

How CSR impacts public M&A deals

A mandatory CSR regime would require investors to ensure that the CSR contributing company has in place adequate avenues for its CSR obligations

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A non-mandatory financial obligation has limited impact on evaluating M&A (mergers and acquisitions) deals. However, once binding, it becomes an important component (typically, as a downward financial adjustment) in valuing the target business. It also brings concerns around ensuring future compliance and potential liabilities of past misdemeanours.

In this article, we briefly discuss the key amendments proposed to the corporate social responsibility ("CSR") regime introduced by the recently passed Companies Amendment Bill 2019 ("2019 Companies Bill") (which is yet to become effective), and its potential impact on public M&A deals.

Change in CSR regime

The CSR regime in its original form solemnised a 'good corporate samaritan' by requiring companies (in existence for three years, and with prescribed turnovers or net worth) to either spend at least 2% of their average profits or explain their failure to do so - an ambivalent policy of 'comply or explain'.

This was sought to be amended by the 2019 Companies Bill on two key fronts: first, by making the CSR spend mandatory (without an option to avoid compliance by providing an explanation) and second, by criminalising non-compliance by making it punishable with a monetary fine and potential imprisonment of up to three years.

Expectedly, this evoked a strong reaction from the corporate community ultimately leading to a roll-back of the criminalising provisions. Based on recommendations set out in the Report of the High-Level Committee on Corporate Social Responsibility 2018 (chaired by Injeti Srinivas, Secretary of the Ministry of Corporate Affairs) issued on 7 August 2019 ("HLC 2019"), the government appears to have (in our view, wisely) decided to categorise non-compliance with CSR as a civil offence (as opposed to a criminal one). The HLC 2019 has also recommended (i) carrying forward of unspent CSR balance for three to five years, and (ii) making CSR spends tax-deductible.

Impact on public M&A deals

Based on amendments proposed in the 2019 Companies Bill, the CSR regime looks to effectively evolve into a mandatory spending system (a departure from its 'comply or explain' regime) tagged with potential financial liability for non-compliance. This would likely result in certain additional considerations in deal-making, including:

Value adjustment: a mandatory CSR spend of 2% of the average net profits of a listed company or its subsidiaries meeting the prescribed threshold (i.e turnover of Rs 1,000 crore or more or net worth of Rs 500 crore or more, or a net profit of Rs 5 crore or more during the immediately preceding financial year) ("CSR Contributing Company") would have an adverse impact on cashflow of the CSR contributing company.

To take a simple example, if the average net profit is Rs 100, the company would face a mandatory cash outflow of Rs 2 (which could earlier have been avoided with an explanation).

An investor would need to factor the financial implications of the mandatory CSR spend into working capital or other cash linked requirements of the CSR contributing company - in effect, calling for a cash adjustment to the underlying cashflow of the business plan.

This assessment may become commercially significant in a down performing year, with the quantum of CSR spend being benchmarked to previous (outperforming) years and the actual CSR spend is required to be made in the current (down performing) year.

On the other hand, if HLC 2019's recommendation of making CSR spends tax-deductible is implemented, a significant positive impact on overall financials of the CSR contributing company could be expected.

CSR Pipeline: A mandatory CSR regime would require investors to ensure that the CSR contributing company has in place adequate avenues for its CSR obligations. The inability to identify and deploy CSR funds in a timely manner would result in adverse consequences for the CSR contributing company, and accordingly investors would need to seek appropriate contractual safeguards on account of any related losses.

Looking Ahead

With the latest round of proposed amendments, the CSR mandate has received a shot in the arm and the level of compliance in CSR spends is expected to increase promptly. Through such developments, it is important that investors do not lose sight of the double-edged sword in CSR - to comply and impact cashflows, or fail and become liable for penalties. In this light, it will be interesting to observe its impact on potential public M&A deals going forward.

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