Ratings

CRISIL
An S&P Global Company

CRISIL's criteria for consolidation

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Executive summary

A company may tap new business opportunities within the ambit of its own operations or through a separate entity (a subsidiary, a special purpose vehicle [SPV], or an associate/group company) for legal, tax and regulatory considerations. In India, companies have increasingly diversified into new businesses and markets including countries through complex corporate structures. Several acquisitions have been leveraged buyouts through SPVs, while some companies have expanded operations through a leveraged project finance structure. Both structures permit the use of considerable debt, without weighing down the acquirer's balance sheet.

A company may also isolate or ring-fence the cash flows of an acquired company. Companies have also resorted to cross-investments and interlocking of equity in related entities[1]. If a parent does not clearly define its obligations and liabilities, intra-group transactions may have a bearing on its financial position and therefore, its ability to service debt.

For analysing the credit risk profile of a company that has a direct or indirect controlling interest in another entity, it is necessary to consolidate the financials of both the company and the related entity for a fair representation of financial health, networth and leverage. Consolidated accounts indicate liabilities that the rated company needs to honour if a related entity is in distress, and these facts may not be captured by standalone financials.

1 Scope of criteria

This criteria document[2] highlights the need to consolidate financials of the company being rated and its related entities, and outlines CRISIL's approach to consolidation. CRISIL's criteria on consolidation incorporates the continuum of support from the parent to its related entities, and specifies the framework for assessing the level of integration between them.

CRISIL may consolidate entities without any apparent shareholding linkages, but held by common promoters, depending on the extent of their business and financial linkages. For more details, refer to '*Criteria for rating entities belonging to homogenous corporate groups*' on www.crisil.com.

2 CRISIL's approach to consolidation

CRISIL also analyses the business risk profile of the group and not just the company being rated, and covers each business that the group is present in, or is likely to have a presence in, during the period of analysis. The approach for evaluating business and management risks is similar to that adopted for businesses considered as divisions of the company being rated *(refer to example in Box 1).*

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[1] *Related entities include subsidiaries, SPVs, associate companies, and companies under the same management.*

[2] This article is being republished following a review of criteria in January 2019, as per the SEBI circular SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2018/ 140 dated November 13, 2018. The previous version of this article, which was updated in December 2017, can be accessed here:

https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/CRISILs-criteria-for-consolidation-dec-2017.pdf

Box 1: The case for consolidation

P Ltd has a subsidiary called S Ltd, which markets more than 80% of its products. Hence, S Ltd is critical to the parent's operations and it is reasonable to expect P Ltd will support S Ltd in case of financial distress. P Ltd's standalone business risk profile, which does not factor in S Ltd's marketing network, will thus not be comparable to P Ltd's competitors. Also, P Ltd's standalone financial statements will not reflect the actual sale price to end customers, or the related marketing and selling costs, and thus, present an incomplete picture. Therefore, it is necessary to consolidate the operations and financials of P Ltd and S Ltd to make the analysis of P Ltd's credit risk profile comparable with that of competitors.

2.1 Pooling of interests: CRISIL's method of consolidation

As per international accounting standards, there are three ways to consolidate accounts: the equity method, the pooling of interests method, and the purchase method. The choice will depend on reasons for consolidation.

CRISIL adopts the pooling of interests method to assess a group's financial risk profile and its impact on the rated company. All related entities are treated as a single economic entity. Consolidation cancels out reciprocal pairs such as assets and liabilities, revenue and cost, and investment and equity accounts in the financial statements of related entities. It nullifies all intra-group transactions, deducts investments in related entities from the group's networth, and cancels borrowings within the group from advances/investments. One advantage is the pooling of interests method does not necessitate a valuation exercise or creation of goodwill *(refer to example in Box 2).*

Box 2: Consolidation by pooling of interests

P Ltd, which has a share capital of Rs 200 million, has invested Rs 80 million in the share capital of its subsidiary, S Ltd. If the share capital of S Ltd is Rs 100 million, then the share capital of P Ltd, on consolidation, will be Rs 220 million, calculated as:

	Rs million
Share capital of P Ltd (parent company)	200
Add: Share capital of S Ltd (subsidiary company)	100
Less: Investment by P Ltd in S Ltd	80
Share capital of P Ltd on consolidation	**220**

Each item of the balance sheet and income statement is consolidated in a similar manner, after adjusting for inter-company transactions.

Thus, we get a clear picture of the economic resources controlled by the group, its obligation, and the results achieved with the given resources.

3 Identifying entities for consolidation

The primary criterion for determining consolidation is the willingness or compulsion of one entity to support the other during exigencies. CRISIL's methodology differs from the one prescribed by the Indian Accounting Standards (Ind AS), which came into force on April 1, 2015, as per the Companies (Indian Accounting Standards) Rules, 2015 *(refer to Box 3 for salient features of the consolidation approach under Ind AS).*

Box 3: Consolidation approach as per Ind AS

Most Indian companies with one or more subsidiaries are required to prepare and present consolidated financial statements from fiscal 2015 as per the Companies Act, 2013. Earlier, the Securities and Exchange Board of India required consolidated financial statements for listed companies. Ind AS came into effect on April 1, 2015, and listed and unlisted companies with networth in excess of Rs 5 billion, were mandated to migrate to the new standards from April 1, 2016.

Ind AS 110 establishes principles for presentation and preparation of consolidated financial statements when an entity controls other entities. Certain entities are exempted from these requirements, which differ from those exempted under the Companies Act. However, the more stringent of the two requirements will apply, and most Indian companies with subsidiaries, associates, or joint ventures, will have to prepare and present consolidated financial statements.

Ind AS 110 establishes control as the basis for consolidation. An investor has control when it has rights to variable returns from its involvement with the investee, and the ability to affect the returns. Consolidated financial statements, in which assets, liabilities, equity, income, expenses, and cash flows of the parent and subsidiaries are presented as those of a single economic entity, must be prepared.

In addition, Ind AS 28 prescribes the equity method for recognising investments in associate companies (where the investor has significant influence over the investee, but cannot establish control) or joint ventures (where two or more investors have a joint control over the investee).

CRISIL believes the willingness or compulsion of one entity to support another is driven by their linkages, which can take various forms. In some cases, the rated company may have no major shareholding in group companies, but transactions between them may have cash-flow implications for all. For instance, if a promoter holds three companies with each performing specific roles such as raw material sourcing, production, and marketing of the same product, consolidation is necessary to evaluate creditworthiness of any one entity in the value chain. Alternately, companies may hold substantial equity, but lack management control over other entities, and transactions may be limited to arm's length dealings. It is, therefore, critical to assess the possibility and extent of cash flow transactions between such entities.

CRISIL generally consolidates all subsidiaries, with the following exceptions:

- The subsidiary does not operate in the same business or sector as the parent (for example, a manufacturing entity having a finance or insurance subsidiary, or a bank having an insurance subsidiary)
- The subsidiary is explicitly ring-fenced (typically in case of SPVs) and debt is raised at the subsidiary without explicit recourse to the parent

However, even in such cases, CRISIL factors the potential impact of cash flow support to the subsidiary, into the rating of the parent. For instance, if the subsidiary and parent operate in different sectors, a capital allocation approach is used to determine their rating *(refer to Box 4 for details on capital allocation approach)*. The potential impact of support is also considered for associate companies or other investments.

Box 4: Capital allocation approach

In case of a finance subsidiary of a manufacturing parent, or an insurance subsidiary of a bank, CRISIL may decide to notch up the rating of the unconsolidated subsidiary, on account of a stronger parent *(refer to 'Criteria for notching up standalone ratings of entities based on parent support' on www.crisil.com).* Line – by – line consolidation in such situations is not appropriate since the parent and subsidiary operate in different sectors. The parameters and ratios used to analyse these entities would be significantly different. In such instances, CRISIL internally follows the capital allocation approach to determine the rating of the parent and the unconsolidated subsidiary, based on capital allocated to the subsidiary. Under this approach, some capital, objectively assessed for the level of support envisaged, is deducted from the parent's networth, and allocated to the unconsolidated subsidiary. The capital support from the parent uplifts the subsidiary's rating. Accordingly, as this capital is no longer deemed to be available to the parent for its operations, the resultant impact is factored into its rating.

3.1 Evaluation of inter-linkages between rated entity and any related entity

CRISIL's approach to evaluate linkages or perceived relationships between the company being rated, and its related entity, focuses on the extent and likelihood of support offered by the parent, to gauge the underlying economic risks. This analysis involves the following steps:

- **Step 1:** CRISIL evaluates the extent of linkages between the parent and related entities, based on the economic importance of the related entity to the parent, the extent to which cash flow of one entity can be used by another, the stated posture of the management, extent of shareholding of one entity in the other, and the presence of a shared name *(refer to Box 5 for the detailed framework for this assessment).*

Box 5: CRISIL's framework for assessing level of integration

1. **Economic importance of the related entity to the parent**: This is the strongest factor affecting the linkage between parent and related entities. CRISIL evaluates the extent of economic incentive based on various factors including the parent's exposure to the related entity with respect to its own networth, strategic importance of the related entity and the expected financial returns.

2. **Extent of cash flow fungibility**: Movement of cash across entities indicates strong likelihood of support from the parent to related entities. Cash flows across entities may include inter-corporate deposits, advances and loans, and equity infusions. Such groups generally have common treasury operations. However, the presence of a common treasury does not necessarily imply free cash flows within the group.

3. **Documentary support**: Documentary support (such as guarantees, letters of comfort, or letters of awareness), provided by the parent to lenders of related entities, provides an insight into level of integration.

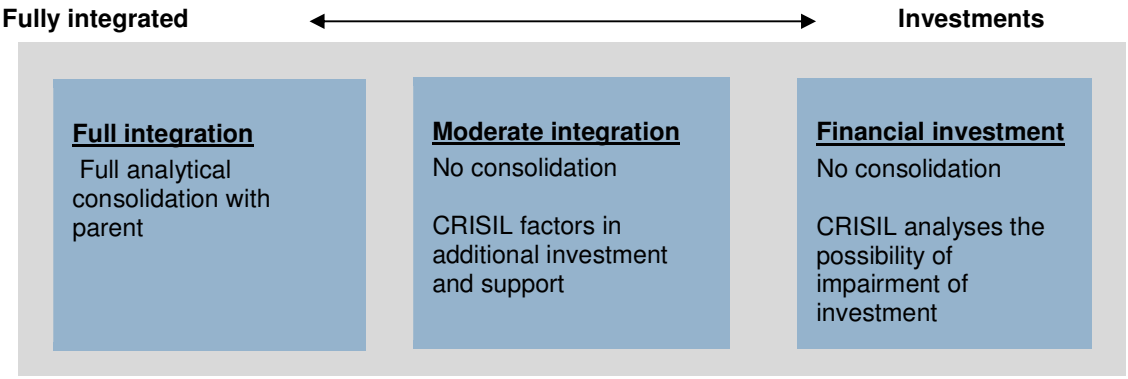
4. **Management's stated posture**: CRISIL evaluates the parent's stated posture on support (or otherwise) to a related entity, and its track record during exigencies. It is important to think ahead, to assess how the parent may act under potential stress scenarios.

5. **Extent of ownership**: Large holdings by the promoter or group companies, reflect a high level of commitment to the related entity. CRISIL assesses current and prospective shareholding patterns.

6. **Shared name**: A common group logo or name, and other forms of association with the group, are manifestations of strong integration.

- **Step 2:** Based on its assessment of the level of integration, CRISIL categorises related entities into three classes (*see Chart 1*): fully integrated, moderately integrated, or held as a financial investment by the parent.

Chart 1: Classification of related entities



- **Step 3:** Based on the classification, CRISIL adopts the appropriate analytical treatment to factor in the potential impact of parent support.

a) **Fully integrated with the parent:** Business and financial risk profiles of the parent incorporate those of fully integrated entities. Operations of these entities are critical to the parent, and there is significant economic incentive to support them, when needed.

While SPVs, on account of their limited recourse structure, are usually not fully integrated with the parent, there might be exceptional instances where the extent of linkages between the parent and SPV are strong enough to warrant full integration. In such scenarios, the pooling of interest method may not be appropriate for consolidating an SPV with the parent – as the visibility of cash flows of SPV might be much longer tenured than that of parent. Consider an SPV in a business that's distinct from the parent's (for example, an SPV that's a toll road project with the parent being an EPC company). In such a case, the quantum and stability of cash flows of the parent and SPV are not comparable. CRISIL may use the combined financial risk profile of the parent and the SPVs, to arrive at the rating of consolidated entity**.**

b) **Moderately integrated with the parent:** CRISIL estimates the extent of additional investment or support that may be required in exigencies, which is factored into the analysis of the parent. CRISIL also tests the value of the parent's investments for impairment, and adjusts the parent's networth, if required. No consolidation is done in such cases, even though the related entity may legally be a subsidiary. For instance, consider a construction company that has invested 15% of its networth in an SPV, with limited recourse executing a toll road project. The SPV may legally be a subsidiary, but considering the limited recourse that its lenders have to the parent, CRISIL will not consolidate the financials of the SPV, while analysing the parent. Extent of additional investment or support required from the parent, if the SPV is in distress, will be factored into the analysis of the parent.

c) **Held as a financial investment by parent:** CRISIL treats a related entity as a financial investment if:

- It is of little strategic importance to the parent
- It offers minimal economic incentive for the parent to provide support
- It features adequate ring-fencing

In such cases, the parent's credit risk profile is assessed independently without factoring in debt of the related entity. However, the value, volatility and liquidity of these investments are analysed in a manner similar to any other equity investment. This includes testing the investment for any impairment in value.

In some situations, CRISIL may also follow proportionate consolidation approach in case of joint ventures (JVs) which are expected to receive minimal support from a JV sponsor. Proportionate consolidation reflects the entitlement of the sponsor to the cash flows, assets and liabilities of the joint venture.

Conclusion

CRISIL considers the impact of related entities on the business and financial risk profiles of an entity being rated. All subsidiaries of the rated entity are generally consolidated through the pooling of interests method for a fair representation of the entity's operations and liabilities. If a subsidiary operates in a sector different from that of the parent, or is explicitly ring-fenced, CRISIL may not consolidate the business and financial risk profiles. However, even in such cases, CRISIL may factor the potential support that the parent may extend to the subsidiary depending on the extent of linkages. Such support may also be factored in case of associate or group companies of the rated entity.

About CRISIL Limited

CRISIL is an agile and innovative, global analytics company driven by its mission of making markets function better. We are India's foremost provider of ratings, data, research, analytics and solutions. A strong track record of growth, culture of innovation and global footprint sets us apart. We have delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

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