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CSR mandate In India: What we have learned so far?

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Introduction

In 2013, one of the most prominent regulations was introduced in India under Section 135 of the Companies Act 2013, passed by the Indian Parliament. The Corporate Social Responsibility (CSR) regulation for the Indian corporate sector requires that listed Indian companies having a net worth of at least INR 5 billion, annual turnover of at least INR 10 billion, or profits of at least INR 50 million in any financial year must spend 2% of their past three years average profits on CSR. Besides that, the disclosure of CSR was also made compulsory in their financial statements. The CSR rule was based on the "Comply or Explain" principle. This became one of the ground-breaking proposals. Several countries required mandatory CSR reporting, which included Sweden, Norway, the Netherlands, Denmark, France, and Australia.[11] However, when it comes to spending on CSR mandatorily, India perhaps became one of the first countries to take the whole CSR game to the next level.

CSR, in general, is an inspirational exercise. Coming out voluntarily makes it more worthwhile at times. The law's initial implementation has been patchy, and several amendments have been carried out since 2013 till date. There are several cases of non-compliance resulting in legal actions by the Government.[12] CSR is the corporate societal contribution that often goes beyond mandated amounts. These contributions provide a positive signal to both stockholders in the marketplace and the broader range of stakeholders. CSR has received significant attention in academia and the press in recent years due to a firm’s complex relationship with multiple stakeholders.

While Indian corporations have had a long tradition of philanthropic activities, CSR as a strategic initiative is a recent phenomenon. CSR as a regulatory requirement may help deal with vast, multifaceted societal problems like poverty, education, environment, health, etc., requiring the business community to share the government’s burden through CSR initiatives (Sarkar & Sarkar, 2015; Krichewsky, 2017). This article discusses the impact of CSR on firm valuation, profitability, accounting conservatism, tax avoidance, and other firm-level aspects, as found in academic research.

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[11] https://ssir.org/articles/entry/mandatory_csr_in_india_a_bad_proposal

[12] http://www.business-standard.com/article/economy-policy/govt-issued-notices-to-1-018-firms-for-csr-non-compliance-117031500891_1.html

CSR, firm value, and firm performance

One of the initial types of research on India's CSR mandate reports that the compulsory CSR expenditure by Indian firms resulted in a drop in firms' profitability and stock market valuation (Manchiraju and Rajgopal 2017; Mukherjee et al. 2018). Manchiraju and Rajgopal (2017) conducted an event study and reported a drop in stock price of about 4.1% when firms are mandatorily required to spend on CSR. Their essential conclusion was that firms voluntarily choose CSR to maximize shareholder value, and forcing them through mandate does not help much.

Mukherjee et al. (2018) document that CSR expenditures fall short of expectations, and firms experience negative profitability. In their work, they identify different groups of firms based on whether the firms were voluntarily spending before the mandate and how these groups behaved post-mandate. Specifically, they create four categories. First, the companies that voluntarily spent on CSR before the mandate and were required to spend after the mandate. Second, the companies that did not spend on voluntary CSR, and now the Companies Act, 2013, makes it compulsory. Third, the companies that were neither voluntarily spent on CSR before the mandate nor are required to spend on CSR post-mandate. Lastly, the companies that did not voluntarily spend on CSR before the mandate are now required to spend after the mandate. Mukherjee et al. (2018) report that several firms that used to spend more than 2% have now reduced their spending to meet the 2% requirement, and those not spending on CSR earlier became more reluctant to spend after the mandate. They also report that the smaller companies that used to spend on CSR before the mandate have reduced their spending since they were not required to spend by law.

CSR and Accounting Conservatism

The early evidence suggests a loss of firm value due to the CSR mandate. Shareholders will not like parting away a portion of their profit with other stakeholders. In this case, firms may use several mechanisms to address their concern. One of the interesting findings is about the financial report conservatism. Accounting conservatism calls for higher verification of financial reports and requires adopting accounting policies that provide for all possible losses. This essentially results in lower profits. Shaw et al. (2021) use CSR mandate and study the relationship between conservative financial reports and CSR compliance. Their results indicate that firms' financial statements have become more conservative when they comply with CSR mandates. Two main arguments drive their findings. First is the burden containment explanation. Firms would resort to more conservatism accounting to report the lowest possible profit, leading to lower spending on CSR expenditures, which are linked to reported net profits. This will help them match their concerns with the shareholders, who may not want to share their resources with other stakeholders. Second, CSR spending will likely affect the firm's cash flow, which may hamper its ability to service debt and other financial commitments. In this case, conservative reporting helps firms signal to the capital providers their concern about parting away with the cash flow. They also document that a stronger board (better corporate governance) enhances the relationship between CSR compliance and accounting conservatism. They also find that the increase in conservatism in the present period reduces the CSR burden in the next year since CSR spending is linked to the reported profits, and firms are more likely to bring down the reported profits.

CSR and Tax Avoidance

Another interesting angle to the CSR mandate is that firms become more visible. Raithatha & Shaw (2022) examine the signaling angle using tax avoidance as the mechanism. They document that a firm's mandatory compliance with CSR, linked with its size and profitability, makes it more visible. This will lead the firm to be more careful. The authors use tax avoidance proxies to document that CSR-compliant firms are less likely to indulge in tax evasion behavior. These findings align with the previous research that CSR effectively establishes social expectations leading to responsible corporate behavior.

CSR in public sector units

In another interesting study, Kansal et al. (2018) examines the quality of CSR disclosures in public sector enterprises in India. They use annual reports of these companies and conduct a content analysis of different CSR areas reported by the firms. They divide CSR spending into several themes: first, community development; second, human resources disclosures; third, product safety and innovation; fourth, environment disclosures; fifth, energy disclosures; sixth, carbon and greenhouse gas emissions disclosures; and lastly, others. They find that Human Resources and Community Development are the critical areas of CSR disclosures in public sector enterprises. On the other hand, carbon and greenhouse gas emissions are the areas where the smallest amount is spent. Kansal et al. (2018) also report that the disclosures are primarily narrative rather than quantifiable.

CSR and International Financial Reporting Standards (IFRS)

In another notable work, Weerathunga et al. (2020) examine the impact of International Financial Reporting Standards (IFRS) convergence on the level of CSR reporting of Indian companies. The IFRSs, are globally accepted accounting standards. India adopted the same in 2016 to improve the information environment for users of financial information. The authors link corporate social responsibility (CSR) and International Financial Reporting Standards (IFRS) convergence using the annual reports as the main data source. They use the sample of 366 listed Indian companies comprising 263 firms that adopted the new Indian Accounting Standards (Ind AS), which are IFRS based, and 103 firms that do not adopt IFRS-based standards. They find support for stakeholder theory and document that the firms that adopted IFRS-based standards reported a higher level of CSR disclosures in their annual reports. They find that CSR reporting increases in employee-related disclosures, environmental disclosures, human rights disclosures, and social and community-replated disclosures.

CSR disclosure and financial transparency

Another interesting angle of CSR is its role in facilitating transparency. Nair et al. (2019) examine the role of CSR in improving financial transparency. They study the mandatory CSR regime in India and document that financial transparency improves. They find that the improvement in transparency is more prevalent when there is higher ownership from the retail investors. They do not find similar results when institutional investors' ownership is high. The authors argue that the retail investor benefit more from the CSR disclosures due to the high level of opacity with the management, which reduces due to CSR disclosures.

Recent amendments – trial and error approach

CSR mandate and its implementation have not been very smooth. Initial implementation, where the "comply or explain" policy was adopted without sufficient clarity, led to several confusions. Subsequently, several changes were made to the CSR requirement. However, several loopholes are yet to be fixed after observing several non-compliances and unpleasant experiences. Some critical aspects affecting the firm and its financial reporting are discussed below.

(a) Companies must transfer unspent funds to a separate CSR unspent account and maintain all the required records. This will keep companies in check because they must set aside funds, so the escape route is somewhat closed.

(b) On an important note, on July 26, 2019, the Government introduced a financial penalty for non-compliance along with an imprisonment provision for directors/officers.[13] Subsequently, the imprisonment provision was removed due to criticisms from all corners. However, the monetary penalty continues for non-compliance.[14]

(c) CSR rules also require forming a CSR committee comprising a Board of Directors. It requires a minimum of 3 directors, one of whom must be independent. This will make the board more responsible for monitoring the firm's CSR activities.

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[13] https://indiacsr.in/jail-term-for-violatation-of-csr-norms/

[14] https://www.business-standard.com/article/companies/no-jail-csr-non-compliance-should-be-a-civil-offence-govt-appointed-panel-119081301401_1.html

(d) In one of the recent announcements, firms will be exempted from CSR spending requirements if they report losses in the previous year. This has important implications. Earlier, the rule was about three years' average profit, in which companies had losses in the immediately preceding financial year, but enough profits in the other two years were required to spend on CSR if they had reported average profits of over Rs 5 crore in the previous three financial years.

Final words

Although debates surround the mandatory CSR regime, regulators are making changes based on their experiences dealing with the cases. Corporations also keep redefining their strategy and focus on CSR. Amid all that, CSR does serve a purpose in a broader context. During one of the most challenging times of the current generation, COVID-19, as much INR 6,947 crore was spent towards healthcare activities through CSR funds by corporates.[15] When we look at how CSR spending is carried out, we see that during the period 2014-15 to 2020-21, about 33% of the CSR expenses by corporates were in the areas of education, healthcare, and rural development-related activities.[16] If we were to go by these data, we realize that the future does look brighter if the initial glitches are handled well. What we need is coordination between different stakeholders and an urge to make a difference in society.

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