

In the United States, fraudulent accounting is taken very severely. Sometimes those involved are acutely punished to reduce incentives for future occurrences. Two extreme cases of companies involving in financial scandal are Arthur Andersen and the Enron. Arthur Andersen, which used to be one of the Big 5 accounting firms, was forced to forfeit its license for negligently auditing Enron. As a result, the United States has invested in reducing such scandals by having the SEC strengthened to decrease the problem of earnings management. It is now more difficult for firms to take part in earnings management. One of the efforts the SEC made is XBRL, the program that electronically detects problems in an audit report. It examines by comparing the trends within the company's financial statements with the trends in the economy. Therefore, if there is any suspicious trend within the firm's financial statements based on the economic trend, the SEC takes a close look at the firm's audit reports. Due to the extreme actions the United States takes to diminish the financial frauds, there has been an evident decrease in the number of earnings management cases occurring in the United States.

A business relationship also exists between clients and accounting firms in the United States. However, each firm has its own duty and responsibility with a comparable degree of power. In the United States, the professional auditors are also sensitive about the fair treatment they receive from the client companies. According to one study, strong relationships develop between the auditors and their clients when the auditors receive fair treatment and the clients' support, which triggers a greater commitment from the professional auditors (Herda and Lavelle 2013). Clients are aware that higher client commitment yields value-added services. Thus, auditors are not the only party that makes an effort, but clients also need to make a comparable amount of effort.

4.2 Accounting Regulation in the United States

To recover the tarnished reputation and lost credibility after the collapse of Enron and WorldCom corporations, the United States had endeavored to reinforce regulations by enacting the Sarbanes-Oxley Act of 2002. This act provides more stringent regulation to improve the quality of audit, and it also has impacted the public perception of accounting transparency. The establishment of Sarbanes-Oxley Act of 2002 had also shaped the accounting regulations in other countries as well.

The Certified Public Accountant (CPA) is required to follow the AICPA's Code of Professional Conduct when performing any services including audits, compilations, reviews, and attestation engagements. This professional code of conduct implies that all CPAs accept a high degree of responsibility toward the public and that they perform the service with the purpose of benefiting the society. There are two main sections of the code: Principles and Rules. Principles provide a solid framework that consists of six articles and they act as a basis of the code of conduct. There are some important definitions to emphasize for this paper and they are:

Principle Article I Responsibility

> *"In carrying out their responsibilities as professionals, members should exercise sensitive professional moral judgments in all their activities."*

Principle Article II Public Interest

> *"Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism."*

Principle Article III Integrity

> *"To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity."*

Principle Article IV Objectivity and Independence

> *"A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services."*

According to this professional code of conduct, no matter the intention or any legal consequences, the independent auditor should not accept management's decision to abusively conduct earnings management. In addition to the Principles, Conceptual Framework for AICPA Independence Standards (ET section 101), which is a part of Rules, describes that a member is no longer independent if he is under the influence of the client's management or others. An auditor needs to be independent in order to perform professional services like audits.

After the Enron and WorldCom's earnings management Case and Arthur Andersen's audit irregularities, Congress intensified accounting regulations by passing Sarbanes-Oxley Act (SOX) in 2002. Among the additional regulations, there is a particular regulation to be emphasized regarding the earnings management, which is:

SOX Title III, Section 303 Improper Influence on Conduct of Audits

> *"It shall be unlawful .... for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading."*

In order to be an independent auditor, a firm has to folow several accounting, which includes Government Auditing Standards, SEC independence rules, and PCAOB Rule 102, 101 and interpretations and rulings under Rules 102 and 101.

It is important to set regulations for auditing procedures and reports, along with having a severe punishment that will prevent the abusive use of earnings management. Audit Professionals are also responsible for performing certain duties under common law to fulfill implied or expressed contracts with clients. In the case where the professionals neglect or fail to exercise due care, they are liable for gross negligence and committing breach of contract. When the CPAs have problems with performing their due care or engaging in any other circumstances that could influence CPA’s liability, they need to deal with harsh SEC sanctions. According to the Securities Exchange Act of 1933 and 1934, the CPA’s liabilities are well defined along with the statements about the rights of third parties and auditors, in addition to possible defenses that CPAs could make in order to defend themselves from any sanctions or punishments. SEC sanctions include suspension from audit work, termination of CPA license, and punitive sanctions. Besides the SEC’s regulations, there were many limitations and stringent regulations that could make CPAs hesitate to conduct such improper behaviors.

4.3 Cases related to Earnings Management

(i) Cardinal Health

In 2007, the Securities and Exchange Commission detected Cardinal Health, Inc, a pharmaceutical distribution company based in Dublin, Ohio, engaging in fraudulent earnings management from September 2000 through March 2004. Cardinal Health reported falsified revenues for four years, and used improper accounting and disclosure methods to complete the financial statements. One of the accounting techniques the company used was inflating the revenue by classifying five billion dollars of bulk sales as operating revenue. The company used other techniques such as acceleration of the payments to vendor without proper disclosure, adjustment of reserve accounts, and improper classification of litigation settlement proceeds. The SEC investigated the financial statements in depth, and Cardinal Health agreed that the company violated accounting regulations and further agreed to work with an independent consultant to review its disclosure processes, practices and controls, and other procedures that were alleged by the SEC. As a punishment of fraudulent earnings and revenue management scheme, Cardinal agreed to pay a thirty-five million dollars penalty to be distributed to affected shareholders in a

Fair Fund. Furthermore, SEC filed a civil action suit against three former finance executives of Cardinal and they agreed to the entry of an injunction and paid additional civil penalties of $245,000. According to the SEC, the three executives were subject to violation of antifraud provisions of the federal securities laws, the Securities Act of 1933, the Securities Exchange Act of 1934, several provisions of the Exchange Act, and they knowingly signed materially falsified management representation letters to the Cardinal's auditors. In addition to the monetary penalty each needed to pay, they were all deprived of the rights as an officer or director of a public company for three to five years, and of appearing or practicing before the Commission as accountants, with a right to re-apply after three to five years.

(ii) Dell

On July 22, 2010, the Securities and Exchange Commission announced that Dell Corporation and its CEO, Michael Dell engaged in wrongly performed earnings management by reporting manipulated financial information and improperly disclosing material information. Dell Corporation decided to understate its operating expenses to achieve Wall Street earnings target. The Commission alleged that Dell failed to disclose a large exclusivity payments received from Intel Corporation for not using central processing units (CPUs). Even after Intel stopped the payments, Dell intentionally did not have any disclosures regarding the payments. As a result, Dell Corporation and Michael Dell agreed to pay a hundred million dollars and 4 million dollars, respectively, and the SEC charged three top executives, Michael Dell, Kevin Rollins, and James Schneider for their violations in disclosure the following. According to Commission's Rules of Practice, each were suspended from appearing or practicing before the SEC as an accountant with the right to apply for reinstatement after five years for Schneider and three years for Dunning and Jackson.

It is evident that the number of earnings management cases decreased after adoption of Sarbanes-Oxley Act of 2002 that made stricter requirements for U.S. public company boards, management, and public accounting firms. The Securities and Exchange Commission thoroughly examines public company's audit reports and financial statements to uncover any concealed fraudulent earning schemes. Moreover, the Commission does not conceal any manipulations but rather publicize the cases in order to prevent from subsequent corporate frauds.

Both Cardinal Health Inc. and Dell Inc. displayed the real-life examples of severe punishments, including high monetary fines and other disciplinary actions. Both companies have lost credibility from their stakeholders and also from the public, which will take a long period of time to recover. Thus, seeing the consequences of fraudulent accounting – being publicized to the media and therefore loss of credibility –, other corporations and businesses will become more circumspect when performing earnings management to aovid their mistakes being publicized.

4.4 Public Perception of Accounting Transparency – Transparency Indexes

Transparency International is an organization that provides several indexes regarding transparency for each country and also public opinions measured by business and expert surveys conducted by independent institutions, structure and appliance of legal framework, and media resources from the public. The mission of this organization is "to stop corruption and promote transparency, accountability and integrity at all levels, and across all sectors of society." Most importantly, it researches to produce certain indexes and the most relevant index is the Corruption Perceptions Index. The Corruption Perceptions Index measures how corrupt the country's public sector is perceived to be. In 2014, the United States scored 74 out of 100, and ranked 17 out of 175 countries in total.

Another Index to focus on is the Control of Corruption Index published by the World Bank. This index is one of the six dimensions of the Worldwide Governance Indicators and reflects perceptions on the public power to achieve private gain. The advantage of this index is that it not only considers a large scale of corruption, but also petty corruptions. This could reflect on the public perception of how much power is used to satisfy private interests by certain people. The United States has ranked 86% and scored 1.2 from the scale between -2.5 and 2.5.

In addition to these indexes, there is an index called The Open Budget Index that is measured by International Budget Partnership. The public perception is highly influenced by this index as it assesses the availability of eight key budget documents, and other material information regarding the budget of each country. It also inspects if these documents are audited in accordance with legislatures and audit regulations. The public considers this index very important because the government takes initiatives to uphold ethical standards for client companies and other public accounting firms to adhere to stringent ethical standards and regulations.

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Chapter 5

Earnings Management in South Korea

5.1 Earnings Management in South Korea

After the financial scandals in the early 2000s, more audit related regulations were formulated and the expectations and standards for auditing procedures also increased. In fact, the Sarbanes-Oxley Act of 2002 had a significant impact on accounting regulations in other countries. Consequently, the South Korean government also made efforts to intensify audit requirements and regulations to prevent corporate frauds caused by the misuse of earnings management. As mentioned, the United States has made efforts to improve the structure of auditing system; they adapted new auditing procedures and methods, which were to detect any audit irregularities. While all new attempts and changes reduced the number of earnings management scandals in the United States, South Korea has not shown as much improvement in accounting transparency and auditing procedures that could prevent earnings management frauds. The situation in the Korean capital market, in fact, became worse, as many information users no longer considered audit reports credible or reliable.

The situation in South Korea is somewhat different from that in the United States. The United States made efforts to recover the lost trust from the public, and it has worked. However, as many still conduct fraudulent acts in South Korea, the investors and creditors still doubt the reliability of audit reports. As briefly mentioned in the introduction, ChosunBiz, a newspaper company in South Korea, conducted a survey on reliability of audit reports to a target segment of 290 professional auditors who had career experiences less than 10 years. The target was carefully selected to avoid any misleading opinions – if the auditors worked more than 10 years, they may concern about the images of public accounting firms. To the survey question, “how much do you trust or rely on the audit report?" the average rate on the reliability of an audit was 3.3 out of 7 points. In addition, 29.7% of clients reported that they do not rely on the auditor's opinion on the audit report. Many interviewees from my survey also mentioned that they provide audit opinions to follow the regulations, but not to provide with users with reliable financial information. This implies that audit reports are not a source for investors to use when they make decisions.

Another potential cause of earnings management in South Korea is due to cultural reasons. In South Korea, there is a term, "Gab-Eur Relation" that describes the relationship between a Client Company and Service Company. According to a Korean-English dictionary, it is defined as:

> *The power dynamic between two people or groups. Gab represents the person with more power, and eur is the subjugated. It originally comes from the legal terminology, but is now used to talk about any relationships such as boss/subordinate, women/men, adult/child etc.*

This term often refers to the relationship between the client company, who is considered "Gab", and the public accounting firm, who is considered "Eur". This further implies that the public accounting firms are at "lower" level in the hierarchy. This relationship arises due to the environment of Free Audit Engagement System that allows every client company to choose its audit partner company and there are many "Gab" companies that take advantage of this situation. This also creates the business relationship between the accounting firms and client companies, which ends up having an impact on the independence of the auditor.

According to research conducted by the Financial Supervisory Service in December 2013, the average assets of the clients, which are subject to public audit service, have increased by 10% from 2012 to 2013. However, the average audit fees increased by 0.7% from KRW 2,780 won to 2,800 won. It is evident that the growth rate of corporate assets is way higher than the growth rate of audit fees in South Korea, that the accounting firms are in highly competitive environments, and that they maintain the business relationships with the clients by lowering audit fees. Hence, the accounting firms have continuously delivered audit reports in poor standards and engaged in more audit irregularities. This competitive environment also enables the "Gab" companies to abuse more power over the audit procedures and audit requirements.

5.2 Accounting Regulation in South Korea

The Korean Accounting Standards Board (KASB) has adopted IFRS as Korean version of IFRS (K-IFRS). K-IFRS and IASB, IFRS are comparable in many aspects. In particular, the KICPA-issued Code is mostly consistent with the IFAC's Code of Ethics for Professional Accountants. The Fundamental Principles of professional ethics on IFAC Code of Ethics include Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, and Professional Behavior.

Integrity

> *A professional accountant should be straightforward and honest in all professional and business relationships.*

Objectivity

> *A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.*

Professional Behavior

> *A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.*

The IFAC Code of Ethics has similar aspects to the AICPA Code of Conduct. Like the common principles of the AICPA Code of Conduct, the IFAC Code of Ethics also provides principles that focus on economic substance over legal form in order to provide with a "true and fair view override." In effect, this could help accountants to deliver a fair look of the financial statements even when they do not follow the generally accepted accounting principles. Also, Integrity, Objectivity, and Professional Behavior are the professional skills that an auditor needs to perform in a conduct of audits. However, as mentioned, these skills are violated when a professional auditor decides to approve earnings management.

While the United States has additional accounting regulations in order to prevent fraudulent earnings management, the IFAC Code of Ethics and additional provisions of more stringent Korean laws on the Korean Code of Ethics in 2006 has governing South Korea. In the United States, the Sarbanes-Oxley Act has been the huge reformation in accounting regulation. However, although it has heavily influenced the perception on transparency for the United States, there is not enough enacted regulation to demonstrate the effect of the Sarbanes-Oxley Act in South Korea. Just by comparing the reinforcements that the United States and South Korea make, we are able to see how the United States is more effective in preventing many manipulation techniques.

As you will refer to the cases below, the sanctions for professional auditors in South Korea are less than in the United States. The monetary damages are very limited, which does not hugely impact on the company or on the person who conducts the misbehaviors. Even for the CPA's liability, IFRS have less detailed guidance about making judgments as the regulations are principal-based approaches. U.S. GAAP regulations, on the other hand, follow rule-based approaches, implying that there are many details to prove the liability of CPAs in the U.S. Nonetheless, IFAC recently made a change to the rule related to sanctions and it mentioned that:

Section 291 – Breach of a Provision

When a breach of a provision of this section is identified, the firm shall terminate, suspend or eliminate the interest or relationship that caused the breach, and shall evaluate the significance of that breach and its impact on the firm's objectivity and ability to issue an assurance report. The firm shall determine whether action can be taken that satisfactorily addresses the consequences of the breach. In making this determination, the firm shall exercise professional judgment and take into account whether a reasonable and informed third party, weighing the significance of the breach, the action to be taken and all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude that the firm's objectivity would be compromised such that the firm is unable to issue an assurance report.

5.3 Cases related to Earnings Management

(i) Daewoo Group

On September 15th 2000, Daewoo Group reported that it had the largest accounting fraud that included KRW forty-one trillion won from abusing earnings management and ten trillion won of illegal loans. Daewoo Group used off-balance-sheet liabilities to understate liabilities and overstate assets. Along with the misuse of accounting technique, the company also manipulated the financial statements in various ways, the most significant case being, one business segment of Daewoo Group reported 7.6 billion won of profits when it actually had a loss of 20 billion won. Despite of several doubts about the financial statements, Chung-Woon accounting firm never attempted to investigate the irregularities. It is assumed that the firm agreed to the violation of earnings management in order to maintain a business relationship with Daewoo Group, the largest client company for Chung-Woon accounting firm.

As a consequence, Daewoo Group decided to liquidate the subsidiaries to pay penalties. The Financial Supervisory Service in South Korea investigated Daewoo's financial statements in depth and charged five subsidiaries of Daewoo Group and forty-one employees in total for their criminal liabilities. The engaged accounting firm eventually decided to liquidate its company after one year of suspension of business. In addition to the suspension, thirty-two accountants were not able perform professional services by being subject to severe disciplinary actions. In addition to these actions, the CPA who decided to tolerate the earnings management was subject to two years of imprisonment and 470 million dollars of additional fees.

From this earnings management case, I would like to highlight the "Gab-Eur Relations" that unduly pressured the professional auditors to conceal fraudulent misconduct that the management performed. The Chung-Woon accounting firm was unable to speak up to Daewoo Group or never investigated the doubtful portions in the financial statements. This implies that Daewoo Group, which constituted of a high share of revenue for the Chung-Woon, took a dominant power over Chung-Woon, which indicates that "Gab-Eur Relations" set an environment in which the misuse of earnings management became more accessible and justified.

(ii) Sambu Finance

On August 2015, Jae-Hyuk Yang, the ex-CEO of Sambu Fiance Corporation was arrested again after a huge corporate fraud case in South Korea. In 1999, Sambu Finance Corporation was engaged in a fraudulent reporting and embezzled approximately nine trillion dollars. Sambu Finance intentionally manipulated its financial statements and did not report a document for registration of securities. It also promised shareholders to pay more than 20 percent of dividends when all securities were not even registered. Sambu Finance was accused of the embezzlement and the court fined 30,000 dollars to Sambu Finance Corporation and 20,000 dollars to Jae-Hyuk Yang, the CEO of the company. The CEO of the company further received four years of imprisonment as a result of corporate fraud.

This fraudulent earnings management case indicates that the monetary fines and four years of imprisonment are relatively small compared to the million dollars and several years of disciplinary actions mentioned in the cases of earnings management in the United States. Compared to the amount of money that was involved in the embezzlement, which was nine trillion dollars, the monetary fines were unbelievably low (at least in comparison to that which would likely have been imposed in the U.S.). As a result of a bearable degree of punishment in South Korea, Jae-Hyuk Yang was able to come back in into business and attempt to conduct another fraud that could have made additional victims.

5.4 Public Perception of Accounting Transparency – Transparency Indexes

(i) Transparency International Organization Index

The Corruption Perceptions Index for South Korea has scored 55 out of 100 full points and ranked 44th countries out of 175 countries. Also, the Open Budget Index has 71 Significant Information, which about measuring the degree of document disclosures in South Korea. Compared to the index results in the United States, South Korea's are in the worse position in overall, meaning the public does not rely on transparency of accounting in South Korea than the public does in the United States.

TI South Korea's 2009 Youth Integrity Index survey showed a slight improvement in overall integrity from past years and due to the adoption of K-IFRS, accounting transparency showed improvements. However, in 2012, there was another financial scandal about Samil PwC's audit irregularities, which again had a huge impact on the public perception of Accounting Transparency in South Korea. This financial scandal eventually led to a decrease in Accounting Transparency Ranking, conducted by the World Economic Forum, from 75th to 91st out of 148 countries in 2013.

Chapter 6

Analysis of Survey and Interview Results

6.1 Purpose of Survey

In order to find about the public perception of accounting transparency, I surveyed 14 auditors in the United States and 18 auditors in South Korea. The survey is designed to assess how important the audit quality is to the independent auditors in both countries. The Questionnaire Form consists of 12 agree or disagree questions and 3 short answer questions. I have targeted professional auditors who are actually working in the audit practice in the big four firms. Also, I have intended to understand the overall perception of the quality of audits in both countries. For example, I tried to ask whether there is any limitation for the auditor to perform the professional services. In addition, surveying on how the professional auditors perceive about their own ethical standards; this could particularly help to assess whether a certain work environment provides an atmosphere for CPAs to exert important professional qualities like independence and integrity. Lastly, I have included 3 short answer questions to better understand about the auditor's' perception on both quality of audit and personal ethical standard in each country.

In addition to conducting the survey, I also had opportunities to interview a partner and two senior managers about the public perception of Accounting Transparency in South Korea. All interview questions were designed to determine whether they have a high standard of integrity and analyze their willingness to perform so as to achieve a high quality of audit reports.

6.2 Survey Results in the United States

I surveyed 14 experienced CPAs and most of them had 2-5 years of professional experience. They have experienced several audit seasons. The survey questions are aligned randomly and cover three main audit procedure topics, which are:

- Question 1,2,8,12: Audit Quality
- Question 3,4,5,6,7: Effective Communication Method
- Question 9,10,11: Ethical Standards

Many respondents answered that their ethical standards are higher than those of average CPAs. Each of them values teamwork, which could enhance the quality of audit work and also the audit methods used in the audit procedures. Many CPAs answered positively to each questions but some mentioned how they have never talked to anyone from the Audit Committee or the Board of Directors, which could be a positive or negative sign. Whether it is positive or negative, the companies need to make sure it is relatively easy for the employees to articulate their own thoughts to people from the Audit Committee and the Board of Directors. Last but not least, another interesting finding was that many of them have chosen Integrity as their most important quality of as an independence auditor.

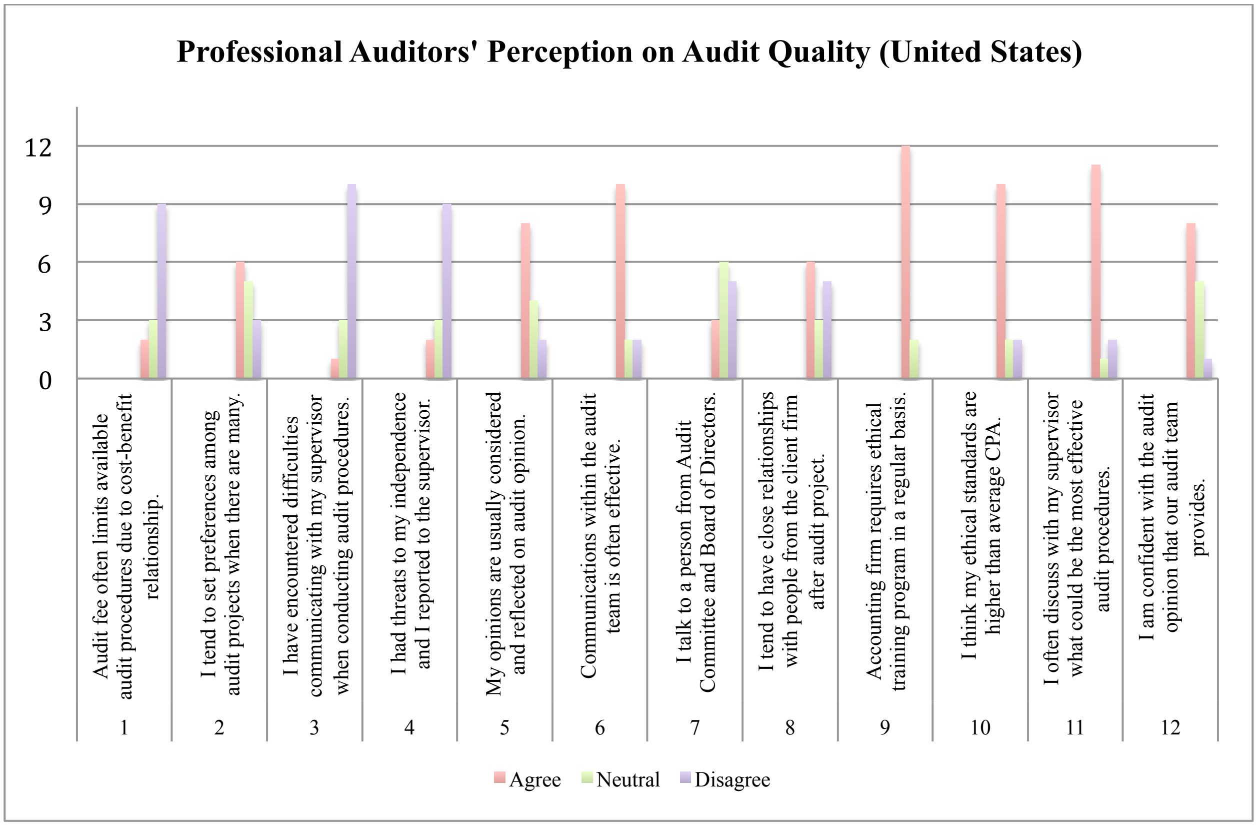

Table 1. Survey Result - United States

6.3 Survey Results in South Korea

I collected questionnaire surveys from 18 audit professionals and most of them had 2-5 years of experience. Even if the professionals from two different countries responded the survey, since they have similar years of experience, I hypothesized that the answers would be comparable to each other.

According to the survey results, unlike the answers from the professionals from the United States, South Korean Professionals had slightly different perspectives of the audit work standards. Many of them mentioned how they do not perform as high standard of audit work as they can, because they have an overload of work to complete. They mentioned that they pursue efficiency more than perfection when engaged in audit procedures. Because of their awareness of their audit standards, audit professionals in South Korea were not certain about the reliability of the audit reports produced in South Korea. They further stated that, regardless of the actual standard of audit reports, the public has a negative perception of Accounting Transparency because of the financial scandals occurring in the previous years. Furthermore, besides these results, I had an opportunity to interview a partner and two senior managers from the Big Four Accounting firms based on the questions on the survey.

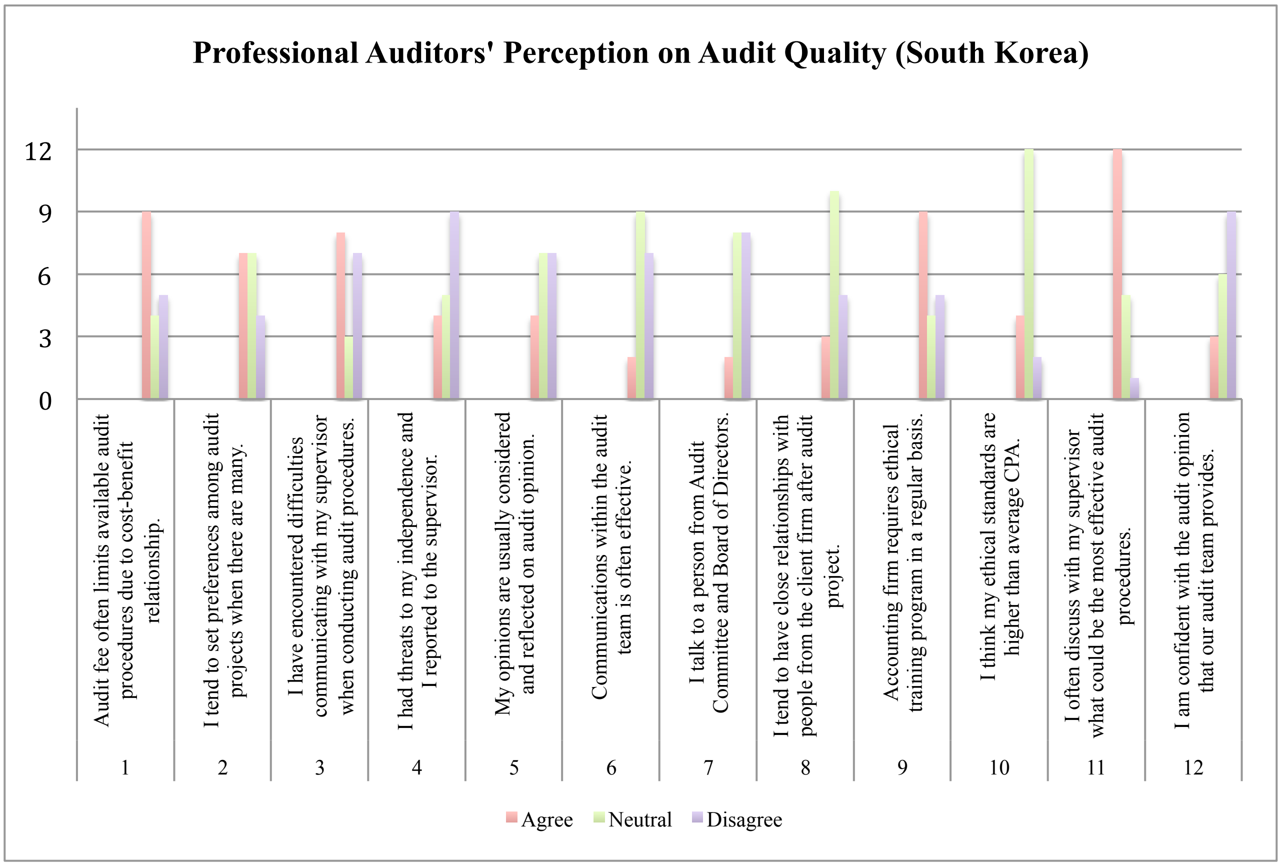

Table 2. Survey Result - South Korea

6.4 Interview Results in South Korea

The interviewees, a partner and two senior managers, stated that accounting and disclosure regulations have continually improved since the financial fraud scandals in the United States. After United States enacted Sarbanes-Oxley Act of 2002 to improve the regulations for accounting firms, the Act eventually had an influence on in South Korea to conduct more reliable audits. They further stated that Accounting Transparency in South Korea is comparable to those in developed countries like United States, it is often understated due to the existence of “Gab-Eur Relations”. Perspectives on Accounting Transparency varied depending on the years of experiences each person had. The more experiences the person have, the more positive perceptions he had on the Accounting Transparency. The variation in answers implies that the audit standards have gradually improved despite the fact that there are more efforts to make higher standards.

Chapter 7

Comparison of Earnings Managements

7.1 Cultural Differences

The major difference between the United States and South Korea in terms of Earnings Manipulation comes from the cultural factors. Any accounting firm would like to maintain a good relationship with clients, and to this extent, this phenomenon is the same for both the countries. As mentioned, in South Korea, “Gab-Eur Relation” plays a significant role in business relationships. To briefly define again, “Gab-Eur Relation” is a power dynamic between two parties, which are clients and accounting firms in this context. In South Korea, most clients, the “Gab”, are in favorable situations to put undue pressure on the accounting firms. This type of hierarchy enables client firms to coerce the accounting firms to comply with management’s decision of earnings manipulation. From the earnings management case of Daewoo Group, the Chung-Woon accounting firm was aware that the Daewoo Group fraudulently manipulated the financial statements; however, Chung-Woon accounting firm was not able to express any adverse opinions on the financial statements because the company constituted a high share of revenue for Chung-Woon accounting firm.

According to the research conducted by the Financial Supervisory Service about relationship between the average assets of the clients and the average annual audit fees, as mentioned previously, indicates that the competition is intense for “Eur” companies. The “Eur” companies attempt to lower the audit fees to maintain businesses with the clients and this behavior enables “Gab” companies to take more roles in the audit procedures.

Although a business relationship also exists between clients and accounting firms in the United States, each firm has its own duty and responsibility with comparable degree of power.

Since the individualism is stronger in the United States than in South Korea, professional auditors are also sensitive about the fair treatment they receive from the client companies, rather than just the auditors' behaviors toward the clients. According to a study conducted, strong relationships develop between auditors and their clients when the auditors receive fair treatment and clients' support, which triggers a greater commitment for the professional auditors (Herda and Lavelle 2013). As the clients are aware that higher client commitment yields value-added services, auditors are not the only party that makes efforts but clients also need to make a comparable amount of effort.

Compared to the public perception in South Korea, the public perception on this type of relationship is not as abusive in the United States. Rather, both parties believe that they pursue mutual benefits. However, the public perception on business relationship differs in terms of cultural factors that are more susceptible to fraudulent opportunities in South Korea where accounting firms more often undergo unwanted pressure. Also, "Gab-Eur Relation" could be a risk factor for independent auditors because in both US GAAP and K-IFRS, undue pressure can hinder a professional auditor's independence.

7.2 Accounting Regulations

The United States has made a lot of efforts to recover its lost credibility by implementing more requirements for U.S. public company boards, management, and public accounting firms. As mentioned earlier, company boards, management, and public accounting firms are not only subject to the Sarbanes-Oxley Act, but also need to adhere to other accounting regulations, which includes Government Auditing Standards, SEC independence rules, and PCAOB Rule 102, 101 and interpretations, and rulings under Rules 102 and 101. According to several Transparency Indexes, accounting transparency in the United States is no longer considered corrupt and that reinforcement of regulations to eliminate corporate frauds has in fact improved the quality of audit in general.

After several corporate frauds occurred in South Korea, they also reinforced the regulations on audit procedures, audit reports, and the ethical standards. One of the main changes was the enactment of the Korean IFAC Code of Ethics in 2006 and this made more thorough guideline for professional auditors to conduct services to client companies. However, as IFAC Code of Ethics itself focuses more on the principles, there is more generosity to these provisions. With the worsening of the accounting transparency in South Korea, it is assumed that the United States was more successful in enactment and implementation of the regulations; and this further implies that the severity of regulations has a huge impact of accounting transparency.

7.3 Earnings Management Cases

The earnings management cases in the United States, Cardinal Health Inc. and Dell Inc. were responsible for their fraudulent misconduct and were subject to millions of monetary fines along with several years of disciplinary actions. The United States took each corporate fraud seriously and charged relentless punishments to those who were engaged in the fraud cases. The Securities and Exchange Commission has been active in detection of audit irregularities and fairly announced to the public about the fraud case. In this sense, corporations in the United States have become reluctant to commit a corporate fraud in the consideration of the consequences of the earnings management.

Compared to the disciplinary actions that the United States made, South Korea charged a tolerable amount of monetary fines and disciplinary actions. In Sambu Finance’s case, the monetary charges were very low compared to the amount the CEO of Sambu Finance embezzled. As a consequence of bearable sanctions, the ex-CEO of the Sambu Finance Corporation has been alleged to another fraud case in 2015. Therefore, there is a need for South Korea to further intensify the regulations for accounting regulations to detect future cases of earnings management.

7.4 Survey Results

As mentioned, the survey is designed to perceive three main things; which are audit quality, effective communication skills, and the ethical standards. These three sections are highly correlated and the factors that have a direct impact on the quality of audit procedure and audit report. Survey questions are in a random pattern to avoid any biases and divided into three main sections, which are:

- Question 1,2,8,12: Audit Quality
- Question 3,4,5,6,7: Effective Communication Method
- Question 9,10,11: Ethical Standards

Professional auditors in the United States answered positively to each sections, and especially in communication section, that they showed a high percentage of positive answers to the survey questions. Also, except the two auditors, other fourteen auditors considered their ethical standards are to be higher or the same as the average and only one auditor answered that he is not confident about his audit opinion. However, South Korean professional auditors in professional auditors in South Korea had relatively negative responses, especially about the communication Section, which is a significant difference. Only two auditors agreed that communications within the team are effective and also only three auditors were confident with their audit opinions that the team produces. The survey implies that the perception of audit quality that auditors in each country has, which is very different and contrasting. Lastly, audit qualities will become more doubtful for South Korea as well.

Chapter 8

Conclusion

In order to compare the degree of impact that earnings management has in the United States and South Korea, I analyzed the differences in the cultural factors, accounting regulations, earnings management cases, and professional auditors' perception on auditing standards across the two countries.

Most importantly, the cultural difference is a key factor; "Gab-Eur Relation" creates an environment for both auditors and clients in South Korea to engage in earnings management more easily. In contrast, in the United States, the both auditors and clients make more of an effort to improve the reporting and audit processes. Based on a comparison between accounting regulations and earnings management cases in both countries, it is evident that the United States has actively implemented regulations and made other efforts to prevent any future corporate frauds.

According to my survey, the professional auditors in the United States have a strong dedication to teamwork, which leads to effective communications within the team. They also stated that their ethical standards are higher than the average, which contributes to the high standard of audit reports. In contrast, the professional auditors from South Korea had negative responses about their teamwork, which implies that the team members do not collaborate as much as the auditors in the United States. Thus, this circumstance it eventually decreases the audit quality.

Just like the Deputy Minister of Information Policy, Artem Bidenko, stated: "Ensuring disclosure of, and access to, information can empower people and institutions to prevent and fight corruption." Governments must proactively release information on what people want to know or what they do. When the government takes the initiative, both accounting firms and the clients will be more open to disclosing their financial information truthfully. All information users have rights to be aware of all material financial information before making any decisions. The users also need to make sure they trust the companies and support them to include reliable information, even when they have adverse information to disclose.

Further, we need to make sure that the accounting regulations are implemented on a day-to-day basis. It is essential for accounting firms to follow those regulations when conducting any professional services. Correct implementation of these laws could be a key in preventing the manipulation of financial statements. Also, if accounting boards pay more attention to monitoring audit work standards and audit procedures, then the accounting firms will be more attentive to their audit procedures.

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APPENDIX A Survey Form

PENNSTATE	2015 Schreyer Honors College

SURVEY ON AUDIT PRACTICES

Years of Audit Experience:	☐ None ☐ Less than one year ☐ 2-3 Years ☐ 4-5 Years ☐ More than 5 years

QUESTIONS		Answer
1	Audit fee often limits available audit procedures due to cost-benefit relationship.	☐ Agree ☐ Neutral ☐ Disagree
2	I tend to set preferences among audit projects when there are many.	☐ Agree ☐ Neutral ☐ Disagree
3	I have encountered difficulties communicating with my supervisor when conducting audit procedures.	☐ Agree ☐ Neutral ☐ Disagree
4	I had threats to my independence and I reported to the supervisor.	☐ Agree ☐ Neutral ☐ Disagree
5	My opinions are usually considered and reflected on audit opinion.	☐ Agree ☐ Neutral ☐ Disagree
6	Communications within the audit team is often effective.	☐ Agree ☐ Neutral ☐ Disagree
7	I talk to a person from Audit Committee and Board of Directors.	☐ Agree ☐ Neutral ☐ Disagree
8	I tend to have close relationships with people from the client firm after audit project.	☐ Agree ☐ Neutral ☐ Disagree
9	Accounting firm requires ethical training program in a regular basis.	☐ Agree ☐ Neutral ☐ Disagree
10	I think my ethical standards are higher than average CPA.	☐ Agree ☐ Neutral ☐ Disagree
11	I often discuss with my supervisor what could be the most effective audit procedures.	☐ Agree ☐ Neutral ☐ Disagree
12	I am confident with the audit opinion that our audit team provides.	☐ Agree ☐ Neutral ☐ Disagree

SHORT ANSWER QUESTIONS

Q: WHAT DOES "AUDIT RISK", "DETECTION RISK", AND "MATERIAILITY" MEAN TO YOU?

Q: WHAT IS THE MOST IMPORTANT QUALITY YOU HAVE AS AN AUDITOR?

Q: WHAT DO YOU THINK ABOUT THE RELABILITY OF THE AUDIT REPORT?

Academic Vita of Soo Ryeon Baek

sxb5299@psu.edu

The Pennsylvania State University, University Park
Smeal College of Business — 150 Credits by Dec 2015
Bachelor of Science in Accounting — Passed CPA Examination
Schreyer Honors College
Honors Thesis: The Relationship between Audit Limitation and Earnings Management and the Differences in the Degree of Impact that Earnings Management causes in United States and South Korea (approved by Henock Louis)

WORK EXPERIENCE

DELOITTE LLP — Seoul, South Korea
Intern, Financial Advisory Services — June 2015 – July 2015

- Supported a Financial Restructuring team in developing a recovery plan for a client company that wanted to liquidate its subsidiary
- Conducted research and applied the customized performance metrics to understand, monitor, and measure financial and operational results of client company
- Compared client company's financial statements with bank statements to testify management assertions
- Led an intern team project on improving Deloitte's future corporate strategy that could impact Young Generation

KPMG LLP — Seoul, South Korea
Intern, Audit Industrial Markets — June 2013 – July 2013

- Completed a research report successfully on feasibility of Wood Pellet as a new and renewable energy source
- Conducted interviews with managers from core power generations about their professional views on the feasibility of Wood Pellet
- Volunteered to teach middle school students about the basic concepts of Accounting as a corporate social responsibility program
- Coordinated and communicated on the project thoroughly with supervisors to learn the efficient way of analyzing a company's financial statements and how they are impacted by the use of Wood Pellet

MILLENNIUM HILTON HOTEL — Seoul, South Korea
Intern, Finance Department — June 2012 – Aug 2012

- Resolved complaints from suppliers and upper management through outstanding interpersonal skills
- Monitored documentation errors, regarding cost of inventory and proceeded orders, implemented by specialists
- Assisted in processing orders, recording individual order information and counting inventory on a daily basis

LEADERSHIP & ACTIVITIES

THE BRIDGE INITIATIVE — University Park, PA
Vice President/ Co-founder — Aug 2013 - May 2015

- Developed and drafted a constitution for the committee
- Held bi-weekly meetings and collaborated with executive officers and managers to plan and to coordinate various events that could motivate the members to participate in voluntary work
- Advertised the organization and its events to people including the members and other Penn State students; resulted in over 300 people joining as members
- Maintained contacts with every members in the committee for higher active participation of members

KOREAN INTERNATIONAL STUDENT ORGARNIZATION (KISO) — University Park, PA
Treasurer/ Mentorship Chair — Aug 2013 - May 2015

- Organized multicultural events for both international students and local students at Penn State to have a better knowledge about the Korean culture and tradition
- Developed Mentor-Mentee program to better enhance the college experience of students at Penn State students
- Managed the program by conducting meeting with mentors to share ideas on how to draw mentees' interests to actively participate in the program

ASCEND — University Park, PA
Active Member — Aug 2012 - May 2015

- Attended meetings and corporate information sessions to gain knowledge on real-life business experience and business networking skills
- Networked weekly meetings and seminars to discuss industry issues, fostering exchange of ideas and issues