

Ifrs 10 application to hyundai and kia

[Business](#), [Company](#)



----- ACCT333 Advanced Financial Accounting
----- Group Project Assignment (IFRS 10)

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Identifying ambiguity of control Background The Hyundai Motor Company
(hereafter referred to as Hyundai) is a multinational automaker based in
Seoul, South Korea. Hyundai is one of the two best-known divisions of the
global conglomerate Hyundai, the other being Hyundai Heavy Industries, the
largest shipbuilder globally. A famous Korean businessman, Chung Ju-yung,
founded Hyundai in 1974.

Following the Asian Financial Crisis in 1997, Hyundai bought over Kia Motors
Corporation (hereafter referred to as Kia) in 1998, which resulted in the

formation of the Hyundai Kia Automotive Group (HKAG). It consists of multiple affiliated companies related through complex shareholding agreements, although Hyundai is taken to be the de facto representative in transactions done with HKAG. During the acquisition of Kia in 1998, Hyundai out-bid Ford motors to acquire 51% of the company's shareholding. After a series of divestments over the years, the total ownership of Hyundai in Kia has been reduced to only 33.5%. Hyundai and Kia are both listed individually on the Korean Stock Exchange. In 2008, Hyundai was ranked the 8th largest automaker in the world. It was also the fastest growing automaker globally for 2 consecutive years (2010 and 2011). The chairman and CEO of Hyundai is Chung Mong-koo, one of the surviving sons of Chung Ju-yung. Control issues Hyundai currently has a 33.75% direct shareholding in Kia, with the remaining shareholdings being presumably widely dispersed. As such, it evidently has significant influence over the operations and running of Kia's business.

However, establishing direct control between Hyundai and Kia is not as straightforward. There are a number of issues that we have to look at. Co-owning of subsidiaries Hyundai and Kia co-own a large number of subsidiaries. As evidenced by the 2010 consolidated financials of Hyundai, the global branches of the Kia Motors Group are 100% held by Hyundai through Kia themselves. Both companies also have percentage ownership in Hyundai's various component manufacturing companies like Hyundai HYSKO Company Limited and Hyundai Powertech Company Limited.

Aside from this, they also have holdings in Autoever Systems Corporation, where their main Research and Development unit is located. Inter-company

director relations The current Chairman and CEO of HMC is Chung Mong-koo. He took over Hyundai in 1992 when the Hyundai Group split into its various divisions. The Hyundai group itself follows a South Korean Business form of conglomerate known as chaebol, where the unique characteristic is that it is usually a huge family controlled corporate group.

As such, it is not surprising to see that many of the third generation members of Chung Ju-yung's family are heading many of the different divisions of the Hyundai Group. Chung Mong-koo's only son, Chung Eui-sun was a key operating officer in various corporate planning divisions in Hyundai-Kia before eventually heading Kia as its president from 2005 to 2009. Currently, he is the vice chairman of Hyundai and is on the internal board of directors for Kia. Aside from this, Chung Mong-koo also has a 5% shareholding in Kia. Same platform manufacturing

Both Hyundai and Kia co-own manufacturing subsidiaries that produce component parts to both companies. As a result, their production facilities get the similar component parts from the same suppliers. The companies also use the same power trains (engines and transmissions) all manufactured largely from the Hyundai Powertech Company Limited. A majority of the automobile electronic components from both brands also come from Hyundai MOBIS Limited. Both these companies are co-owned subsidiaries of Hyundai and Kia. Both Hyundai and Kia also share design studios.

In fact, the vice president of design based in HMC actually oversees the design management of both brands. The family controlled heading of both Hyundai and Kia allows us to consider the possibility of Hyundai having a <https://assignbuster.com/ifrs-10-application-to-hyundai-and-kia/>

controlling influence over Kia, especially with Chung Eui-sun's dual positions on both companies' board of directors. Furthermore, given the fact that both companies virtually sprout from the same supply chain, and control over their research and development and design of the vehicles are headed by staff based in Hyundai, we can see that these revenue generating activities greatly affect the business operations of both companies. Even though Kia is clearly not a subsidiary at first glance, given the meagre 33.75% ownership by Hyundai, it would appear that Hyundai may be exerting more than just significant influence over Kia through the various factors mentioned. (b) & (c)

Application of IFRS 10 flowchart to determine existence of control by Hyundai

Step 1: Determine the purpose and design of investee (Kia)

Hyundai purchased shares in Kia for 1.18 trillion won in November 1998.

The purpose of this acquisition in Kia is for Hyundai to gain significant foothold and widen its market share in the auto industry. By taking over Kia Motor, the Hyundai-Kia group was able to forge a solid position having over 70% of domestic market share and become the 7th or 8th global automaker by combining its affiliates' production capacity into the total volume of 2.9 million units in 1999.

Step 2: Determine relevant activities

Activities | Does it significantly affect investees' returns --> relevant activities? | Example of decisions about relevant activities | How decisions about relevant activities are made?

Research and development | Yes | Reduce the number of platforms to 718 by the end of 2005, in order to save the costs of product development and manufacturing and produce a variety of car models having differing external styling and interior options for the brands of Hyundai and Kia | Decisions are made by a joint R&D Division led by the

ChiefTechnologyOfficer (for Hyundai and Kia combined)| Auto-assembly| Yes| Which type of vehicle that each plant should produce? Whether Hyundai and Kia should share power-train parts (i. e. engine and transmission) to be supplied to assembly plantsWhether Hyundai and Kia should share production technology| Decisions are made by top management of the Hyundai-Kia group, where the de facto representative is Hyundai| Auto parts supply| Yes| Which vendor should supply auto parts to the companies? How many vendors should they engage? | Decisions are made by Joint Material Handling Division that Hyundai and Kia set up| Marketing and competition| Yes| Whether to focus on price or non price competition such as customer service and product quality| Decisions are made by top management of the Hyundai-Kia group|

Step 3: Determination of ability to direct relevant activities Hyundai owns 33. 75% of the shares in Kia Motors. In addition, Chung Eui-sun, the son of the Hyundai Motor Group Chairman, owns another 1. 73% of the shares. This presumably gives Hyundai control of 35. 48% of Kia Motors, which is significantly less than the 50% shareholding that would give Hyundai the majority of the voting rights. However, we are unable to find any evidence that anyone has control of a large proportion of the remaining shares, and thus we feel that the assumption that the rest of the shares in Kia are highly dispersed is a reasonable one.

If that is the case, then it is almost impossible that all these shareholders will collectively outvote Hyundai when a decision needs to be made, so Hyundai can be said to have power over the relevant activities. Another factor to consider is that Mr Chung is both the vice chairman of Hyundai and an

internal director of Kia. As Mr Chung sits on Kia's board, he should have a certain amount of influence over Kia's decision-making process. This factor, coupled with Hyundai's holding of voting rights, lend much weight to the claim that Hyundai can direct the relevant activities.

Last but not least, we notice from the table above that the Hyundai and Kia managements jointly make most decisions regarding relevant activities. In fact, Hyundai and Kia share almost the same supply chain. Many companies in the supply chain are subsidiaries or associates co-owned by these two parents. However, because Hyundai owns a larger portion of shares, and hence voting rights, in most of these entities, Kia is understandably at risk if it goes all out to oppose Hyundai in some way or another.

It can be seen that when decisions are made, Hyundai is better represented because of both the presence of its management and its voting rights, and Kia would tend to concede ground to Hyundai when there are disagreements. So, even though Hyundai owns less than 50% of the shareholding in Kia, they probably still have enough power to direct the relevant activities. Step 4: Determine if exposed to variable returns If Hyundai has actual control of Kia, they will be exposed to returns, which can be positive, negative or both.

Also these returns must be variable rather than fixed. The returns that Hyundai is exposed to can be classified into two categories: 1) Returns not available to other interest holders. This refers to cost savings and synergies that arise from Hyundai owning Kia, which other shareholders in Kia would not be entitled to. In this case, they are mostly in the form of cost savings, due to the similar operations of the two companies. Consolidation of R&D

centres of Hyundai and Kia, sharing of R&D centres allowed both companies to lower costs by reducing number of employees in the R&D centres *

Products share similar core platforms leads to savings and economies of scale *

Sharing of factories leads to further specialisation, for example, Kia's Kwangju plant was designated as a specialised assembly plant for small-sized commercial vehicles for both Hyundai and Kia, leading to cost reduction *

Sharing auto-part suppliers to apply greater pressure on suppliers for cost savings on supplies

2) Dividends Kia paid out 96 billion won in dividends in 2010 *

Hyundai's ownership of common stock entitles them to receive dividends from Kia. Thus, it can be seen that Hyundai meets all our requirements that would allow it to classify Kia as a subsidiary. Our last step would be to ensure that Hyundai is acting in the capacity of a principal, rather than that of an agent, which is holding delegated power.

Step 5: Determine if Hyundai is a principal or an agent

In determining whether Hyundai is acting as a principal or an agent, we need to consider four factors:

1) Scope of decision making authority *

Unable to find information proving that Hyundai has any limits to the decisions it can make for Kia *

Presumably, Hyundai can make most decisions for Kia

2) Rights held by other parties *

No evidence of rights held by other parties

3) Exposure to variability of returns from investees *

High cost savings due to economies of scale

Many of Hyundai's subsidiaries depend on Kia for revenue *

Affected by dividends paid out by Kia

4) Remuneration *

Almost solely dependent on dividends, which are highly variable *

No actual fixed remuneration

In consideration of all the four factors, Hyundai is most likely a principal and not an agent. Hence we can reasonably conclude, after

thorough application of the framework, that Kia is a subsidiary of Hyundai.

Question 3

Identification of four requirements in IFRS 10 that are challenging to interpret and apply. Considering the purpose and design of the investee, Paragraph B5 of IFRS 10 explains that “when assessing control of an investee, an investor shall consider the purpose and design of the investee in order to identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities”.

Paragraphs B51-B53 then go on to explain the factors to be considered when determining the purpose and design of the investee. However, IFRS 10 does not explain how the purpose and design of the investee can be used to “identify the relevant activities, how decisions about the relevant activities are made, who has the current ability to direct those activities and who receives returns from those activities”, which paragraph B5 suggested. A simplistic scenario is given in paragraph B6, whereby the investee is controlled by means of equity investments.

Beyond this straightforward case, paragraph B7 directs readers back to the factors listed in B3 to determine control (relevant activities, ability to direct relevant activities, variable returns and ability to use power over investee to affect returns). Furthermore, the factors provided in paragraphs B51-B53 are hard to determine and require much professional judgment. For instance, paragraph B51 states that in the process of assessing the purpose and design, we “evaluate whether the transaction terms and features of the

involvement (at investee's inception) provide the investor with rights that are sufficient to give it power".

No conclusive elaboration is provided by IFRS 10, and it is uncertain whether being involved in the investee's inception signifies control. This creates much ambiguity and inconsistent interpretation across firms. Rather than making it seem like an isolated step with little purpose, IFRS 10 should provide clearer guidance for the objective of determining the purpose and design of the investee. Clearer linkages, between the consideration of purpose and design of investee and the other factors to be considered when determining control, could also be provided to improve the flow of IFRS 10.

Furthermore, more comprehensive and conclusive guidelines could be included to standardise the interpretation of the purpose and design of the investee. Determining the relative size of voting rights According to paragraph B42, an investor can consider the size of its holding of voting rights relative to the size and dispersion of other holdings of the other vote holders to determine whether its rights are sufficient to give it power. However, because relativity encompasses the use of personal judgement, this section may be open to manipulation.

In Hyundai's case, it holds around 35% of the voting rights, including those held by its vice chairman, Chung Eui-sun. If the rest of the voting rights are very widely dispersed, with nobody else holding more than 1%, Hyundai can say that it has control because it is very improbable that all the other parties will come together to collectively outvote Hyundai. On the other hand, Hyundai can also claim that there is still a possibility that the other

shareholders will collectively vote against Hyundai if it introduces a policy that does not benefit them, so in that case, Hyundai does not have control.

We notice that the voting structure remains the same, yet different interpretations can be derived. Paragraph B42 also says that other circumstances, such as voting patterns at previous shareholders' meetings, can be considered, but it is hard to say if the historical patterns are able to predict the future. Shareholders might not have voted in previous meetings because there were no major decisions that affected them, but if Hyundai intends to propose something revolutionary, the voting situation will definitely change.

IFRS 10 can provide more detailed guidance to ensure that this section is applied appropriately and consistently. For example, when determining how widely dispersed the rest of the voting rights are, an investor should consider only the next 10 largest shareholders. If their combined holding is larger than that of the investor, then the investor does not have control based on this requirement alone. When assessing previous voting patterns, the investor should only look at shareholders' meetings where issues of similar impact were raised.

If previous meetings did not encompass such issues, then the voting patterns for those meetings cannot be considered. Considering related parties Paragraph B18 states that an investor can consider whether the investee's key management personnel are related parties of the investor when determining if the investor has the practical ability to direct relevant activities unilaterally. However, it does not specify how much influence the

related parties must have over the investee, so this may not always be a good indicator of power.

For example, Hyundai's vice chairman, Chung Eui-sun, is also on Kia's internal board of directors. According to paragraph B18, this should provide evidence that Hyundai has power over Kia. But in order to determine whether Hyundai can direct relevant activities through Chung Eui-sun, we must also consider the amount of influence that he has over Kia's decision-making process. Kia has 9 directors on its board, of whom two are also presidents in the company, so Chung Eui-sun may not always have his way. If the investor does not take this into consideration, then the determination of control would be flawed.

In that sense, this requirement would be more complete if guidance on the influence commanded by related parties was given. Instead of only determining whether there are related parties in the investee's governing bodies, the investor should also take into account the role and power of the related parties. If the related parties have the final say when it comes to decision-making over relevant activities, then this factor can conclusively determine that the investor has power. But if the related parties do not have the final say, then only a minimal weight should be placed on this factor.

Determining if investor is a principal or agent Being able to determine if the investor is a principal or an agent is crucial to determining whether the investor has control over the investee. A principal would have power over the investee, but an agent would only have delegated power. Delegated power is held on behalf of a third party who ultimately controls the investee. The

method prescribed in IFRS 10 for determining if a decision maker is an agent is the consideration of the factors listed in paragraph B60.

Upon further elaboration of the factors, IFRS 10 provides certain cases where the investee is definitely a principal or an agent. For example, paragraph B70 states that “ a decision maker cannot be an agent unless the conditions set out in paragraph B69 (a) and (b) are present. ” However, if none of these extreme conditions are met, we must assume that we would have to take all five conditions into account when trying to decide if the investor is an agent. However, there is no prescription in IFRS 10 about how to consider these conditions.

In a situation where some of the conditions point towards the investor being an agent and some point towards them being a principal, there is a certain amount of ambiguity in whether the investor should be classified as a principal or an agent. This gives the company some leeway in choosing the decision that would reflect a better financial position of the firm. This could lead to reduced accuracy of financial statements and less comparability among financial statements of different companies.

To make this requirement easier to interpret and apply, IFRS 10 should clearly state the relative importance of each factor. For example, the factors which are given a higher relative importance would have a higher influence on whether the company is a principal or an agent, as compared to those with a lower importance. As such, in ambiguous cases, companies will know which factors should be considered first. Given this, all companies will have more similar definitions of principal/agent, thereby reducing the ambiguity and increasing comparability among different financial statements.

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