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# CORPORATE ACCOUNTING: LEGAL RISKS AND COUNTERMEASURES

## Legal Risks

Liability for fraudulent accounting is at once the most important and overarching of legal risks associated with corporate accounting practices. The consequences range from criminal punishment for fraudulent accounting, itself (a violation of the External Audit Act and/or the Financial Investment Services and Capital Markets Act), or the procuring of an investment, loan or other transaction through window-dressed financial statements (a fraudulent transaction), to civil liability for losses claimed by investors or other transaction parties (including by means of class-action lawsuits) who relied on window-dressed financial statements in entering into an impugned transaction.

Most window-dressing cases are uncovered through accounting inspections of the Financial Supervisory Service ("FSS"). The FSS conducts three general types of inspections: sampling inspections, charge-based inspections and commissioned inspections; and of these, the sampling inspections are the most predominant.

The FSS does not provide an express and exhaustive list of selection criteria for sampling inspection targets. These can only be inferred from rules disclosed in the past (and now deleted): mandatory targets included any company with the highest debt ratio, the highest inventory asset ratio, or the lowest operating cash-flow ratio in its respective industry, and any company which had not been inspected for five years or longer, had changed its accounting procedures, or had a net profit or loss to sales ratio of less than 1% was to be selected in priority to other companies. In addition, according to the recently published 'Selection Criteria for Inspection Targets with Fraud Risk', any company for which there has been a case of embezzlement or breach of trust, or of which the representative director has been frequently replaced, among others, will be selected as a subject for sampling inspection in priority to other companies.

The FSS determines whether to take administrative measures (imposition of a penalty surcharge, designation of an auditor, etc.) and to file a complaint and a report with the prosecutors' office by applying the 'Criteria for Determination of Measures Based on Inspection Results' to its accounting inspection results.

Such criteria center largely on determinations of the gravity of, and motive behind, the alleged illegal act. The 'gravity' of an alleged illegal act is measured

on the basis of the type and scale of the illegal act concerned. The 'motive' behind an alleged illegal act is categorized as intent, gross negligence or negligence.

## Countermeasures

If your company has not yet had an instance of fraudulent accounting detected internally or exposed externally, the importance of promoting ethical awareness among your corporate officers and employees cannot be over-emphasized. The lack of ethical awareness among the officers and employees of Lehman Brothers has been widely cited by the media as the leading cause of its downfall; it was peopled with the finest minds and talent in the world but crossed the line into bankruptcy and failure due to a lack of ethics.

If fraudulent accounting has been detected internally but not yet exposed externally, it is of utmost priority to maintain strict confidentiality; this is because any external disclosure may make it virtually impossible to take otherwise possible corrective measures due to the conflicts of interests of numerous interested parties. As soon as appropriate measures to maintain confidentiality have been taken, the fraud and/or errors in accounting should be swiftly and accurately identified, and necessary and corrective legal and accounting measures determined and implemented to contain the situation and minimize the damage to the company.

After any exposure of fraudulent accounting to external parties, it is imperative to take immediate and concentrated action. Efforts should focus on mitigating as much as possible the daily erosion to the credibility of the company and its management, to avoid lost opportunities to formulate necessary arguments and plans of action.

Further, such arguments and plans of action should focus more on how best to frame or present the motive behind the alleged illegal act, than downplaying the level of its gravity. This is because the primary determinant for whether the FSS will file a complaint and/or a report with the prosecutors' office will be its assessment of the alleged motive behind the committing of the alleged illegal act; and, once the prosecutors' office commences an investigation into a charge of fraudulent accounting and decides to prosecute the charge, the probability of acceptance of a company's defense is effectively reduced to near zero, with resulting large-scale damage to the company.

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