

Corporate Social Responsibility – Complexity of Compliance

By Mr. Sunil Kumar, Partner, Rajani, Singhanian & Partners LLP



Philanthropy and the spirit of giving back to society are not unknown, certainly not unheard of, ideas in India. History is replete with kings in ancient India who utilized the royal coffers for the larger public good – planted trees, opened drinking water kiosks and established charitable endowments for feeding the poor and educating their subjects. Scriptures dating back to the Vedas also exhort the spirit of giving and extoll the virtues of charity. Businesses and rich merchants in their turn also establish charitable institutions and the tradition has continued into modern times by leading business groups such as the Tatas, Birlas and several other business houses. Gandhi, the most famous of India's national leaders, who lead the freedom movement, in one of his first speeches during British rule strongly advocated to India's rich to hold in trust their wealth for the benefit of the poor. Perhaps the experience in post-independence India gave the government cause to ponder whether the voluntary spirit had somehow fallen short in motivating the rich to share their wealth with the needy and the time had come to mandate Corporate Social Responsibility through the law. The Companies Act, 2013 is the first known example of a Corporate Governance Law enacting specific provisions to mandate and secure corporate spend on a set of socially desirable objectives as laid down by the government.

The guiding principles stated in the proposed draft Corporate Social Responsibility Rules under Section 135 of the Companies Act, 2013, enunciates CSR as the process by which a business organization evolves its relationships with stakeholders for the common good, and demonstrates its commitment in this regard by adoption of appropriate business processes and strategies. Thus CSR is not charity or mere donations. CSR is a way of conducting business, by which corporate

entities visibly contribute to the social good. Socially responsible companies do not limit themselves to using resources to engage in activities that increase only their profits. They use CSR to integrate economic, environmental and social objectives with the company's operations and growth.

Legal Framework

Under the Companies Act, 2013, companies in India, starting from April 1, 2013 shall undertake CSR expenditure as mandated in Section 135, Schedule VII and CSR Rules 2013 of the Act. Any Company incorporated under the Act shall be obliged to ensure it spends at least 2% of the average net profits which were booked during three immediate preceding financial years, if the company achieves any of the following three criteria:-

- (i) Net worth of INR 50 Billion
- (ii) Turnover of INR 100 Billion
- (iii) Net Profit of INR 50 Million

Even if any one of the above criteria is achieved in any given financial year (1st April to 31st March) the mandate to spend is triggered. The company must then ensure that it spends at least 2% of the average net profits earned by it during three immediate preceding financial years. Thus, assuming the net profits to be 100 Million plus 80 Million plus 120 Million in 2013-2014, 2012-2013 and 2011-2012 respectively, the company must determine the average of 300 Million, which comes to 100 Million. 2% of 100 Million i.e. 2 Million must be spent in the financial year in which the applicability of the law is triggered. Going forward, it must spend the mandated amount in every succeeding

financial year. Of course, if there is a loss in all the three years, then no such spend would have to be incurred as there would be no profit to begin with for a given block of three years.¹

Recommended CSR Activities

The government has annexed a Schedule to the Act which specifies a whole range of activities to undertake – (i) eradicating extreme hunger and poverty; (ii) promotion of education; (iii) promoting gender equality and empowering women; (iv) reducing child mortality and improving maternal health; (v) combating human immunodeficiency virus, acquired immune deficiency syndrome, malaria and other diseases; (vi) ensuring environmental sustainability; (vii) employment enhancing vocational skills; (viii) social business projects; (ix) contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government or the State Governments for socio-economic development, relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and (x) such other matters as may be prescribed. Although it

¹ Net worth – "Net worth" is defined to mean the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

Turnover – "Turnover" is defined to mean the aggregate value of the realisation of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year.

Net Profit – "Net profit" is defined to mean the total and final revenue of the company after deduction of expenses, interests, dividends etc. (Section 198 of the Act). Net profit is a profit before tax.

may look comprehensive, this is by no means an exhaustive list of activities as government may add to it. A moot question that may arise is whether corporates may come up with something different or innovative which does not figure on this menu. The short answer would be, but of course, most certainly, depending on your ingenuity and imagination. There is no legal bar.

Among the recommended activities, item no. (ix) of the list has caused eye brows to be raised as it does not fit in with the concept of CSR as it is normally or universally understood. Contribution to the Prime Minister's Relief Fund surely is more akin to doing an act of charity like dropping cash in a relief fund for disaster relief and such like. Corporates wishing to develop programmes for creating visible social impact and expanding their own social reach and brand appeal may not wish to part with valuable funds over the disposition of which they would have no control. It would certainly not create something of lasting value on a sustainable basis.

Opportunities and Challenges

Undoubtedly, the objective of CSR is laudable and has become axiomatic with socially responsible corporate behaviour. There is, in India, a large school of opinion that is already staunchly in favour of the government's initiative to induce corporate spending through legislation. Even among the corporates, there is already an increasing trend of undertaking programmes for building of skills, spreading of literacy and gender equality. The legislative initiative has been well received and criticism of the government muted as business leaders are not against the concept as much as wary of having to deal with a legislation that seeks to enforce compliance. The mandate to spend 2% year on year smacks of a tax on corporates but at the same time it

presents an opportunity to invest in a resource starved economy for creation of social assets which will bear testimony to the social good that the private sector has the potential to achieve. However, the overarching regulatory framework is what will pose a huge challenge to corporates. The theme, as the title suggests, highlights the legal and regulatory labyrinth which corporates must negotiate as they discharge the onerous statutory burden of allocation, mandatory spend, disclosures, filings and reports. Global businesses with Indian entities must prepare themselves to not only undertake the obligation to spend on the legally prescribed list of socially desirable activities but render a true and accurate account to the government. All this is mandated in the newly enacted legislation – The Companies Act, 2013 and the Draft Rules which are in the public domain for discussion. The burden of compliance is best illustrated by discussing some of the key features of the provisions as set out in Section 135 and the Rules framed under the Act.

Constitution of a CSR Committee

Any company which meets the criteria for application of the law for mandatory CSR spend shall be required to set up a CSR Committee. The Committee must comprise of three directors, of whom at least one director shall be an independent director. This means that an independent director must be appointed by a company for this purpose even if the company is not otherwise required to have an independent director on its board. Under the new Act, the appointment of independent director on the board of the company is a mandatory requirement only for a public listed company, but the provision of Section 135 as presently worded would seem to impose this requirement on all companies to which the CSR law applies. This is an anomaly that the government may have to address sooner or later.

Formulation of CSR Policy

The Committee constituted in terms of Section 135 of the Act has the mandate to formulate and recommend to the board a CSR Policy. The CSR Rules specify in minute detail that CSR policy must include the projects and programmes that are to be undertaken, the list of projects and programmes which the company plans to undertake for implementation during the year, spell out the modalities of execution, the sectors or areas selected for implementation and publish the implementation schedule for the same. Further, Rule 1 also exhorts that projects undertaken must also focus business models on social and environmental priorities of the government. Perhaps the idea of this is to direct companies to integrate their business models with government's priorities. The "tablet" of things to do have the ring of a "Commandment", and must be reported to the government.

Disposition of CSR Surplus

Finally, Rule 1 directs that the company must ensure that the surplus arising from any CSR activity or project must not form part of the business profits of a company. The CSR policy must specify that the corpus would include – (a) 2% of the average net profits, (b) any income arising therefrom (c) surplus arising out of CSR activities.

The idea though not explicitly stated in these sub-rules may be inferred from them that the corpus of 2% year on year may be held or invested in income earning securities till such time as the funds are actually deployed in projects or programmes. Conceivably, the funds could also be invested in creation of capital assets which would be dedicated and used for the social sector activities. This seems to be the only logical conclusion as

huge corporate funds set aside for social sector programmes cannot be spent without considerable planning and research. Undoubtedly, companies should and must take time to identify projects and develop capability to harness resources for project selection and implementation. The risk that companies would be expected to develop implementation schedules to spend the corpus at the speed of thought may have to be explained to the bureaucracy which will monitor the schemes. Hence, keeping the corpus in safe investments rather than losing them in a hurry must be a part of the strategy which is suggested in the sub-rules mentioned above. Despite the seemingly contradictory directions in Section 135 of the Act, it should be possible for corporates to take the position that 'investing' the money rather than merely spending it is not only in the spirit of CSR but is the mandate of the law.

Duty of the Board to Approve and Disclose

The responsibility of the Board is mandated in Section 135 for approving not only the CSR policy, but all the related aspects specifically tasked in the rules for implementation. The Boards must find the resources and time to undertake the activities and prepare programmes with due diligence, deliberation and care.

The duty is also cast on the Board to disclose the contents of the CSR policy in its report and to publish it in the company's website. The Board is also obligated to make an upfront statement of reasons for not spending the corpus in the same year if for some reason that is not feasible. Sub-Section (5) of Section 135 appears to suggest that the Board shall ensure that the company spends in every financial year at least 2% of the Average Net Profits made during the three immediately preceding financial years. Translated literally, the language suggests that the company must spend the

amount set aside in pursuance of its CSR policy. As suggested in this para, what if the Board exceeds the time limit for spending the amount, or if it fails to spend the entire 2%? What if the company allocates and sets aside the corpus without actually being able to spend it? A specific proviso to sub-section 5 contains the answer to these teasing questions. The Board shall in its report to be made under clause (o) sub-section 3 of Section 135 specify the reasons for not spending the amount. Any reasonable law would certainly be expected to accept the Board's reasons for failing to implement the mandate literally as sub-section 5 would suggest. The failure to comply with the mandate will hopefully be viewed with appropriate understanding by the government. Yet the pressures of interface with the bureaucracy turning oppressive cannot be ruled out.

Company may set up a Trust, Society or Foundation

Rule 3 of the Draft Rules envisages that a company may set up a separate organization for implementation of its CSR activities in conformity with its stated CSR policy. Such an organization may be registered as a Trust or Section 8 company (Non Profit Company), or Society or Foundation or any other form of entity operating within India. This means a company may pursue the programmes or projects by establishing an organization specifically dedicated to implementation of CSR programmes. Here again, the Rule further directs that the company contributing the money must specify the programmes to be undertaken by such an organization and ensure that the funds are utilized for the stated purpose. To ensure this, the company shall establish a monitoring mechanism so that the allocation is spent for the intended purpose only. The Rule does not indicate what is meant by "monitoring mechanism" but

leaves it to the company to put in place appropriate measures or systems which are designed to effectively monitor the utilization of the funds. Clearly, the law obligates the company to design and implement an effective system of monitoring, and though not said in so many words, it is implicit in the Rule that the company will be held accountable for successful delivery of the programmes. Managements would be advised not to set up a Trust or a Society outside the company and then leave it to the outside agency to do the rest. The government will hold the company accountable for delivery up to the last mile. Failures, shortcomings or financial diversion of funds will eventually come back to roost on the company.

Disclosure and Reporting

Section 134 (3) (o) of the Act makes for interesting reading. The board shall prepare a report which must be attached to the financial statement of the company and placed before the company in the general meeting – “(o) the details about the policy developed and implemented by the company on corporate social responsibility initiatives taken during the year.” The Report by the Board of Directors shall include the details mentioned in clause (o). This report shall be approved by the Board of Directors before it is signed on behalf of the Board at least by the Chairperson of the company if he is authorized by the Board or by two directors of which one shall be Managing Director and the Chief Executive Officer if he is the director in the company, the Chief Financial Officer and the Company Secretary of the company.

The responsibility for putting a mechanism in place encompasses conceivably the following:-

- (i) Details of the Policy developed on the initiatives for the year;
- (ii) And implemented during the year;
- (iii) Disclose the composition of the CSR Committee;
- (iv) The amount of expenditure to be incurred on the activities with reasons if any for allocating less than the minimum 2% required by the law;
- (v) Monitoring mechanism established to monitor the implementation of the programmes or the details of the initiatives to be undertaken and actually undertaken by the company;
- (vi) Monitoring mechanism to ensure utilization of the funds for the purpose;
- (vii) For this purpose, Draft Rules have prescribed Annexure-1, which provides the Format for the Annual Report on CSR initiatives to be included in the Board Report by Qualifying Companies. The Format has to be signed by the CEO/Managing Director/Director.

The new Companies Act contains an ominous provision which provides for penalty for non-disclosure of the policy developed and implemented by the company on CSR initiative during a financial year. Failure to make such disclosure shall be punishable with a fine which shall not be less than fifty thousand rupees and may extend to twenty five lakh rupees. Further, every officer who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which may extend up to twenty five lakh rupees. Well that should certainly make Directors take CSR reporting seriously!

Obligations for Accountability and Auditing mechanisms

Going forward, companies will have to work to increase accountability for CSR performance at the Board level. This will entail conscious policy decisions by the Board as to how directors handle CSR issues, and how the Board manages itself, and fulfils its responsibilities mandated by the law. Companies will have to establish accountability norms for CSR performance at the senior management level by creating a dedicated position responsible for oversight of a company's CSR activities. Even more importantly, companies will have to integrate accountability for CSR performance with long-term planning for decision-making with periodic reviews including rethinking processes for establishing appropriate internal audit mechanisms, and changing practices used to hire, retain, reward resources and create a capacity building system to orient their stakeholders towards social sector delivery. In the final

analysis, corporate accountability will have to encompass policies, indicators, targets and processes to manage the CSR tasks and programs.

In conclusion, accountability will demand that companies report publicly on their social sector performance with accent on communication to government and to stakeholders as a management tool which will progressively steer towards more effective implementation of the programs. The road will not be smooth as these are still early days but over a period of time corporates will certainly move up the learning curve with experience, expertise and government advocacy programs.



Sunil Kumar
Partner
sunil.kumar@rsplaw.in