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Kordant Report Series



The 2% CSR Clause: New Requirements for Companies in India

INTRODUCTION

In an effort to properly position the Indian economy for the remainder of the century, India is on the verge of replacing its fifty-seven-year old Companies Act of 1956 with the pending Companies Bill, 2012. Already passed in India's lower house of parliament in December of 2012, the Companies Bill is expected to become law by the end of 2013.

Harmonizing with international norms, fraud reduction measures, new government powers, and accountability provisions are all important new facets of the Bill.

India, however, is setting itself apart from other Asian countries by codifying corporate social responsibility (CSR) spending for targeted companies. Clause 135 of the Companies Bill, 2012 (the "CSR Clause") requires targeted companies to spend a prescribed formula-based amount on CSR for the applicable fiscal year, report on these activities, or explain why they failed to spend, in the annual board report.

Specifically, the CSR Clause applies to any company, during any fiscal year, with (1) a net worth of rupees 500 *crore* (about U.S. \$90 million) or more; (2) a turnover of rupees 1,000

crore (about U.S. \$180 million) or more; or (3) a net profit of rupees 5 *crore* (about U.S. \$900,000) or more.

The CSR Clause will only apply to some of the over 800,000 companies in India, including over 8,000 publicly listed companies and multinational companies. The accounting firm Ernst & Young estimates that the law would cover over 2,500 companies in India and generate over U.S. \$2 billion of CSR spending in local communities.

CSR CLAUSE REQUIREMENTS

The CSR Clause requires a targeted company to make changes within its board of directors, to spend on government delineated categories of CSR, and to formulate and publicly disclose an official policy on its CSR activities. While there is no penalty for failing to spend on CSR, there are penalties for failing to report on CSR activities conducted or explain why CSR spending was not carried out.

CSR Committee

The CSR Clause requires companies to form a Corporate Social Responsibility Committee (“CSR committee”) within the board of directors that will devise, recommend, and monitor CSR activities, and the amounts spent on such activities, to the rest of the board. The CSR committee must consist of three or more directors, at least one of which must be an “independent director” (defined in Clause 149(6) of the Companies Bill). The composition of the CSR committee must be disclosed in the annual board report.

CSR Spending & Government Approved CSR Categories

The company must spend at least two percent of its average net profits made in the preceding three financial years (the “Two Percent Formula”) on government approved categories of CSR. The CSR Clause states that companies must give preference to local areas where the company operates. Further, CSR activities developed and implemented during the year by the company must be detailed in its board report. On the other hand, if the company is unable to spend the required two percent on CSR, it must explain why in the board report.

The term “CSR” itself is not defined in the Companies Bill. However, Schedule VII of the Companies Bill, quoted below, requires the CSR policy created by the CSR Committee to involve at least one of the following focus areas:

- Eradicating extreme hunger and poverty;
- Promotion of education;
- Promoting gender equality and empowering women;
- Reducing child mortality and improving maternal health;
- Combating HIV, AIDS, malaria and other diseases;
- Ensuring environmental sustainability;
- Employment-enhancing vocational skills;
- Social business projects;
- Contribution to the Prime Minister’s National Relief Fund or any other fund set up by the Central

Government or the state governments for socioeconomic development, and relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and

- Such other matters as may be prescribed.

Failure to Comply

While a company is not subject to liability for failing to spend on CSR, a company and its officers are subject to liability for not explaining such a failure in the annual report of the board of directors. There is currently no guidance as to what constitutes a sufficient or statutorily valid explanation for failure to spend in the board report. In addition, a company and its directors are liable even if they fail to report on CSR activities that actually were conducted.

Failure to explain is punishable by a fine on the company of not less than 50,000 rupees (about U.S. \$900) and up to 25 lakh rupees (about U.S. \$46,000). Further, officers who default on the reporting provision could be subject to up to three years in prison and/or fines of not less than 50,000 rupees (about U.S. \$900) and as high as 5 lakh rupees (about U.S. \$9,200).

OBEYING AND OBLIGING

Companies have no shortage of CSR opportunities or issues areas to address as the needs in India are immense. A 2011 study by the Oxford Poverty and Human Development Initiative estimated that approximately 650 million people, or fifty-three percent of India’s population, live in poverty. In 2010, the World Bank estimated that about 400 million people in India live on less than U.S. \$1.25 a day. Poverty is also intertwined with illiteracy, gender inequality, and disease. Vast environmental issues confront India, such as deforestation, illegal wildlife trading, loss of biodiversity, water pollution, air pollution, and the particular vulnerability of Indian populations to natural disasters, among other issues.

Crucially, companies should not view the CSR Clause as an onerous reporting requirement—i.e., a necessary cost of doing business in India. Instead, they should utilize the two percent amount of the CSR Clause as an opportunity to effect positive impact in the communities where they work and in the communities they affect. These concerns are not mutually exclusive to enhancing a company’s brand value and market equity through CSR activities. Indeed, some companies feel CSR is simply the right thing to do and already give beyond the tentative requirements of the CSR Clause. Regardless of

a company's giving ethos, if done strategically, spending under the CSR Clause can develop business goodwill with shareholders, consumers, the Indian government, Indian citizens, and the international public at large.

SIDE-STEPPING

While the Companies Bill promulgates strong language for CSR, companies can, in practice, spend nothing on CSR. The CSR Clause is a type or regulation commonly referred to as a “comply or explain” clause. Therefore, as long as an explanation for not spending the required amount is contained in the annual board report, a targeted company has thereby performed its statutory duty under the CSR Clause. Such a policy makes sense if the company is facing deficits or downsizing, and the CSR Clause foresees and accommodates such situations.

However, hazarding ethics and reputational perceptions from the public, boards of directors can include explanatory statements in their report simply because they do not want to engage in CSR. More appropriately, board of directors may feel it is in the company's best interest to spend the money elsewhere. As the Companies Bill does not provide a definition of what constitutes a valid explanatory statement, such explanations could plausibly contain reasoning that the money was better spent on research and development, information technology infrastructure, or acquisitions, among many other valid reasons.

IMPLEMENTATION ISSUES

Starkly absent from the CSR Clause are any indicators for measuring CSR impact. A targeted company should be hyper-conscious that indiscriminately spending the required amount on CSR is not a strategic way to comply with the CSR clause. CSR must be tailored to the company's industry, location, supply chains, in addition to customizing the project to Indian cultural nuances and local community needs. To do otherwise can be harmful to intended beneficiaries of CSR projects and reputationally disastrous for the company.

Companies must always perform proper due diligence on entities that receive CSR funds both to ensure that a positive impact is being effected and to ensure that funds are not being used illegally or for corrupt practices. Depending on whether the targeted company is based solely in India, or is a subsidiary or a U.S. or U.K. company, laws such as the U.K. Bribery Act or the U.S.

Foreign Corrupt Practices Act may apply to grants made by the company.

Unfortunately, little is known at this stage as to what activities satisfy the CSR categories listed in Schedule VII of the Bill. For example, a company could spend CSR funds on a charitable trust it owns. It is unknown if the CSR Clause would allow this to qualify as CSR spending. Schedule VII, section (vi), mentions “ensuring environmental sustainability” as an approved CSR spending category. It is not clear if a company spending money to implement a reduction in its own packaging, and thereby reducing its carbon footprint, would count as CSR spending under Clause 135. The same is true under Schedule VII, section (vii), for “employment-enhancing vocational skills.” It is unknown if an internal employee skills training on new equipment or software would qualify.

IMPACT

There are several behaviors that we expect companies to exhibit following the law's passage. Some companies will make the structural changes to their board to avoid fines, only to explain in their board report why they are unable to spend on CSR. Others will allocate an additional portion of their budget to meeting the reporting requirements and/or use the board report as an opportunity to showcase their CSR activities. Many companies are likely to re-categorize current quasi-CSR activities so as to fall within the scope of the new law. This is not altogether contrary to the spirit of the CSR Clause, so long as actual benefits inure in the forms listed in Schedule VII. Whether the CSR Clause actually encourages more CSR spending or not, it will certainly force companies to seriously contemplate social responsibility or risk becoming a conspicuous non-spender among peers who already invest heavily in it.

On the international stage, India will be at the forefront of CSR law should the Companies Bill pass with the CSR Clause intact. We expect India to be a testing ground for CSR laws of this kind in future years. Indeed, a trend is already apparent as the European Union is considering a law that would require CSR reporting and disclosure for certain companies, something the European Union calls “non-financial information.” While the E.U. law does not require mandatory CSR spending, it demonstrates that governments are expecting companies to do more than simply conduct business, provide services, and make a profit within their borders.

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THANK YOU

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