CSR MADE EASY

Corporate Social Responsibility

Learning Series ◆ Vol.- I ◆ Issue - 3 ◆ 2014-15

CONFUSING & DEBATABLE ISSUES UNDER CSR

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Initiative of Credibility Alliance, CPA & FICCI-Aditya Birla CSR Centre for Excellence

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A joint initiative of Credibility Alliance, CPA & FICCI-Aditya Birla CSR Centre for Excellence

CONFUSING & DEBATABLE ISSUES UNDER CSR

*Principal Author * :*
Dr. Manoj Fogla

* The Author is a freelance consultant, can be contacted at mfogla@yahoo.com

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Confusing & Debatable Issues under CSR

Introduction

1.1.1 With effect from 01.04.2014 Corporate Social Responsibility (CSR) has become mandatory for Indian Companies and Foreign Companies working in India. The law relating to CSR in India is provided in Section 135 of the Companies Act, 2013 read with Schedule VII of the Act and The Companies (Corporate Social Responsibility Policy) Rules, 2014. The CSR laws are new and still evolving, therefore, there are many areas which lack clarity. In this issue some of the confusing and debatable issues have been discussed.

Independence of CSR Committee & NPOs Promoted by Company

1.2.1 Under Rule 4(2) a Company can implement CSR activity through Trust or Society promoted by it. A Company can promote a Trust and immediately start working through such Trust. It may be noted that if a Company works through other Trust or Society (which are not promoted by the Company) then such Trust or Society should have at least 3 years existence and experience.

1.2.2 A Trust or Society promoted by the Company can be controlled by the Company. There is no requirement of having Independent management or Directors in such Trust or Society promoted by the Company.

1.2.3 However, Section 135(1) requires that a CSR Committee should be formed. There should be at least one Independent Director in such CSR Committee. More importantly the CSR law does not address the independence of the NPO or Trust to be promoted by the Company, which is more important.

1.2.4 It may further be noted that contribution towards corpus to a Trust or Society promoted by the Company is also permissible as CSR expenditure. Currently a Company can create a closely held Trust and transfer funds including corpus without any real utilisation or control mechanism.

CSR Expenditure whether charge against Income or Appropriation

1.3.1 Whether CSR is a charge to the income or appropriation of income has not been clarified. Expenditures of various nature have been allowed as permissible under CSR. For instance the following type of CSR expenditures are permissible :

- Direct expenditure on charitable activities
- Direct expenditure on charitable activities in local area
- Direct expenditure on capacity building of employees and implementing NPOs
- Grant to Trust or Society
- Transfer to other corporates under pooling of expenditure
- Donation to Govt. recognised funds where 100% tax relief is available.

1.3.2 All the above type of expenditures require different type of accounting and tax treatment. For instance, 5% expenditure on capacity building of employees or local area development are judicially/legally considered as a charge against the income. Therefore, they can be directly claimed as expenditure. If that is true then it is not clear whether the 'average income' for CSR should be determined before or after charging such expenditure.

1.3.3 On the other hand Grant, Donations etc. are voluntary appropriation of income and cannot be charged as expenditure against the income. The CSR law allows all these various type of applications as CSR expenditures. Therefore, there is lot of ambiguity with regard to the accounting and legal treatment.

The Fundamental Difference between Sections 181 and 135

1.4.1 Section 181 of the Companies Act, 2014 allows all the Companies to make voluntary contribution to bonafide charitable funds upto 5% of profit even without the

approval of the general body. In other words there is an overlap in the provisions of the Companies Act, 2013 with regard to voluntary contribution for charitable purposes. The fundamental difference between Section 181 and 135 has not been addressed and therefore, there is lack of clarity as far as income tax on CSR is concerned. It is not clear whether a contribution for charitable purposes will be permissbile under Section 181 or 135 or both.

1.4.2 Ideally all application under Section 135 should be treated as charge against the income. And all contribution under Section 181 should be treated as voluntary contribution which are appropriation of income. Section 181 and Section 135 should be linked when CSR funds are utilised through other NGOs/Trust.

Accounting and Utilisation issues in CSR

1.5.1 When CSR funds are utilised through other NPOs/Trust–then there are Accounting and Disclosure issues which need attention :

- If voluntary contribution is given to a Trust then the transfer itself should be treated as expenditure, irrespective of subsequent utilisation. However, under Schedule VII a Company has to give restricted grant as legal obligation for specific purposes, therefore it is not clear whether CSR grant can or cannot be voluntary contribution or should they be restricted grant only.
- If restricted project grants are given, then such grant are given as a fiduciary responsibility to the recipient organisations. Therefore, there should be clarity on how it should be treated in the books of the Company. If it is treated as application then an unexecuted contract at both ends is accounted as complete. Such treatment would not be correct. The other option would be to show utilisation to the extent of utilisation made by the implementing organisation. However, the follow such accounting the CSR grant will remain a liability in the NPO's books and an asset in the Companies book. The Company cannot show it 'to the extent utilised' unless the grant continues on the asset side of the Company.
- If restricted project grants are given, such grant cannot be treated as income in the books of the recipient (unless the recipient organisation itself is the beneficiary and its networth increases). If it becomes a liability then there should be a corresponding asset in the books of Company.

1.5.2 The Accounting Standards issued by Institute of Chartered Accountants of India (ICAI) do not distinguish the grants received in Independent capacity and fiduciary capacity. On the contrary the judicial precedence on such distinction is very clear and well settled.

Corpus Donation and Allied Issues

1.6.1 Corpus Donations cannot be given for specific purpose, they are normally given with specific direction for indefinite retention without assigning any purpose. In other words a corpus fund is like a general fund; the only difference being the authority to retain the corpus fund for long period.

1.6.2 In such background (i) it is not possible to give a corpus donation for the specific activities mentioned in Schedule VII because, then a corpus would become an endowment. In other words, even if a long term fund is given for purposes under schedule VII, it cannot be, technically a corpus donation. It has to be a restricted endowment (ii) an endowment is held in fiduciary capacity therefore, it cannot increase the corpus or networth of the recipient Trust

1.6.3 The current CSR provisions provide undue leeway to Companies to claim CSR without spending through corpus donation. Moreover, as discussed a corpus donation cannot be given for purposes under schedule VII.

Companies Facing Conflict with FCRA Laws

1.7.1 Under Foreign Contribution Regulation Act (FCRA), 2010 the Foreign Companies and even Indian Companies are not allowed to provide grant to other NPOs unless they have FCRA prior permission or registration. There are many Indian Companies having more than 50% share holding by foreigners; ICICI Bank, HDFC Bank, Infosys etc. are few examples. A corresponding amendment in the FCRA law is necessary otherwise most of the larger Companies will be implicated. Technically an Indian Company like HDFC Bank or Infosys cannot give grant to its own NPO or Foundation unless it has FCRA registration or prior permision.

1.7.2 As a matter of fact such deemed Foreign Companies cannot even setup Indian Trust or Society by making initial contribution/expenditure, because technically, even for such initial contribution/expenditure also FCRA permission is necessary.

1.7.3 It is important that such clarity is brought in both FCRA and Companies Act.

Reporting requirement of CSR

1.8.1 The reporting format under the Companies (CSR) Rule is a broad guideline. It should have been linked with the schedule III of the Companies Act in order to

create formal responsibility of the auditor. Currently there is no formal linkage of CSR reporting with the audited financial statements, except as notes to be accounts.

1.8.2 In the formal financial audited reports, reporting on CSR expenditure is not required to be reported in the main statement, they only come as a note to the auditors report. It is important to provide more specific reporting and disclosure requirement including :

(i) the break up between Companies in case of pooling of expenditure;

(ii) the activity wise break up;

(iii) a declaration on the actual status of fund which have been given as grant to other NGOs because as per law the grant itself should be treated as application in the books of the Company;

(iv) in case of corpus donation the status & activities of the organisation.

1.8.3 In other words, the current reporting format under CSR should be linked with schedule III of the Companies Act. Currently in the audited accounts, the CSR expenditure is required to be disclosed under clause (k) of para 5(i) of Schedule III in the notes to accounts.

Lack of Clarity regarding Administrative Expenses

1.9.1 There is no accounting standard or mechanism to determine administrative expenses. The judicial precedence is confusing and most of the administrative expenses have been treated as programme expenses. This will result in use of discretionary norms in determining the administrative expenses, affecting the uniformity in reporting under CSR Rules.

CSR Expenditure Before or after determining Net Income

1.10.1 The computation of average net income shall be made under Section 198. For the purposes of CSR irrespective of the nature of expenditure, the Company has to apply 2% of the net profit computed under 198. From a finance planning point of view, a Company may distinguish between the chargeable expenditure and the voluntary expenditure, because the chargeable expenditure can be deducted during computation of net profit under Section 198.

1.10.2 For example, a Company spends Rs. 4 lakh on CSR including Rs. 2 lakh on local area issues which are directly incidental to the business. Therefore, the Company can claim Rs. 2 lakh on local area issues as business expenditures, which will reduce its net profit as well as the CSR spends. The question which needs to be clarified is that whether such overlapping expenditures (which can be claimed both as business as well as CSR expenditures) be treated as CSR expenditure and if so should they be deducted during computation of net profit under Section 198.

Treatment of Short fall or Excess in CSR Expenditure

1.11.1 Under Section 134(3)(o) the Board of the Company is required to report the short fall in CSR expenditure, however, there is no such requirement of reporting the short fall of CSR expenditure, in the audited financial statements.

1.11.2 A short fall in expenditure is a financial issue with a legal accountability of the board. Such shortfall should be formally computed in the audited statement and the Company should be required to apply such short fall in future years based on Rules as may be determined.

1.11.3 Similarly, there is lack of clarity in reporting and off setting of surplus in CSR expenditures. For example, if a Company spends more than 2% of the average profit in any year towards CSR, then will it be allowed to spend less in subsequent years. Ideally such set off should be permissible.

Treatment of Income made from CSR Activities

1.12.1 There is lack of clarity about incidental income from CSR activity. This issue becomes more complicated when the income happens at the end of the implementing NGO.

1.12.2 Under Rule 6(2) the CSR Policy of the Company shall specify that the surplus arising out of the CSR projects or programs or activities shall not form part of the business profit of a Company. In other words surplus generated from CSR activities should be ploughed back to CSR funds over and above the 2% contribution.

1.12.3 In this context, it is not clear how the taxation of such surplus will be treated. Any income including the surplus from CSR activities will be taxable if the CSR activities are implemented directly by the Company. However, such surplus shall be exempted from tax, if the CSR activities are implemented through registered NPOs. Similarly if surplus is generated by another Corporate under pooling of expenditures, then also reporting and taxation issues remain unresolved.

1.12.4 There is a need to distinguish the various kind of surplus generated at various level and the treatment thereof.

Compliance of a loss Making Company Falling in CSR Criteria

1.13.1 Corporate Social Responsibility (CSR) will apply even to a Company which is making losses if the networth exceeds Rs. 500 crore or the turnover exceeds Rs. 1,000 crore.

1.13.2 The current CSR provisions does not require any CSR activity if such Companies are making losses. There might be Companies which are making cash profits but book losses. For example, a Company may have cash profit before charging depreciation but loss after charging depreciation.

1.13.3 The intent of the Act seems to make CSR an appropiation of income activity rather than a charge against income. For instance, even a loss making Company is required to make all statutory payments and expenditures.

1.13.4 The current CSR laws do not distinguish between the statutory nature and the voluntary nature of CSR expenditures

Can Losses be Treated as Negative Income for Average Profit ?

1.14.1 The current CSR law require computation of average profit for the past 3 years. 2% CSR expenditure has to be made based on such average profit. However it is not clear whether losses in any particular year be treated as negative income for average profit. For example, a Company has made profit in past 2 years and loss in one of the past 3 years. In such circumstances it is not clear whether the loss should be deducted for computing average profit. Ideally loss should be allowed to be deducted.

Can Companies average out CSR Expenditure in Case of Pooling ?

1.15.1 Under Rule 4(3) a Company may also collaborate with other Companies for undertaking projects or programs or CSR activities in such a manner that the CSR Committees of respective Companies are in a position to report separately on such projects or programs in accordance with the Rules. In other words, a group of Companies can jointly execute CSR programmes, such Companies can be holding and subsidiary Companies also.

1.15.2 However, it is not clear whether, in case of pooling of expenses, one Company spend less and another more. In other words, can Companies average out CSR expenditure. Normally each Company should be required to spend the requisite amount under CSR with or without pooling of expenses.

Will CSR Apply in first three year ?

1.16.1 A Company which falls into the CSR criteria in the first year of its operation, the question arises whether it should conduct CSR activities. There is no clarity in this regard. However, since the CSR expenditure is based on the last 3 years average profit, it seems that the CSR law shall not apply in the first 3 years of existence, even if a Company falls into the CSR criteria.

Can Foreign Branches do Activities Directly ?

1.17.1 By virtue of the CSR Rule 3(1) the branches or project office of any Foreign Company as defined under Section 2(42) of the Act is also required to implement CSR.

1.17.2 However, the Foreign Companies and their Branches are subject to FEMA approval and restrictions. Under FEMA Foreign Companies are permitted to conduct only those activities which are specifically permitted by Reserve Bank of India. Therefore, technically CSR activities cannot be implemented unless approved by RBI under FEMA. As the normal permissible list of activities does not include charitable activities.

1.17.3 Any Foreign Corporate or Foreign NPO does not have a right to do charitable activity in India without specific approval from RBI under FEMA. A Foreign

Corporate or Foreign NPO can have charitable activity in India only through registered charitable organisation having FCRA registration.

1.17.4 Technically and under strict legal interpretation all branches of Foreign Company should seek specific approval from RBI under FEMA if they fall under the criteria specified for CSR, otherwise they cannot do direct implementation of CSR activities.

1.17.5 However, as per the new Companies Act, 2013, CSR has been made mandatory as a part of business activity, therefore, even if CSR is not explicitly provided in the RBI letter of approval, it should be construed as permissible.

1.17.6 It is important that clarification is issued by RBI under FEMA in this regard.

Applicability of CSR in first 3 years of Foreign Branch or Project Office

1.18.1 In case of a Foreign Company the net profit for CSR purposes has to be determined for the Indian operations for a period of 3 years under Section 381(1)(a). This issue is not clear from CSR Rule, however, in our opinion Foreign branches and project offices will not come under the CSR provision for the first 3 years of their operation.

How Monitoring will be done when funds are given to other NGOs ?

1.19.1 Under CSR laws, the CSR Committee is required to monitor the implementation of CSR activities and report to the Board. However, when a Company is working through other Trust or NPOs, legally, the grant itself is treated as application of funds. In other words the CSR funds are utilised the moment the transfer of funds is made. In such circumstances it is not clear how the monitoring will be done by the CSR Committee. It seems that the audited statements and activity report from the implementing partner have to be relied upon.

Activities under Schedule VII do not seem to be Mandatory

1.20.1 The Section 135 and the Companies (CSR) Rules, 2014 provide that specific activities have to be conducted under CSR. Further, schedule VII has been provided which elaborate the specific activities.

1.20.2 Section 135(3)(a) provides that the activities should be undertaken by the company as specified in Schedule VII. In other words on plain reading of section 135 it seems that no other activities other than the one specified in Schedule VII are permissible.

1.20.3 However, Rule 2(c) defines that Corporate Social Responsibility shall not be confined to the projects and programmes specified in Schedule VII therefore, if one goes by the definition of CSR then all kinds of charitable activities are permissible and Schedule VII is just a indicative list.

1.20.4 Under the current enacted Rules it seems that there would not be any violation if a company conducts legitimate charitable activities even beyond the list provided in Schedule VII. However, it could be legally debated whether a Rule can supersede the Act because Section 135(3)(a) clearly provides that the CSR activities should confirm to Schedule VII.

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Credibility Alliance (CA) is a consortium of Voluntary Organizations committed towards enhancing Accountability and Transparency in the Voluntary Sector through good Governance. Registered in May 2004 as an independent, not-for-profit Organization, CA emerged as an initiative from within the Sector after an extensive consultative process over a period of two years involving thousands of VOs all over India. As an Organization, CA aspires to build trust among all stakeholders through improving Governance within the Voluntary Sector. As an initiative whose hallmark has been the participatory approach, CA has developed suitable Norms through wide-ranging consultation with & participation of diverse Organizations within the Sector by developing a large membership base.

With the mission *'to build credibility of the Voluntary Sector through creation and promotion of Norms of Good Governance and Public Disclosure'*, CA's core programme areas comprise of: Accreditation, Capacity Building, Networking and Information Dissemination.

Centre for Promoting Accountability (CPA) is an organisation "To promote accountability and sustainability amongst organisations in the non-profit & CSR sector". It is promoted by Financial Management Service Foundation and is a part of FMSF family.

CPA assists civil society organisations to achieve development effectiveness by promoting transparency and accountability.CPA achieves this through an integrated process of accompaniment, systems development in financial management and governance, training and capacity building, research and publication, reviews and evaluations.

CPA came into existence in the year 2007. CPA firmly believes on the values of accountability, transparency and good governance. CPA is also involved in research and publication of materials that promotes accountability and involved in information dissemination on financial management, governance and legal regulations.

FICCI-Aditya Birla CSR Centre for Excellence has evolved in consonance with Mahatma Gandhi's dream: ethics-based business practices leading to improvement in the quality of life for the common people. The centre envisions- To incubate, nurture and accelerate a paradigm of sustainable and inclusive CSR in India and across the globe, thereby raising the Human Development Index through poverty alleviation.

The Centre for Excellence is a joint endeavor of Federation of Indian Chambers of Commerce & Industry (FICCI), a rallying point for free enterprise in India since 1927 and the Aditya Birla Group - a prominent business group with a mission to deliver superior value to customers, shareholders, employees and society at large.

CREDIBILITY ALLIANCE
214, DDA Building No. 1, District Centre,
Janakpuri, New Delhi -110 058.
www.credibilityalliance.org

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ADITYA BIRLA GROUP
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CSR Centre for Excellence
www.csrcfe.org

CPA
CENTRE FOR PROMOTING ACCOUNTABILITY
404, White House, 382, Sant Nagar,
East of Kailash, New Delhi 110065,
Website: www.cpaindia.in

Send your feedback to : selvi@credibilityalliance.org, cpa@cpaindia.in, kkupadhyay@gmail.com, mfogla@yahoo.com