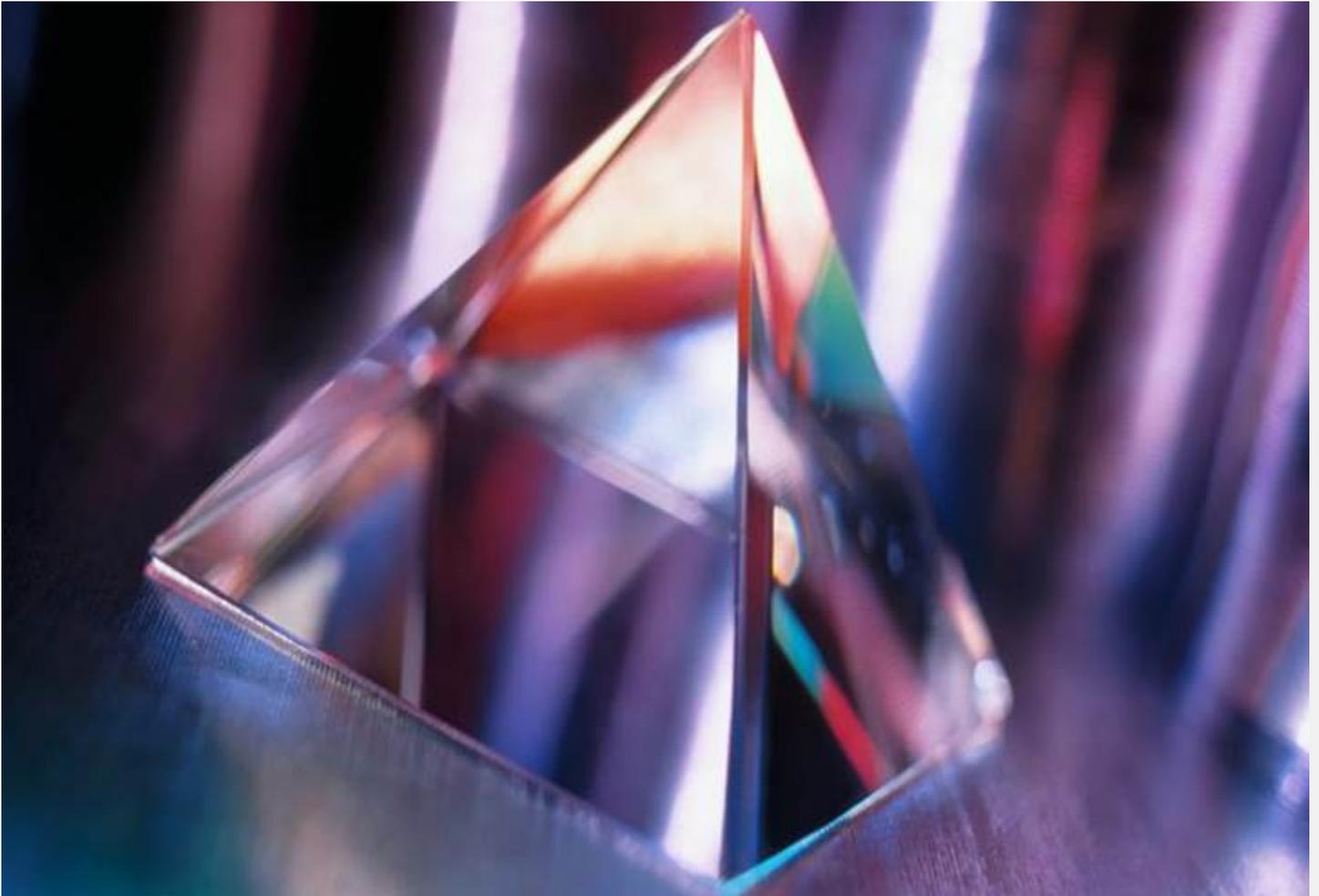


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A series on the Companies Act,
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Corporate Social Responsibility

Overview

Corporate Social Responsibility ('CSR') is the process by which an organisation thinks about and evolves its relationships with stakeholders for the common good and demonstrates its commitment in this regard by adoption of appropriate business processes and strategies. The Board of Directors (the 'Board') is to discharge its obligations through its Corporate Social Responsibility Committee ('CSR Committee') constituted for this purpose.

On 27 February 2014, the Central Government has notified the provisions and corresponding Rules pertaining to CSR under the Companies Act, 2013 ('2013 Act') and has appointed 1 April 2014 as the date on which the section and the aforementioned Rules will come into force. While many companies have, over a period of time, embarked on laudable CSR activities, the 2013 Act has brought about a purposeful direction, monitoring and communication of such activities. In this issue, we discuss some CSR related matters that need to be considered by a company under the 2013 Act.

Issue 2: Corporate Social Responsibility

June 2014

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Key provisions of section 135

Particulars	2013 Act
Applicability ^[1] [section 135(1)]	Every company having during any financial year: <ul style="list-style-type: none">• 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. Company includes a foreign company having its branch office or project office in India.
CSR Committee ^[2]	<ul style="list-style-type: none">• Constitution - minimum three directors, of which one director to be an independent director ('ID').• Where an unlisted public company or a private company is otherwise not required to have an ID, the CSR Committee for such a company need not have an ID. In other words, where the 2013 Act does not mandate a company to have an ID (such as in the case of the specified class of unlisted public company or a private company), the CSR Committee does not require an ID to be specially appointed.• In the case of a private company having only two directors, both should be on the CSR Committee.• In the case of a foreign company, the CSR Committee should comprise of at least two persons, of which one person should be nominated by the foreign company and one person should be an Indian resident, authorised to accept notices on behalf of the company.
Amounts involved	<ul style="list-style-type: none">• Spend in every financial year, at least two percent of the average net profits of the company made during the immediately three preceding financial years, in pursuance of its CSR policy.

^[1] Every company which ceases to fall in any of the three criteria mentioned above for three consecutive financial years will not be required to comply with provisions relating to CSR, till such time it meets the said criteria.

^[2] Clarity may be required from the Regulator whether in case of a one person company which is covered by the CSR provisions, where only a single director exists, whether two directors would be required for the CSR Committee.

The 2013 Act requires constitution of a CSR Committee once the aforesaid criteria are met during any financial year and also spend the amount required every financial year. Net worth and net profit are normally determined reliably after the end of the financial year (in the subsequent year) based on the audit of such financial statements. Though not free from doubt, we believe that the assessment for constitution of the CSR Committee should be done annually immediately after the audit, based on the immediately preceding financial year's audited accounts to determine if the company is required to incur the required CSR spend that year. Accordingly, since the CSR provisions are effective from 1 April 2014, this would mean that all companies following the financial year (FY) ending 31 March 2014 as the accounting year, which meet any of the qualifying criteria as per their audited FY 2013-2014 financial statements, will have to constitute a CSR Committee, determine and incur the CSR spend during FY 2014-2015.

The 2013 Act requires every Board to ensure that the company spends in every financial year at least two percent of the average net profits of the immediately preceding three years on activities that fall within those covered and specified under Schedule VII to the 2013 Act. While there are no penal provisions for not spending the amount, disclosure in the Board Report together with reasons for not spending such amounts is required. Therefore, a provision for the CSR spend would be required only if there is a present obligation stemming from a specific accounting standard. In short, a company need not accrue a liability for the unspent amount of CSR unless it has contractually incurred a liability to such spends. This is consistent with the disclosure requirement for amount of expenditure incurred on CSR activities in the financial statements and details of CSR spent, including amounts unspent in the Board Report.

The Rules state that CSR activities exclude activities undertaken in pursuance of the normal course of business of a company. A question therefore arises as to whether CSR expenditure is tax deductible. The Income-tax Act, 1961 permits deduction of expenditure if it is an allowable expenditure specifically determined or if it is "wholly or exclusively incurred for the purposes of business". This being a contentious issue, a clarification from the income tax authorities as regards the allowability of such expenditure for the calculation of taxable income would help allay the uncertainty in this regard.

Net profits

Once an entity is required to set up a CSR Committee as required under section 135(1), the Committee is tasked with ensuring that the company formulates a CSR policy, recommends the expenditure on permissible activities and monitors the policy. The table below provides a bird's eye view of the meaning of the term 'net profit' in the 2013 Act and Rules for purposes of CSR.

Act/ Rule Reference	Particulars
Section 135 (1) – scoping in	Net profit of Rs. 5 crores.
Section 135 (5) – spend	Two percent of average net profits (to be calculated in accordance with section 198).

Rule 2(f)	Net profit as per its financial statements, excluding the following: <ul style="list-style-type: none"> Profits arising from any overseas branch, whether operated as a separate company or otherwise; and Dividend received from companies in India which are covered under and comply with the CSR requirements of the 2013 Act.
Rule 2(f)	Net profit relating to financial statements prepared as per the Companies Act, 1956 ('1956 Act') not required to be re-calculated.
Rule 2(f)	In the case of a foreign company, net profit is as per profit and loss account prepared in terms of section 381(1)(a) read with section 198 of the 2013 Act.

While the term 'net profit' has not been explained in section 135 of the 2013 Act, the same has been defined in the CSR Rules. Hence, on a harmonious reading of the 2013 Act and the Rules, we believe that determination of net profit (to determine coverage, as well as determination of spend/disclosure) should be made as follows:

S. No	Particulars	Step	For immediately preceding financial year	Preceding three financial years		
1	Calculate profit in accordance with section 198 of the 2013 Act. In case profit for the financial year before 1 April 2014 is required to be considered, calculate profit in accordance with section 349 of the 1956 Act.	A	xx	xx	xx	xx
	Less:					
2	Profits from overseas branches/ companies	B	xx	xx	xx	xx
3	Dividend received from companies in India which are covered under and compliant with the CSR requirements	C	xx	xx	xx	xx
4	Total deductions	D = B+C	xx	xx	xx	xx
5	Net profit for the purpose of CSR	E = A - D	xx	xx	xx	xx

The CSR Rules state that net profit relating to financial statements prepared under the 1956 Act shall not be required to be re-calculated as per section 198 of the 2013 Act. With respect to determination of net profit relating to financial statements prepared under the 1956 Act, net profit could mean:

1. Profit after tax as per the financial statements
2. Profit before tax as per the financial statements
3. Profit after tax less profits from overseas branches/companies and dividend received from specified class of Indian companies
4. Profit before tax less profits from overseas branches/companies and dividend received from specified class of Indian companies
5. Profit before tax less profits from overseas branches/companies and dividend received from specified class of Indian companies adjusted for items specified in section 198 of the 2013 Act/ section 349 of the 1956 Act (since the provisions of these sections are similar)

Though not free from doubt, interpretation 5 above appears to be appropriate since CSR is expected to be incurred out of profits before tax, the CSR Rules provide for exclusion of profits from overseas branches/companies and dividend received from specified class of Indian companies in the determination of net profits and the Rules do not mandate that the profits as per the financial statements prepared under the 1956 Act should not be recalculated as per section 198 of the 2013 Act. Clarification would be required with regard to the manner of interpreting net profit in case of financial statements prepared under the 1956 Act in order to ensure consistency of such determination across companies.

With respect to exclusion of profits arising from any overseas branch or branches of the company, the books of account of the company should be maintained in a manner that facilitates determination of such profits. With respect to exclusion of profits arising from an overseas branch operated as a separate company, we believe that such a situation may arise in certain jurisdictions which do not permit operation as a branch, unless incorporated; where such incorporated entity is in substance like a branch. Under such circumstance, we are of the view that the exclusion would be for dividends which represent distribution of profits and are included in determination of the net profits. Further, since Rule 2(f) states that the net profit shall not include any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise, clarification would be required if such exclusion with respect to the term 'separate company' is applicable only in case of a wholly owned subsidiary or if it would extend to all foreign subsidiaries, whether wholly owned or not.

With respect to dividend received from Indian companies, exclusion of dividend received in determination of net profit is available only if such dividend paying companies are 'covered under' and 'comply with' the provisions of section 135 of the 2013 Act. The term 'covered under' would relate to the applicability of the provisions of CSR to a company under section 135(1) of the 2013 Act and the term 'comply with' would relate to compliance with the spending requirements specified in section 135(5) of the 2013 Act. Accordingly, in our view, only dividend of such companies that have an obligation to incur CSR spend and have spent such amounts in the year to which the dividend relates to ('CSR compliant companies'), should be deducted in determining profits as stated in Step C in the table above. Thus holding companies whose primary source of revenue is dividends from CSR compliant companies may have no or significantly reduced obligations on CSR spend.

Duties of the CSR Committee and the Board of Directors

CSR Committee	Board of Directors
<ul style="list-style-type: none"> Formulate and recommend to the Board, a CSR policy indicating the activities to be undertaken by the company (including modalities of execution and implementation schedules for the same). 	<ul style="list-style-type: none"> Approve the CSR policy after considering the recommendations of the CSR Committee.
<ul style="list-style-type: none"> Recommend the amount of expenditure to be incurred on the activities referred to above. 	<ul style="list-style-type: none"> Disclose the composition of the CSR Committee and contents of CSR policy in the Board report.
<ul style="list-style-type: none"> Monitor the CSR policy of the company from time to time. 	<ul style="list-style-type: none"> Ensure that the activities included in the CSR policy are undertaken by the company. Ensure that the company spends in every financial year two percent of the average net profits during the three immediately preceding financial years in pursuance of its CSR policy. Disclose in the Board report reasons for not spending the CSR spend amount. Include an annual report on CSR in the Board report containing the specified particulars including, inter alia, a responsibility statement of the CSR Committee that the implementation and monitoring of CSR policy is in compliance with the CSR objectives and policy of the company.

CSR activities

The undermentioned activities qualify as CSR activity as per Schedule VII of the 2013 Act:

- Eradicating hunger, poverty and malnutrition, promoting healthcare including preventive health care and sanitation and making available safe drinking water.
- Promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly, and the differently abled and livelihood enhancement projects.
- Promoting gender equality, empowering women, setting up homes and hostels for women and orphans; setting up old age homes, day care centers and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backwards groups.

- Ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agroforestry, conservation of natural resources and maintaining quality of soil, air and water.
- Protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts.
- Measures for the benefit of armed forces veterans, war widows and their dependents.
- Training to promote rural sports, nationally recognised sports, Paralympic sports and Olympic sports.
- Contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government for socio-economic development and relief and welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women.
- Contributions or fund provided to technology incubators located within academic institutions which are approved by the Central Government.
- Rural development projects.

The CSR activities can be undertaken through:

- a registered trust; or
- a registered society; or
- a company under section 8 of the 2013 Act or otherwise, established by the Company or its holding or subsidiary or associated company.

If any of the above entities is not established by the company or its holding or subsidiary or associate company, it must have an established track record of three years in undertaking similar programs or projects. The company would, however, be required to ensure that the exact activities/projects/programs are appropriately specified, including modalities of use of the funds. The company would continue to be responsible for the end use of the funds and, hence, needs to put in place a rigorous and transparent implementation, monitoring and reporting mechanism. Further, the Rules also permit the company to collaborate with other companies for the CSR activities so far as the activities and related 'spend' can be identified and reported separately. The CSR spend needs to be in India and companies are required to give preference to the local area where they operate. Activities that are exclusively for the benefit of employees and their families are not regarded as CSR activities. Hence setting up of a school by a company to promote education as per Schedule VII of the 2013 Act, which also has children of employees may still be treated as a permissible activity. Contributions to any political party are not considered as a CSR activity. Companies may build CSR capacities of their own personnel as well as those of their implementing agencies through institutions with established track records of at least three financial years but such expenditure should not exceed five percent of total CSR expenditure of the company in one financial year.

The Board is required to approve the CSR policy and disclose the same in its report and on the Company's website including the details of the amount spent. A responsibility statement of the CSR Committee is required to be included in the annual report on CSR activities to be included in the Board's report which would confirm that the implementation and monitoring of the CSR policy is in compliance with the CSR objectives and policy of the Company.

Rule 7 of the CSR Rules states the expenditure that qualifies as CSR expenditure. As per the Rule, CSR expenditure should include all expenditure including contribution to corpus, or on projects or programs relating to CSR activities approved by the Board that is in conformity with Schedule VII.

It may be noticed that the Schedule is wide in coverage and the current activities of many companies could be covered under one or more of the activities listed above. It is, therefore, important for companies to take stock and reassess their current activities to see, whether and how they are covered by the Schedule. The 2013 Act does not restrict an entity from undertaking other activities (or disclosing them).

It is very critical for any company to develop a clear CSR strategy, perform adequate due diligence of the entities/agencies the company is proposing to partner with and oversee proper implementation. The onus is on the Board, through its committee for defining the CSR policy, monitoring spends and reporting, resulting in an increased involvement of the directors. CSR Committees would be required to evaluate current CSR practices, if any, and align the same with the requirements of the 2013 Act. An efficient implementation, monitoring and reporting system also needs to be put in place.

CSR activities exclude activities in the normal course of business. What would constitute normal course and what would not, is open to interpretation. For e.g., would a pharmaceutical company that offers free medicines to the poor, be able to consider the same as CSR activity? Similarly what happens to companies that run hospitals which provide discounted facilities or free facilities for the poor or contributes to a Trust for healthcare and such Trust pays to the hospital for treatment of patients? Or for that matter a section 8 Company (section 25 under the 1956 Act) formed for charitable purposes? Although open to interpretation, in our view, the objectives of the 2013 Act are met so long as the activities (whether or not linked to the business of the company) are on the list of matters in the Schedule and, hence, should be capable of being considered. On a word of caution, however, only the costs so incurred may be considered and not the benefits forgone, e.g., where a pharmaceutical company provides medicines for activities covered under the Schedule, the cost of these should be considered and not the rates the company could have realised in the normal course of business.

Further, the amount incurred should be in the nature of 'expenditure' to qualify as CSR spend. For e.g., amounts paid as advances for a CSR project activity carried out by the company will not be considered as a qualifying expenditure until the goods or services are consumed in such project. Further, since Schedule III requires the "amount of expenditure incurred on corporate social responsibility activities" to be disclosed as part of the Statement of Profit and Loss, we are of the view that CSR spend is an expense and not an appropriation.

It is quite likely that prior to the 2013 Act, a company has already been incurring spends on certain CSR activities, though not strictly covered under the permitted list of activities. Such a company may continue with its existing CSR activities in addition to those required under Schedule VII. Spends on such additional activities will not require disclosures (although some companies may consider making additional disclosure), as envisaged in the 2013 Act and Rules.

Conclusion

It is clear that CSR is a welcome initiative. However, the manner in which it is sought to be enforced (and policed) leaves a doubt as to whether the regulators believe that such activities are (and have been) an integral mandatory part of being a good corporate citizen. Therefore, the robust monitoring and communication mechanism to cajole and nudge companies to compliance should not be overshadowed by the bureaucratic implementation requirements. The soft balancing between these two is the key to success of this initiative.

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