***Query No. 25***

***Subject: Accounting for unspent expenditure towards Corporate Social Responsibility.***[1]

## A. Facts of the Case

1. A public sector company is engaged in the field of power equipment manufacture. The company has manufacturing units, power sector regions, service centers and regional offices besides project sites spread all over India and abroad. Shares of the company are listed at NSE and BSE. The turnover of the company was Rs. 50,156 crore in the financial year 2012-13. The company had employee strength of 48,399 Nos. as on 31.03.2013.

2. *DPE Guidelines on Corporate Social Responsibility (CSR) for Central Public Sector Enterprises:*

As per DPE Guideline No. 15(3)/2007-DPE(GM) dated March 2010, each Central Public Sector Enterprise (CPSE) has to mandatorily create CSR budget through a Board Resolution as a percentage of net profit of the previous financial year. CSR budget should be fixed for each financial year. This funding will not lapse. It will be transferred to a 'CSR Fund', which will accumulate – as in the case of non-lapsable pool – for the North East.

The implementation of CSR Guidelines will form a part of the Memorandum of Understanding (MoU) that is signed each year between CPSEs and the Government. The performance of each CPSE with reference to its CSR activities should be monitored by the Ministry/ Department concerned on a regular basis.

3. *Policy of the company relating to the unspent expenditure towards Corporate Social Responsibility and Sustainability Development (SD):*

[1] Opinion finalised by the Committee on 15.11.2013.

DPE Guidelines on CSR were adopted by the Board at its 427th meeting held on 23.07.2010 wherein it was decided that CSR budget for financial year 2010-11 would be 0.5% of profit after tax (PAT). Accordingly, any unspent amount on this account was transferred to a separate 'CSR Fund', which is non-lapsable, for spending on CSR activities exclusively in subsequent years. This is shown under Note 9 as 'Corporate Social Responsibility' for CSR and 'Other short term provisions' for Sustainability Development (SD) in line with paragraph 8.6.4 of the Guidance Note on the Revised Schedule VI to the Companies Act, 1956.

4. *Point raised by Government Audit:*

During the audit of annual accounts for the year 2012-13, Government auditor has raised a query stating that unspent amount related to CSR and SD should be shown as 'CSR & SD reserve' under 'Reserve & Surplus' instead of 'Provision for CSR activities'. They have referred to the opinion of Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI), which states that "the requirement in DPE Guidelines for creation of a CSR budget can be met through creation of a reserve as an appropriation of profit rather than creating a provision as per Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets'". This opinion of the Expert Advisory Committee has also been made available by the ICAI on its website.

5. *The querist's views:*

Paragraph 14 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', notified under the Companies (Accounting Standards) Rules, 2006, (hereinafter referred to as the 'Rules') states as below:

> ***"14. A provision should be recognised when:***
>
> ***(a) an enterprise has a present obligation as a result of a past event;***
>
> ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***

***(c) a reliable estimate can be made of the amount of the obligation.***

***…"***

Since the amount to be spent on CSR is linked to the net profit for the previous year, the company has a present obligation as a result of profit generated in the previous year. As defined in AS 29, notified under the 'Rules', ***"an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."*** Other two conditions as given in paragraph 14 of AS 29 for recognising the unspent amount is also satisfied as an outflow of resources will be required to settle the obligation and a reliable estimate can also be made of the amount of the obligation. Considering intention of DPE Guidelines which depicts obligating nature of CSR & SD expenditure, the company seems to be correct in its treatment of unspent amount as provision in line with above paragraph of AS 29.

6. The querist has stated that the point raised by Government auditor for treating the unspent amount on CSR and SD as 'Reserve' is stated to be based on EAC opinion (referred above) which stresses on non-obligating nature of CSR and SD fund on account of no penalty prescribed for non-incurrence of such expenditure. But inclusion of CSR and SD expenditure in MOU targets for evaluating company's performance hints at its obligating nature. Moreover, this obligating nature is confirmed by the clauses newly introduced in the Companies Bill already passed by Lok Sabha and Rajya Sabha which proposes that "The Board of every company shall ensure that the company spends in every financial year at least 2% of the average net profits of the company made during the three immediately preceding financial years in pursuance of its CSR policy. Where the company fails to spend such amount, the Board shall in its report specify the reasons for not spending the amount." In view of this, it is felt that the present practice of the company of creation of provision for the unspent amount of CSR is in line with AS 29 as it fulfills all the criteria given in paragraph 14 of AS 29.

**B. Query**

7. Based on the above facts, the querist has sought the opinion of the EAC on the following issues:

(i) Whether treatment of unspent amount of CSR and SD as provision by the company is correct and in line with AS 29 or not.

(ii) In case, if it is not, then how to account for the change during the financial year 2013-14. Also, whether financial statements of previous year be restated for such change, if any.

**C. Points considered by the Committee**

8. The Committee notes from the Facts of the Case that while raising issue on accounting for funds earmarked for CSR and SD activities, the querist has referred to DPE Guidelines No. 15(3)/2007-DPE(GM) dated 9th April, 2010 which were effective till 31.03.2013 and has raised the issue in respect of financial year 2012-13. Further, the querist has also referred to an earlier opinion of the Committee which was also based on these Guidelines. Accordingly, the Committee has considered the issue only in the context of the above-mentioned Guidelines effective till 31.03.2013 and it has not considered the issue in relation to the revised Guidelines on Corporate Social Responsibility and Sustainability for Public Sector Enterprises, issued by DPE, coming into effect on 1st April, 2013. Further, it has also not considered the issue in the context of proposed requirements of the Companies Act, 2013 as that matter has not been raised by the querist. The Committee also wishes to point out that before the revised DPE Guidelines coming into force, there were separate Guidelines on CSR and Sustainability Development. Since the Guidelines on Sustainability Development have neither been referred to by the querist in the Facts of the Case nor it was the subject matter of the earlier EAC Opinion referred to by the querist, the Committee has examined the issues raised by the querist in paragraph 7 above viz., relating to accounting for unspent expenditure towards CSR only in the context of DPE Guidelines on CSR. The Committee has also not examined any other issue arising from the

Facts of the Case, such as, determination of the amount to be earmarked for CSR activities, legal interpretation of DPE Guidelines, etc.

9. The Committee notes the definitions of the terms, 'provision', 'liability', 'obligating event', 'present obligation' and paragraphs 14, 16, 17 and 18 of AS 29, notified under the Rules, as follows:

> ***"10.1 A <u>provision</u> is a liability which can be measured only by using a substantial degree of estimation.***
>
> ***10.2 A <u>liability</u> is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***
>
> ***10.3 An <u>obligating event</u> is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation."***
>
> ***"10.6 <u>Present obligation</u> - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not."***
>
> ***"14. A provision should be recognised when:***
>
> ***(a) an enterprise has a present obligation as a result of a past event;***
>
> ***(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and***
>
> ***(c) a reliable estimate can be made of the amount of the obligation.***

***If these conditions are not met, no provision should be recognised."***

"16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised."

10. The Committee further notes the following features of the DPE Guidelines:

(i) The CSR *budget* will be mandatorily created through a Board Resolution as a percentage of net profit in the manner specified in the DPE Guidelines. (Clause 5.1 of DPE Guidelines)

(ii) Loss-making companies are not mandated to *earmark specific funding for CSR* activities. (Clause 5.2 of DPE Guidelines)

(iii) The CSR *Budget* should be fixed for each financial year. This funding will not lapse. It will be transferred to a *CSR Fund*, which will accumulate - as in the case of non-lapsable pool – for the North East. (Clause 5.4 of DPE Guidelines)

(iv) The implementation of CSR guidelines will form a part of the Memorandum of Understanding that is signed each year between CPSEs and Government. (Clause 8.4 of DPE Guidelines)

(v) In MoU Guidelines from 2010-11 onwards, 5 marks have been earmarked out of the non-financial parameters for CSR activities. … (Clause 8.6 of DPE Guidelines)

(Emphasis supplied by the Committee.)

From the above, the Committee notes that as per the DPE Guidelines, there is a mandate for creation of a budget/fund and not to spend on CSR activities as a percentage of profits, which would only form a basis for evaluation of the performance of an enterprise. However, there is no mandate on the amount of expenditure, which has to be necessarily incurred by an enterprise during a period of its operation. Thus, there is a mandate only on the creation of a budget or fund rather than an obligation to incur expenditure during a period. Further, neither there is any time limit for incurring the expenditure out of CSR fund nor any penalty is prescribed for non-incurrence of such expenditure. The Committee also notes that as per the provisions of AS 29, a provision should be recognised when there is a present obligation involving incurrence of expenditure, arising from a past event that leaves no realistic alternative apart from settling that obligation and that obligation exists independently of an enterprise's future actions. Since as per DPE Guidelines, there is no such obligation on the enterprise, provision should not be recognised. Accordingly, the Committee is of the view that the requirement in the DPE Guidelines for creation of CSR budget is to be met through creation of a reserve as an appropriation of profits rather than creating a provision as per AS 29.

As regards the querist's argument that since the amount to be spent on CSR is linked to the net profit for the previous year, the company has a present obligation as a result of profit generated in the previous year, the Committee is of the view that for an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event. Further, as per the requirements of paragraph 18 of AS 29, if the enterprise can avoid the future expenditure by its future actions, it has no present obligation for that future expenditure and no provision is recognised. The Committee notes that in the extant case, the company can avoid the obligation to create CSR fund and spend on CSR activities by compromising on a lower scale of performance evaluation by the DPE and thus, the earning of profits in itself cannot be considered as an obligating event, requiring recognition of provision as per AS 29.

11. On the basis of the above, the Committee is of the view that in the extant case, it is not appropriate to recognise a provision in respect of unspent expenditure on CSR activities. However, a CSR reserve may be created as an appropriation of profits.

12. With regard to the accounting treatment to be followed by the company in the financial year 2013-14 for rectifying the treatment made by it in previous years in relation to the above transaction, the Committee notes the definition of the term 'prior period items' as defined in Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the 'Rules' as follows:

> ***"4.3 <u>Prior period items</u> are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***

On the basis of the above, the Committee is of the view that since the company has wrongly treated the amount set aside for future expenditure as provision, it is an error in the preparation of the financial statements. The Committee is of the view that the company should rectify its

error of prior accounting periods by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the provisions of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, the question of restatement of financial statements does not arise.

## D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

(i) No. The treatment of unspent amount of CSR as provision by the company is not correct and not in line with AS 29, as discussed in paragraphs 10 and 11 above.

(ii) During the financial year 2013-14, the company should rectify its error of prior accounting period(s) by making appropriate changes in the current reporting period by treating it as a 'prior period item' as per the provisions of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'. Accordingly, the question of restatement of financial statements does not arise, as discussed in paragraph 12 above.