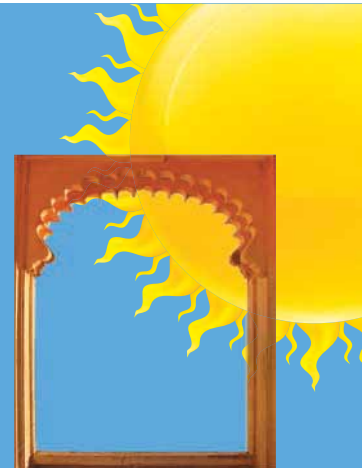


CORPORATE SOCIAL RESPONSIBILITY UNDER COMPANIES ACT, 2013

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Executive Summary

The newly enacted Companies Act, 2013 and the Rules notified thereunder makes it statutory for all companies above a certain size to spend 2 percent of their profits towards meeting Corporate Social Responsibility. India is the first country in the world to have mandatory CSR spending (with provisions for exemption) along with mandatory reporting. According to some quick estimates, Indian companies have to spend upwards of Rs. 10,000 crores on CSR in FY 15 and more in subsequent years as the corporate profits grow. While the new CSR regulations will not be a game changer in terms of enhancing overall social spending, the Briefing--after assessing their pros and cons--argues that the CSR regulations are a step in the right direction. The implementation of the new CSR regulations, however, entails certain challenges, which would require measures such as improved regulatory oversight, further clarity on what constitutes CSR spending and coordination among companies. The success of the CSR regulations would depend mainly on how well these challenges are addressed.

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Provisions in Companies Act, 2013

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- Every company having net worth of Rs 500 crore or more, or turnover of Rs 1000 crore or more, or net profit of Rs 5 crore or more during any of the three preceding financial years (as per circular no. 21/2014 dated June 18, 2014) should spend, in every financial year, at least 2 per cent of the average net profits of the company made during the three immediately preceding financial years.
- Every such company shall give preference to the local areas around it where it operates for spending the amount earmarked for CSR activities.
- In case the company fails to spend the stipulated minimum amount, the Board of Directors shall specify the reasons for not spending the amount.
- Finally, companies have to set up CSR committees. The CSR committee of a company will be responsible for: (a) formulating its CSR policies, (b) recommending the size of expenditures on various activities and (c) monitoring its CSR policy.

The provisions of Section 135 and the Rules framed under them came into force from April 1, 2014. Subsequently, the Ministry of Corporate Affairs notified the CSR Rules on February 27, 2014 (MCA, 2014a) listing out the specific activities on which the companies are free to spend the amount earmarked under their CSR Policy. Notable among these are expenditure on education and vocational training, eradication of poverty and hunger, promotion of gender equality and women empowerment and environmental sustainability and ecological balance. The Rules guard against self-serving expenditure by companies by specifying that CSR activities that benefit only the employees of the company and their families shall not be considered as CSR spending under the provisions. (An analysis of the distribution of CSR activities by listed companies for the year 2011 shows that companies typically engaged in activities related to education, health and women empowerment, which together accounted for 70 per cent of all CSR spending.)

How much spending does Section 135 entail?

A quick analysis of all the listed companies can help one get a perspective (see Table 1). The data in Table 1 shows that had the present CSR criterion been applied to listed companies in FY 2012, an estimated amount of Rs. 8343.9 crore would have had to be spent on CSR activities by them. Moving the figure to FY 2015 and recognising that CSR Rules apply to the unlisted companies as well, the amount could well be around Rs. 10,000 crore; and the annual spending in subsequent years is likely to be higher as corporate profits grow.

Table 1: Estimated CSR Spending by Listed Companies

Indicators	FY 2012	FY 2011	FY 2010
Total BSE Listed Co.	5138	5138	5138
Total no. of qualifying companies in terms of Section 135 criteria	1372	1409	1500
Total qualifying companies with PAT > 0	1265	1312	1457
Total PAT of qualifying companies with PAT > 0 (Rs. Crore)	417198.6	383487.1	380453.1
Total estimated CSR spending of qualifying companies with PAT > 0 (Rs. Crore)	8343.9	7669.7	7609.1
Total social expenditure of Central and State Government	617939.0	529398.0	446382.0
CSR spending as percentage of total social expenditure	1.35 percent	1.45 percent	1.70 percent
Max PAT (Rs. Crore)	21000.1 (Reliance Ind.)	25100.2 (ONGC)	20300.7 (Reliance Ind.)
Max CSR (Rs. Crore)	420.0	502.0	406.0
Min PAT (when PAT0) (Rs. Crore)	0.3	0.37	0.14
Min CSR (Rs.)	60,000	74,000	28,000
Median PAT (Rs. Crore)	27.7	30.4	33
Median CSR (Rs.)	55,40,000	60,80,000	66,10,000

Source: Author's computation based on all listed companies in terms of market capitalization. Data is sourced from the Annual Reports of Companies for FY 2011 from the PROWESS database.

CSR – An effort to bridge the welfare gap

There is considerable debate regarding whether companies should be mandated to discharge corporate social responsibility. Proponents of mandatory CSR argue that companies have a responsibility that beyond the company's shareholders and extends to the society at large. Some believe that there is a stronger ground for this responsibility in developing countries where companies should supplement governmental efforts for generating adequate resources to support developmental goals. These ideas are encapsulated in the Triple-Bottom-Line approach according to which a company must achieve a balance of economic, social and environmental objectives (ESG) while at the same time addressing the expectations of its shareholders and stakeholders. It is also known as the stakeholder theory.

Economists, however, are generally cautious on the issue of whether companies should be mandated to spend resources on CSR activities. Many believe that such mandates are inconsistent with the efficient operation of the company. According to them, multiple objectives inherent in the stakeholder theory are likely to create complexities and distort managerial incentives because it raises the following issues. What will be the weights on the objectives of the different types of stakeholders and who will determine them? Will not the opportunistic managers strategically use this theory for furthering their personal goals? A very strong form of this view is reflected in the Friedman Doctrine that “the only objective of the corporation is to maximize profit and any social responsibility beyond this should be deemed as ‘corporate social irresponsibility’ (Friedman, 1962).”

There is also a concern that mandated CSR may impose disproportionate cost on smaller and younger companies for whom net profit forms an important source of funds for investments. Forcing such companies to undertake CSR expenditure can lead to loss of efficiency for the economy as whole, particularly because these companies are strong drivers of long term growth of nations, as evidenced by recent research. Economic efficiency thus dictates that CSR should be voluntary. A company would undertake it if its perceived benefits at the margin outweigh the perceived cost. In line with this thinking, most countries have left the decision of CSR spending to the discretion of the companies and the market forces but have required mandatory reporting of such activities. India is the first country in the world to have mandatory CSR spending (with provisions for exemption) along with mandatory reporting.

Strong points of the CSR provisions in Companies Act, 2013

Keeping the above arguments in mind, a systematic evaluation of the CSR provisions contained in Section 135 suggests that these are conceptually well laid out.

- First, the mandated CSR expenditure is a utilization of profit (and not revenue) and hence, it avoids the issue of multiple objectives inherent in the stakeholder theory. Companies can thus still engage in the single objective of maximization of profit (shareholder value)--from which two per cent are to be spent on CSR activities.
- Second, the amount of two per cent of PAT is not such a huge demand on corporate resources as to lead to significant loss in competitive advantages in international markets. In fact, CSR spending can many times have a positive effect on the companies in the context of the growing recognition that it sends a positive signal to investors.
- Third, the CSR rules adopt a “comply or explain” approach; thus a company which determines that CSR spending of 2 per cent is not in its best interest may not spend the required amount provided its explanation is acceptable by the regulator. This provision can address for example the concern of those companies (typically smaller and younger ones) for whom opportunity cost of internal capital is likely to be high.
- Finally mandated spending with justifications for exceptions may generate more CSR spending than voluntary spending due to pressure of social norms.

Notwithstanding these points, most people would like to consider the mandated CSR provisions as an implicit tax on companies. While this is true to a large extent, there is one key difference. The CSR provisions works like a *centralized tax with decentralized utilization* of the garnered revenue. The CSR as an implicit tax gives companies control over the disbursement over their own funds with incentives to choose the right projects having synergies with their lines of operation (which the Rules allow for), and greater incentives to monitor effective implementation. The result is likely to be better project delivery and reduced fund leakages that are widely perceived to be the key challenges of large scale government welfare schemes.

Challenges in implementing CSR provisions

Some issues, however, are likely to surface during the implementation of the new CSR rules and they have to be addressed by setting up appropriate mechanisms.

First, if a company has to spend relatively large sums on CSR year after year, because its profits are huge, it will face the challenge of identifying appropriate projects on a sustained basis. It is important to realise that companies need to pump in 2 per cent of their net profits every year. This can put a strain on the company's management to search, select, implement and monitor new projects every year. The task is likely to cumulatively build up both in terms of scale and scope over time. The CSR spending by the median listed firm (i.e., a firm managing a turnover of Rs. 33 crore) is about Rs. 55 lakhs per year (see Table 1), and CSR projects worth this value would have to be identified annually and followed through. For large companies the issue of identifying appropriate projects on a sustained basis could be even more challenging. Companies such as Reliance and ONGC would have had to spend upwards of approximately Rs. 400 crore in 2012 towards CSR activities (see Table 1) and this amount is likely to increase every year as the net profit of these companies increase.

Spending of such large amounts may require large companies to have dedicated centres that identify, implement, and monitor large scale projects or a large number of smaller projects. This would entail additional costs for a company that need to be factored in. The Rules foresee this to some extent and allows companies to carry out their CSR activities through registered trusts set up by the companies or outside trusts with good track records; but the activities of these trusts would in turn become challenging and will possibly need monitoring. In this context, it is important for the government to guard against the possibility of promoters routing monies through CSR activities into trusts and organisations in which they have interest. Government will need to develop an effective way of monitoring such transactions and make legislative provisions as well.

Second is the issue relating to the treatment of CSR kind of expenditure that companies may already be incurring. Would reclassifying them as CSR expenses meet the requirements of law? For example, can companies that are operating educational institutions or running major hospital facilities for their employees beyond what the law requires, claim the excess facilities as CSR expenditure under Section 135? Will this be allowed if such facilities are also open to non-employees as well? Some questions have already been raised as to whether certain types of expenditure which companies have been incurring will qualify as items towards meeting the specified CSR target. In response to this, the Ministry of Corporate Affairs issued a circular dated June 18, 2014 (MCA, 2014b) specifying that "the activities undertaken in pursuance of the CSR policy must be relatable to Schedule VII of the Act and the activities mentioned in the Schedule VII must be interpreted liberally capturing the essence of the subjects enumerated therein." As stated earlier, the circular also lists certain specific types of expenditures that will count as CSR expenditure for meeting the provisions of Section 135 and those that will not. More such explanations and clarifications are likely to be made over time.

Third is the problem relating to coordination among companies in choosing their respective CSR activities. This is a concern, particularly because the Rules recommend that the companies give preference to local areas in their CSR spending. To prevent duplication in particular types of CSR projects by companies within a particular region, formal partnerships or consortiums can be set up to achieve better coordination of CSR activities among companies within that region. In instances where large investments are necessary, such as in hospitals and schools, smaller companies may be better off by pooling their CSR resources through such consortiums.

CSR – Way forward

The current CSR provisions are not a case of government abrogating its responsibility to the private sector. The estimated annual amount of CSR spending by corporates (based on a rough estimate presented in Table 1, of what listed companies would have spent after applying the criteria under Section 135) is just about one per cent of the total social sector spending by the government. In that sense, it may not be a game changer. Yet the decentralized spending by corporates may promote efficiency in project choice and implementation without the CSR Rules coming into serious conflicts with the primary objective of shareholder value maximization of companies. Social and economic incentives seem to have been well balanced in the new CSR rules and one can hope that the corporate sector will lend a helping hand to the government in contributing to the inclusive growth of the nation.

Box 1: CSR - Way Forward

- ✓ Companies can set up a separate CSR Cell to identify, implement and monitor CSR spending effectively
- ✓ The CSR Cell can be entrusted to meet the reporting requirements as per the format specified under the CSR Rules
- ✓ Companies should coordinate their CSR activities to prevent overlap in CSR projects within a local region
- ✓ Smaller companies can benefit from pooling resources or donating to the Prime Minister's Fund
- ✓ Government should develop an effective way of monitoring CSR transactions by Trusts and provide legislative protection as well

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