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A Periodic Auditor Designation and the Role of Audit Committee

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A B S T R A C T

Purpose: The purpose of this study is to review the new regulations on the periodic auditor designation system and to investigate the role of the Audit Committee in implementing the periodic auditor designation system.

Design/methodology/approach: To achieve the objectives of this study, this study examines the revisions of the External Audit Law that stipulates the periodic auditor designation system. This study examines the expected positive and negative effects of the periodic auditor designation. This study suggests the role of the Audit Committee for the successful implementation of the periodic auditor designation system.

Findings: The findings of this study are as follows. First, the periodic auditor designation system improves the independence of external auditors, improves the quality of accounting audits, and improves the reliability of financial information. Second, the Audit Committee's authority has been strengthened regarding the appointment of external auditors, including audit fees, audit hours, and compliance with audit contracts. The Audit Committee should communicate sufficiently with the external auditor and should fully monitor the audit process of external auditors. Third, improving the independence of external auditors, improving the quality of accounting audits, and improving the reliability of financial information has the effect of converting the supervisor's supervisory competency from post-detection supervision to preventive supervision.

Research limitations/implications: The results of this study provide practical implications for the role of corporate governance by emphasizing the role of the Audit Committee.

Originality/value: Korea is the first country in the world to apply the periodic auditor designation system. This study is worthwhile as the first paper to introduce the expected effects of the application of the periodic auditor designation system.

Keywords: Periodic auditor designation, Audit quality, Audit committee, Accounting Innovation, Management and supervision system

1. Introduction

The Korean government (Financial Supervisory Service) strengthened the regulations to secure independence and improve audit quality. In 2017, the External Audit Law was revised to introduce

a system for designating periodic auditors. A periodic auditor designation is a method in which the company is free to appoint an external auditor for six consecutive fiscal years, designated by the supervisory authority for the next three years.

A regular auditor designation system is adopted to improve audit quality by securing the independence of external auditors. According to the External Audit Law, the designation of periodic auditors is effective from November 1, 2019 (New External Auditing Law

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in Korea, 2017). It is an innovation in the accounting system that the Korean government (Financial Supervisory Service) introduced a system of periodic auditor designation, which does not originate worldwide. This is because external auditors are determined differently than before, thereby improving the quality of accounting information and creating new values for companies and stakeholders. The innovation of the accounting system can increase the reliability and transparency of Korean companies' financial information. Also, through the innovation of the accounting system, the corporate value of Korean companies in the capital market can be evaluated positively.

Designated as periodic auditors, not only can the innovation of the accounting system be achieved, but also the innovation of accounting management and supervision system. If the periodic auditor designation system is in place to ensure the reliability of accounting information systematically, supervisors can save time and money spent investigating accounting fraud. Supervisors will be able to focus their efforts on reforming preventive and systematic accounting management systems rather than exposing accounting fraud. Innovation in accounting management and supervision will create better creative value.

The Korean government (Financial Supervisory Service) announced in advance 220 companies that would be subject to periodic auditor designation in the 2020 fiscal year, ahead of the implementation of the periodic auditor designation (Financial Supervisory Service, 2019). The supervisor's preliminary announcement is intended to prevent side effects that may arise from the gathering of a periodic auditor-designated company. The adoption of a periodic auditor designation system is expected to lead to difficulties in securing qualified personnel and stable manpower management for accounting firms. Also, if the auditor is freely appointed after the appointed period of the external auditor, audit quality may deteriorate due to intensifying competition among auditing firms.

Periodic auditor nominations, which are implemented for the first time in the world, maybe soft landing

and the company may request reassignment to another external auditor to address the shortcomings of the supervisory nomination. Exceptionally, companies that do not find a violation of accounting standards within the past six years as a result of supervisory supervision are exempt from periodic designation. The company needs to review the possibility of replacing auditors due to the implementation of a periodic auditor designation system and risk factors that may occur during replacement and prepares countermeasures. For example, if an external auditor's efficiency is expected to be reduced due to auditor discrepancies between subsidiaries and subsidiaries, the request for re-designation may be requested.

This study examines the periodic auditor designation system that is applied only in Korea to secure independence and improve the audit quality of external auditors. Creating a good corporate governance environment is necessary to solve or prevent agency problems. The Audit Committee is one of the representative internal control bodies for establishing good corporate governance. Improving corporate governance improves the credibility of the capital market. As capital markets become more sophisticated, the measure of investor decision-making will become the soundness of corporate governance.

The periodic auditor designation system was introduced by the External Audit Law, which was revised in 2017. The revised External Audit Law not only introduced the system for designating periodic auditors but also significantly strengthened the authority and responsibility for the external auditor appointment of the Audit Committee, an internal control organization. The Audit Committee shall appoint an external auditor for six years in which the entity is free to appoint an external auditor in the periodic auditor designation system. Therefore, the role of the Audit Committee became more important in the periodic auditor designation system. In addition to the periodic auditor designation system, this study examines the role of the Audit Committee, which is more important than in the past.

This paper is organized as follows. Section 2 provides a literature review. Section 3 examines the

background of periodic auditor designation, advantages, and disadvantages of periodic auditor designation. Section 4 provides an external auditor appointment system in foreign countries.

II. Literature Review

In the case of companies that voluntarily set up the Audit Committee, the accounting information is highly reliable and the demand for accounting transparency is high (Pincus, Rusbarsky, and Wong, 1989). According to McMullen (1996), the Audit Committee plays a major role in monitoring the credibility of a company's financial reporting process. In particular, the Audit Committee has been shown to curb accounting errors, fraud, and other distrusting factors. According to Xie et al. (2002), the higher the professionalism and activity of the Audit Committee, the more limited the firm's profit adjustment behavior. In particular, if the Audit Committee members have financial knowledge, and the Audit Committee meetings are frequent, the number of outside directors among the Audit Committee members decreases the earnings management. Klein (2002) verified that the higher the board's independence, the more effectively it monitors the firm's financial accounting process. In other words, the higher the independence of the Audit Committee, the lower the occurrence of abnormalities. Krishnan (2005) verified that the more independent and professional the Audit Committee, the better the internal accounting management system. As mentioned above, the independence of the Audit Committee, the higher the professionalism and the higher the activity, the higher the credibility of the accounting information.

If the Audit Committee plays its role as an important internal control body within the company, it can be seen that earnings adjustments are reduced and accounting information is more reliable. In the new External Audit Law, a periodic auditor designation system was introduced, and the Audit Committee

should play an important role in exerting expertise and independence in the appointment of external auditors. As discussed in previous studies, the Audit Committee plays a major role in enhancing corporate governance and accounting transparency, and the responsibility and role of the Audit Committee are becoming more important. Accordingly, in Korea, the External Audit Law has been revised to strengthen the responsibility and role of the Audit Committee (New External Auditing Law in Korea, 2017).

Audit opinion shopping means checking whether the audit client can contact the new auditor candidates in advance to receive qualified opinion and if so, replace the auditor. As such, when an auditor is replaced to purchase an audit opinion, the independence of the new auditor may be impaired and the audit quality may be impaired. For a long time, regulators have been very interested in purchasing audit opinions from audited companies. In the United States, the importance of maintaining audit quality has increased after accounting frauds such as World-com and Enron, and social attention has been focused on audit qualities. The US supervisory authority GAO (2003, 2008) also considered the partial introduction of a forced auditor replacement system to prevent auditor replacement for an audit opinion. The Sarbanes-Oxley Act (SOX) has decreased the number of discretionary accruals, addressed the backdating of stock options, addressed material reporting weaknesses, and increased the quality of internal controls (Daniel Boylan, 2015).

However, although several previous studies confirmed the possibility of purchasing audit opinions due to auditor replacement, no specific evidence was found (Chow and Rice, 1982; Smith, 1986; Krishnan, 1994; Krishnan and Stephens, 1995). In contrast, Lennox (2000) used a statistical model to verify auditor replacements for audit opinion shopping. The results of this study suggest that the purchase of audit opinions using auditor replacement is occurring. Myers et al. (2003) analyzed the relationship between audit duration and audit quality. The results of the study report that the shorter the duration of the continuous audit, the lower the audit quality. This means that the initial quality of the auditor's replacement is low.

The result of previous research in the United States does not show consistent results regarding the replacement of auditors to purchase audit opinions. For this reason, the United States did not introduce the designation of periodic auditors as in Korea.

III. External Auditor Appointment System in Korea

A. Background of Periodic Auditor Designation

In the case of companies based on the financial statements of the individual, the semi-annual report and quarterly report do not show the status of the gain or loss associated with the subsidiary until before the annual report of the consolidated financial statements are published at the end of the year. It is the blind spot that cannot be confirmed in the individual financial statements of each company exists. In other words, the consolidated financial statements published standard grace of quarterly report or semiannual report expand the period of asymmetric information in the capital market between participants (Krishnan, 2005). Korea is free to appoint external auditors. In exceptional cases, however, supervisors appoint external auditors. As of 2015, 92.2% of listed companies were free to appoint external auditors, while the remaining 7.8% were appointed by the supervisory authority (The Korean Accounting Association, 2016).

Table 1 shows the comparison of auditor's free appointments system and designation system. As shown in Table 1, in the case of auditor's free

appointment system, auditor's independence is somewhat inferior, but audit quality can be improved by auditor's competition to improve audit quality. Auditor designation can enhance the independence of auditors by forcing the supervisor to appoint auditors, but the competition for enhancing audit quality may disappear, resulting in lower audit quality. Under the free appointment system, since the audited company hires an external auditor, it inevitably creates an "economic dependency" structure between the audited company and the external auditor. Accordingly, criticism has been raised that the free appointment system undermines the independence of external auditors. Ownership and management are separated so that external auditors play a role in checking management. However, there is criticism in Korea that external auditors are unable to check management under control due to the weakness of corporate governance. Some companies have been blatantly pressured to replace external auditors.

Under this background, the need for resolving economic subordination between audited companies and external auditors has emerged. In other words, it was necessary to find a fundamental solution to the economic dependency structure that was firmly established between the audited company and the external auditor.

To solve this problem, a periodic auditor designation system was introduced in the New External Audit Law. A periodic auditor designation is an innovation in accounting systems. This system improves the quality of accounting information and creating new values for companies and stakeholders. These innovations can increase the reliability and transparency of Korean companies' financial information and positively evaluate the corporate value in the capital market.

A periodic auditor designation can also innovate accounting management and supervision system. A periodic auditor designation system is a device that can ensure the reliability of accounting information systematically. If accounting information is secured, supervisors can focus their efforts on reforming preventive and systematic accounting systems rather than exposing them to post-accounting fraud. Innovation

Table 1. Comparison of Auditor Free Appointment System and Designated System (The Korean Accounting Association, 2016)

| Division | Auditor Free appointment | Auditor Designation |
|-----------------------|--------------------------|---------------------|
| Auditor Independence | low | high |
| Auditor's eligibility | high | low |
| Audit Quality | high | low |

in accounting management and supervision will create better creative value. The listed companies are free to appoint external auditors for six consecutive business years, and the external auditors for the next three business years are designated directly by the supervisory authority. Through this, the Korean government (Financial Supervisory Service) tried to secure the independence of external auditors and improve the quality of the audit.

B. Advantages of Periodic Auditor Designation

The periodic auditor designation system is a combination of the free appointment system and the designation system. In the case of the application of periodic auditor designation, external auditors may conduct audits in a more independent position. Therefore, audit quality can be improved. Under the periodic auditor designation system, after the free appointment of an external auditor for some time, the supervisory authority appoints an external auditor. Thus, the limitation of the free appointment system can be supplemented. If appointees are appointed after the free election, auditors may be neglected to develop and improve their auditing skills, and the independence may be reduced due to the relationship between the audited company and external auditors. Therefore, the three business years are limited to the external auditor's designation period. In the past, Korea had introduced and implemented a forced replacement system. However, criticism that frequent auditor replacements lowered audit fees and did not improve audit quality.

This experience led to the introduction of a designation system for periodic auditors that combines free appointments and designation systems. Under the External Audit Law, an audit contract is signed every three years, so a six-year free appointment is made, and a three-year auditor designates an external auditor. If an external auditor is changed, the auditor is initially at risk of failing to understand the company. Therefore, a sufficient audit period is given with a free appointment period of six years.

In other words, during the six years, an external auditor is freely appointed to allow the external auditor to fully understand the audited company and improve the audit quality.

Periodic auditor designation combines the advantages of free appointments with those of the designation system. The competition will lead to improvements in auditors' auditing skills. Also, the designation of an external auditor by the supervisor for three years will improve the independence of the external auditor by reducing the economic dependency between the audited company and the external auditor.

At present, the biggest problem of the external audit market in Korea is the loss of independence due to the economic dependency between the audited company and the auditor. In this situation, the introduction of a periodic auditor designation system is an effective way to solve the problems of economic dependency and improve the independence of external auditors. Periodic auditor designation will maintain tensions between the audited entity and the auditor. It also allows capital markets and supervisors to monitor the quality of audits indirectly and periodically, leading to improved audit quality.

Designated periodic auditors can expect the effects of proactive and indirect auditing. In the face of the current lack of accounting supervision, manpower, and budget of the supervisory authority, a periodic designation system can be introduced to induce efforts to improve financial information and audit the quality of audited companies and external auditors. From the external auditor's point of view, the introduction of a periodic auditor designation system can increase audit time and audit fees, thereby improving audit quality. Improving audit quality reduces social costs and enables efficient resource allocation across society.

C. Disadvantages of Periodic Auditor Designation

The periodic auditor designation shall be free to appoint an external auditor for six years, and after three years of appointment as another external auditor,

the external auditor must be replaced. Such a replacement may interrupt the duration of the ongoing audit and reduce the effectiveness of external audits. In other words, if the external auditor who understands the audited company cannot audit the company continuously, there is a risk that the auditing efficiency is lowered and the audit quality is lowered. If the same external auditor continues to audit for a long time, a deeper understanding of the company can reduce audit risk. However, changes in auditors due to the designation of external auditors may increase the risk of audit failure in the initial audit year.

In the case of designating an external auditor, audit fees may be excessively increased compared to the appointment of an external auditor by free competition. There are also costs associated with the designation of auditors, which can create additional social costs. In the case of the introduction of a periodic auditor designation system, the supervisor should appoint an external auditor. In such cases, it may be difficult to assign the auditors fairly. External auditors who can audit companies in large or complex industries may be limited. The introduction of a periodic auditor designation system allows auditors to conduct several external audits without special effort. This may reduce the efforts of external auditors to improve their audit quality. The introduction of a cyclical auditor designation system may also level down the quality of audits in the capital markets.

IV. External Auditor Appointment System in Foreign Countries

Table 2 shows the external auditor appointment system in foreign countries. The designation system is one of the leading systems in Korea and is rarely found abroad.

In Korea and the United States, external auditors are appointed by the Audit Committee. Australia and Japan require the appointment of external auditors at regular shareholders' meetings. Auditors' forced replacement system is not applied in most countries including Korea. In Korea, the forced replacement system for auditors was implemented in the past and was abolished in 2009 due to many problems. The auditor forced replacement system assumes that prolonging the audit period will reduce the quality of earnings. The long-term audit period can be regulated through a forced replacement system to enhance the independence of the auditor. However, in Korea, research results on whether forced replacement of auditors improves the quality of audit showed inconsistently. Therefore, in 2009, the forced replacement system for auditors was abolished.

V. Periodic Auditor Designation System and Role of Audit Committee

The New External Audit Law ensures the expertise of the Audit Committee as the subject of accounting innovation. The Audit Committee should include at least two auditors or financial experts to ensure the

Table 2. Appointment System as an External Auditor in Foreign Countries (The Korean Accounting Association, 2016)

| Division | Korea | USA | Australia | Japan |
|----------------------------------|-----------------|-----------------|-----------------------|-----------------------|
| Auditor Determiner | Audit Committee | Audit Committee | Shareholders' Meeting | Shareholders' Meeting |
| Mandatory Audit Firm Rotation | No | No | No | No |
| Mandatory Audit Partner Rotation | Yes | Yes | Yes | Yes |
| Auditor Designation | Yes | No | No | No |

expertise of the Audit Committee. The communication between the Audit Committee and the external auditors is specified. Also, the New External Audit Law requires the company's management to produce reliable accounting information and the Audit Committee should provide effective oversight of the accounting and work. External auditors should audit accounting information and internal accounting management systems, and supervisors should ensure efficient oversight of external auditors' appointments and audits.

The New External Audit Law emphasizes the role of the Audit Committee as an internal control device. The Audit Committee has strengthened its authority to appoint external auditors. In addition to the appointment of external auditors, the Audit Committee's authority has been strengthened regarding the appointment of external auditors, including audit fees, audit hours, and compliance with audit contracts. The reason why the Audit Committee could appoint an external auditor is to secure the independent auditor's independence from management. The quality of the audit can be improved if the external auditor is independent of management. Financial information users with improved audit quality will be able to make more informed decisions.

If an external auditor is independent of management, collaboration with the external auditor and Audit Committee can be enhanced. This is because external auditors can supplement the Audit Committee's accounting expertise. Even during the external audit, the Audit Committee should communicate sufficiently with the external auditor. The Audit Committee should fully monitor the audit process of external auditors to ensure the high quality of external audits.

If the company freely selects an external auditor, it will appoint an external auditor selected by the Audit Committee. The Audit Committee plays an important role in the appointment of external auditors. The Audit Committee should carefully examine whether or not the auditor's designation is excluded for three years of the designation system. For example, an auditor may not be assigned if there are exceptions to the auditor's designation, such as a supervisory

oversight of the company's financial statements within the last six years and no accounting violations have been found. Audit Committee should, therefore, look carefully at these exceptions.

The Audit Committee should check whether the company is subject to the periodic designation and, if appropriate, identify the auditor's designation schedule and play the necessary role promptly. The Audit Committee may request to reassign an external auditor designated by the supervisor to another external auditor. The Audit Committee may request re-designation as another external auditor if it is determined that the external auditor originally designated is undermining independence, or if the terms of the audit contract, such as audit fees, are unreasonable. Therefore, the Audit Committee should conduct a careful review of the reasons for re-designation. The Audit Committee should consult with designated auditors on audit fees, audit hours, and audit staff. The Audit Committee should document these. When the Audit Committee receives an audit report from an external auditor, the Audit Committee should check that the audit fees, audit time, and input staff determined during the audit contract have been fully complied with.

VI. Conclusions

The periodic auditor designation system is a combination of the free appointment system and the designation system. In the case of applying periodic auditor designation, external auditors may conduct audits in a more independent position. Therefore, audit quality can be improved. A periodic auditor designation system is a device that can ensure the reliability of accounting information systematically. If accounting information is secured, supervisors can focus their efforts on reforming preventive and systematic accounting systems rather than exposing them to post-accounting fraud. Innovation in accounting management and supervision will create better

creative value.

The New External Audit Law defines the Audit Committee as the subject of accounting innovation. The Audit Committee may also require a balanced and independent external audit between shareholders and external auditors to prevent violations of shareholder rights due to information asymmetry. The Audit Committee can ensure accounting transparency by monitoring and monitoring management. Accounting and work supervision through the Audit Committee can effectively supervise the management and provide reliable financial information. The Korean government requires the accounting and supervision of the Audit Committee. The role of the Audit Committee as an internal control system is emphasized, and the professionalism of the Audit Committee is secured as an agent of accounting innovation. The role and responsibility of the Audit Committee in Korea are becoming more important due to the introduction of a designation system for periodic auditors, which does not come from all over the world.

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