



CORPORATE SOCIAL RESPONSIBILITY IN INDIA: LEGAL ISSUES AND CHALLENGES

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ABSTRACT

For the first time, the new Companies Act, 2013 has given legal recognition to Corporate Social Responsibility (CSR) in India. The paper has explored various provisions of the Companies Act, 2013 and related Rules in respect of CSR. The Act requires some specified companies to spend in every year 2% of their average profits made during the last three years on CSR activities. For this purpose, Schedule VII to the Act has provided a list of CSR activities. The manner of undertaking CSR activities has been specified in Companies (Corporate Social Responsibility Policy) Rules, 2014. These rules have also provided a format for disclosure of such activities in the Board's report.

Introduction of the new CSR provisions under the Companies Act, 2013 and related Rules is a welcome step from the perspective of socio-economic development of India. But there are certain legal issues inherent in CSR provisions posing some problems and challenges that need to be addressed. For example, applicability of mandatory CSR provision to loss making company, disclosure of surplus from CSR activities, absence of any penal provision for default in making CSR expenditure, auditor's report on compliance with CSR obligations, etc. The paper makes an attempt to discuss and analyse such legal issues and offer some specific suggestions to deal with them.

KEYWORDS: Corporate Social Responsibility, Legal Issues, CSR Spending, CSR Activities, Companies Act 2013, Companies (Corporate Social Responsibility Policy) Rules 2014, India.

1. Introduction

In August 2013, the Government of India has passed the Companies Act, 2013. One of the new features under the Act is the first time introduction of mandatory provision in respect of corporate social responsibility (CSR). According to section 135, companies having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more, or a net profit of rupees five crore or more during any financial year, are required to spend certain percentage of their net profit on CSR activities in every financial year. Schedule VII to the Act has provided a list of CSR activities in respect of which companies may incur CSR expenditure. The Act requires the formation of a Corporate Social Responsibility Committee of the Board consisting of three or more directors, with at least one independent director. The CSR Committee is required to formulate and recommend a CSR Policy to the Board, recommend the amount of expenditure to be incurred on CSR activities and monitor the CSR Policy of the company from time to time [Section135(3)].

The Act also specifies the duty of the Board of Directors. According to section 135(4) the Board has to approve CSR Policy recommended by its CSR Committee and disclose contents of such Policy in its report and place the same on the company's website. It should also ensure that in every financial year at least 2% of average net profit of the company made during the three immediately preceding financial years is on CSR activities in pursuance of its CSR Policy [Section135(5)].

When a company does not spend the required amount of CSR expenses in any year, the Board has to specify the reasons for not spending the amount in its report made under section 134(3)(o). If a company fails to disclose CSR information in board's report as required under section 134(3)(o), the Act prescribes punishment under section 134(8) for the company and defaulting officer both. But for failure to make CSR spending, no penal provision has been prescribed under the law.

In exercise of the powers conferred under section 135 and sub-sections (1) and (2) of section 469 of the Companies Act, 2013, the Central Government has made the Companies (Corporate Social Responsibility Policy) Rules, 2014. These Rules, inter alia, have laid down the meaning of corporate social responsibility and CSR Policy, specified the manner of undertaking CSR activities and provided format of disclosure of such activities in the Board's report.

Introduction of the new CSR provisions under the Companies Act, 2013 and related Rules is a welcome step from the perspective of socio-economic development of India. But certain legal issues are involved in regulatory provisions relating to CSR which creates some problems and challenges. For example, applicability of mandatory CSR provision to loss making company, disclosure of surplus from CSR activities, non-punishment for default in making CSR expenditure, auditor's report on compliance with CSR obligations, etc. The paper makes an attempt to discuss and analyse such legal issues and challenges.

The rest of the paper proceeds as follows. Section 2 specifies the objectives of the present study. Research methodology is stated in section 3. Section 4 has discussed and analysed some legal issues and challenges inherent in regulatory provisions of CSR under the Companies Act, 2013 and related CSR Rules. This section also offers a few suggestions to deal with identified issues and challenges. Section 5 concludes the paper.

2. Objectives of the Study

The study has following two objectives:

- (i) To identify, discuss and analyse some legal issues which pose certain problems and challenges to implement and operationalise CSR provisions and
- (ii) To offer some specific suggestions to deal with such legal issues and make CSR regulations more effective and fruitful.

3. Research Methodology

The present research is theoretical and explorative in nature which is based on relevant provisions of the Companies Act, 2013, Companies (Disclosure of Particulars in the Report of Board of Directors) Rules, 1988, Companies (Corporate Social Responsibility Policy) Rules, 2014 and other relevant literature.

4. Legal Issues and Challenges Involved in Regulatory Provision Relating to CSR

In this section, we have discussed and analysed certain legal issues which create some problems and challenges to implement and operationalise the CSR provisions. This section also offers specific suggestions to deal with such legal issues

(i) Applicability of Section 135 to Loss Making Company

According to section 135 of the newly introduced Companies Act, 2013, if a company satisfies any one of the following three criteria during any financial year, it shall be covered by the mandatory CSR provision:

- (i) It has net worth of rupees five hundred crore or more during any financial year, or
- (ii) It has turnover of rupees one thousand crore or more during any financial year, or
- (iii) It has a net profit of rupees five crore or more during any financial year.

Thus, requirement of CSR spending under section 135 is applicable also to companies which are suffering losses but having net worth of rupees five hundred crore or more, or having turnover of rupees one thousand crore or more during any financial year. Section 135(5) requires the board of such companies to spend in every financial year, at least 2% of their average net profits made during the three immediately preceding financial years, in pursuance of their CSR Policy. It may so happen that a company earned profits in one year and incurred losses in the next two years. If the amount of profit earned during the 1st year exceeds the total amount of losses sustained during the 2nd and 3rd year, the average net profits of the company made during the three immediately preceding financial years comes to a positive figure. Consequently, the company comes within the purview of CSR obligation under section 135 and has to spend 2% of such average profit on CSR activities even if it suffers losses during the last two years. In case of companies having no reserve, this situation may lead to erosion of capital.

Suggestion

Criteria of net worth or turnover specified under section 135 for mandatory CSR obligation should not be made applicable to loss making companies unless such companies have certain percentage of reserve in proportion to their share capital (say, 25% of share capital).

(ii) Relevant Date for Determining Net Worth

One of the criteria for applicability of section 135 is net worth of rupees five hundred crore or more during any financial year. Neither the Companies Act, 2013 nor the Companies (Corporate Social Responsibility Policy) Rules, 2014 specifies the date of ‘any financial year’ with respect to which net worth of ‘rupees five hundred crore’ should be calculated for verifying applicability of section 135.

Suggestion

The Companies Act, 2013 or the CSR Rules should be specific regarding the date of ‘any financial year’ (like opening or closing date of the financial year) as of which net worth should be calculated for applying the provision of section 135.

(iii) Option for Creating CSR Reserve and Making CSR Expenditure over Longer Period of Time

Companies falling under the ambit of section 135 may have the liquidity problem for incurring full amount of CSR expenditure in every financial year as required under subsection (5) of this section. Though a company may incur CSR expenditure on ‘due basis’ but outstanding CSR expenses are to be repaid within a stipulated period of time. This may create problems to companies suffering from liquidity crisis unless the Act allows the ‘unspent’ amount of CSR expenses of the current year to be spent in the next year.

Besides, some companies may have plans to undertake big social projects requiring huge amount of capital investment in a single year. In such cases, the Companies Act does not give any option to accumulate the annual amount specified for CSR expenses in reserve over a number of years and utilize it as per their CSR Policy within a stipulated period of time.

Suggestion

Companies covered under section 135 should be given the opportunity to transfer the unspent amount of ‘required CSR expense’ to Corporate Social Responsibility (CSR) Reserve and utilize the transferred amount (along with accrued income thereon) on permitted CSR activities within 3 to 5 years of its transfer.

(iv) Disclosure of Surplus from CSR Activities

Rule 6 of the Companies (CSR Policy) Rules 2014 requires that CSR policy should specify that the surplus arising from CSR activities are not to be considered as business profits of the company. Surplus arising from CSR activities may therefore need to be ploughed back into CSR activities (KPMG, 2014). However, neither the Companies Act, nor the Companies (CSR Policy) Rules prescribe any disclosure norm of such surplus. Even Schedule III to the Companies Act, 2013 is silent about such surplus.

Suggestion

Schedule III to the Companies Act, 2013 should include specific provision for disclosure of surplus arising from CSR activities.

(v) No Disclosure Requirement in the Financial Statements in Respect of Shortfall of CSR Expenditure and Reasons Thereof

In case a company fails to incur CSR expenses amounting to 2% of average net profits, the reasons for shortfall of CSR expenditure are required to be disclosed in the report of the Board of Directors under section 134(3)(o). But there is no such legal requirement for disclosure of the same in the Financial Statements. Schedule III to the Companies Act, 2013 requires mere disclosure of aggregate amount of expenditure incurred on corporate social responsibility activities by way of notes.

Suggestion

To enhance the usefulness of financial statements, the following information needs to be disclosed by way of notes:

- (i) Details of CSR expenditure showing activity wise break-up,
- (ii) Statement showing computation of specified amount of CSR expenditure, i.e., 2% of average net profit computed under section 198 and
- (iv) Shortfall in CSR expenditure, if any, and reasons for shortfall.

(vi) Preference to Local Area for CSR Expenditure

First proviso to section 135(5) lays down that the company shall give preference to the local area and areas around it where it operates, for spending the amount specified for CSR activities. While making CSR expenditure, preference to local area is a welcome provision to build a stronger community-business relationship (Borman and Chakraborty, 2014). If on account of giving preference to local area and area of operation, CSR expenses are concentrated in industrially developed states ignoring industrially backward region, it may adversely affect the effort of equitable socio-economic development in India.

Suggestion

If a part of the CSR expenditure can be utilized for the socio-economic development of the backward region, it will help in achieving a balanced and sustainable development of India.

A portion, say 40% to 50% of the amount of CSR expenditure specified under Section 135(5) may be suggested to spend in development of backward areas of the country, keeping the other portion earmarked for local area development.

(vii) Auditor’s Report on Compliance with CSR Obligations

Neither the Companies Act, 2013 nor the CSR Rules requires an auditor to make any express statement in his report regarding compliance with CSR provisions by companies covered under section 135(1). However, for expressing opinion in his report on the truth and fairness of accounts and financial statements under section 143(2), an auditor has to check compliance with those provisions of the Act which affect the accounts and financial statements. The General Instructions [Item 5(i)(k)] for Preparation of Statement of Profit and Loss under Schedule III to the Companies Act, 2013 requires a company, covered by section 135, to disclose aggregate amount of expenditure incurred on corporate social responsibility activities by way of notes. Thus, an auditor has to verify whether total amount expended on CSR activities has been disclosed in the notes to the Statement of Profit and Loss and whether such amount has been spent on CSR activities which are in conformity with the CSR Policy of the company and Schedule VII to the Companies Act, 2013. But he is not supposed to check compliance with other provisions of section 135 and related CSR Rules like non-spending or short spending of CSR expenditure, reporting of reasons for non-spending or short spending of CSR expenditure in board’s report.

Suggestion

Considering the role of corporate social responsibility in the country’s economic development, the Central Government may prescribe under section 143(3)(j) or section 143(11) to include in auditor’s report a specific statement regarding compliance with CSR obligation under section 135.

(viii) Punishment for Default in Making CSR Expenditure

There is no specific provision of punishment for failure under section 135(5) to spend specified percentage of net profit on CSR activities. In such a situation, question arises whether the penal provision of section 450 can be invoked or not. Section 450 lays down provision of punishment where no specific penalty or punishment is provided. According to section 450 if a

company or any officer of a company or any other person contravenes any of the provisions of this Act or the rules made thereunder for which no penalty or punishment is provided elsewhere in this Act, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to Rs. 10,000, and where the contravention is a continuing one, with a further fine which may extend to Rs.1,000 for every day after the first during which the contravention continues.

For not incurring CSR expenditure, the second proviso to section 135(5) specifically states “Provided further that if the company fails to spend such amount, the Board shall, in its report made under clause (o) of sub-section (3) of section 134, specify the reasons for not spending the amount.”

Thus, for non-spending on CSR activities, the course of action directed by the Act itself is to explain reasons for the same in board’s report. As such, the default in making CSR expenditure under section 135(5) may not amount to ‘contravene’ the provision of section 135 and hence, such default may not attract punishment under section 450.

Suggestion

It is suggested that the Ministry of Corporate Affairs should issue a clarification in this regard.

(ix) Absence of Penal Provision May Lead to Non-Compliance of CSR Obligation

The Act prescribes penal measure under section 134(8) for non-disclosure of the reasons for failure to spend the amount of specified percentage of net profit on CSR activities under section 135(5) but there is no specific provision of punishment for failure to spend such amount on CSR activities. In the absence of any penal provision, the mandatory provision for CSR spending stands as ‘comply or explain’. As a result, instead of ensuring compliance with CSR obligation, many companies may be interested to provide fictitious explanation for not spending or short spending of CSR expenditure in their board’s report.

Suggestion

If the intention of the Government is to ensure real compliance of the provision regarding CSR expenditure under section 135(5), it should be backed by penal provision for non-compliance and there should be appropriate enforcement mechanism.

5. Conclusion

The new CSR provisions under the Companies Act, 2013 has given legal recognition to corporate social responsibility in India. The new CSR provisions have several positive aspects like channelizing corporate investment in targeted social sector, motivating companies to collaborate for undertaking big social projects by pooling together their CSR contribution, etc. If CSR provisions are observed by companies in true spirit, it may contribute to equitable and sustainable development of India. However, to get true socio-economic benefits from this legislative effort, CSR regulations are to be made more effective and fruitful and for that reason, the problematic and challenging issues, as discussed, need to be resolved.

Reference

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