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**Section 135 of Companies Act (2013): Implementation
challenges faced by Companies and NGOs**

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Section 135 of Companies Act (2013): Implementation challenges faced by Companies and NGOs

The completion of the first year of implementation of the provisions of Section 135 of the Companies Act (2013) is perhaps an opportune moment to take stock of the potential implementation challenges faced by companies and non-governmental organizations (NGOs). The provisions of the section require companies to establish a CSR committee consisting of three members of the Board of Directors, develop a CSR policy, review the CSR activities and prepare periodic reports (the latter will be done by the CSR Committee). The above mentioned CSR infrastructure therefore necessitates significant capacity building within companies. With respect to implementation, companies may channel the resources through qualified NGOs engaged in social enterprise. Consequently NGOs will also require significant capacity building. In this paper we identify the implications of the new guidelines that are worthy of consideration; these implications are for companies that will invest the financial resources in CSR activities, the organizations that will implement the activities and other general implications. Furthermore the paper suggests mechanisms by which several of these challenges can be met and managed.

Introduction.

The Companies Act, 2013 passed by the Parliament, received the assent of the President of India on 29th August, 2013 and replaced the 57-year-old Companies Act, 1956. The Act has prescribed for companies, an expenditure on corporate social responsibility activities in their respective geographical areas of operation in an outcome and time-driven manner. This is a historic development making India the only country in the world to mandate corporate social responsibility (CSR) for companies. Although there is an increasing emphasis on social responsibility across the world, other countries only require companies to disclose information about their environmental, social and employee-related impact, as well as their diversity policy (Rao, 2015).

One cannot deny the wisdom behind the new provision especially seen from the context of government failure to provide for its people's social and educational development. Through such a mandate, companies can be co-opted into investing funds and resources into projects and overseeing their implementation in education, health, skill development and in building social infrastructure. Such a partnership is vital for the nation if it has to successfully translate its population into a demographic dividend.

Another reason why companies would themselves benefit from undertaking CSR activities is the fact that several of them have by now realised that the 'licence to operate' is no longer given by governments alone, but by communities that are impacted by these businesses (Walhurst, 2005). A CSR program that meets the aspirations of these communities not only provides them with the licence to operate, but also to maintain the licence, thereby prevent a 'trust deficit' with external stakeholders (PwC, 2013).

Section 135.

The provisions of Section 135 outline a significant step in attempting to change the way business and society engage with each other. The recent revision mandating qualified companies to contribute a minimum of 2% of their net profit towards CSR opens the door to a significant investment in social, environmental and economic development activities across the country. Every company with a net worth of at least ₹ 500 Crores, a minimum turnover of ₹ 1,000 Crore, or a minimum net profit of ₹ 5 Crore, is obligated to make the contribution to a variety of initiatives, such as promoting education, gender equality, women's

empowerment, improving maternal health, or ensuring environmental sustainability. The company's net profit calculation excludes any profit from its overseas branches or companies, as well as any dividends received from other companies in India. Foreign companies, including those doing business in India, whether by themselves, or through an agent or even electronically are also included under the new provisions. For example the Korean company POSCO has been asked by the Environment Ministry to spend 2% of its annual profits on CSR (Babu, 2015).

Schedule VII of Section 135 elaborates that activities such as promotion of education, gender equity and women's empowerment, combating HIV/AIDS, malaria and other diseases, eradication of extreme poverty, contribution to the Prime Minister's National Relief Fund and other central funds, social business projects, reduction in child mortality, improving maternal health, environmental sustainability and employment enhancing vocational skills can be undertaken under CSR. Upon closer scrutiny one cannot miss the point that the focus of schedule VII is largely on the social dimension and to a lesser extent on the economic and environmental dimensions. Sachin Pilot, the then minister of state for corporate affairs opined that "private companies, while maximising growth, also have a greater responsibility towards society, besides equitable and sustainable growth of the country" (ET Bureau, 2013). This preference for social activities is reflected in the CSR undertaken by Indian companies that are mainly focused in the social sector in contrast with the developed countries where CSR activities are undertaken mainly in the areas of environmental concern. An industry wise analysis of CSR spending by the top 200 Indian companies across ten sectors for 2012-13 reveals six sectors contributing the maximum to community and rural development, three to health care and one each to education and environment (Rai and Bansal, 2014).

Issues and Challenges.

Although the section includes a number of guidelines there are still several areas that are ambiguous and/or unclear. A general question that several prominent businessmen have raised is whether it was right to mandate CSR for companies. For example Azim Premji, a renowned business leader and philanthropist who has been donating to several charitable causes, thinks it is not a good idea for the government to force companies to spend money (Jayashankar et al., 2013). Such a mandate can be interpreted as another form of corporate tax masquerading as CSR, the argument being that contributions to social causes should come

out of volition not compulsion. A review of 37 definitions of CSR by Dahlsrud (2008) suggests that voluntariness is an important aspect. However, the United Nations Industrial Development Organization (UNIDO) views CSR as a way in which companies can help governments in achieving a balance of economic, environmental and social imperatives. Data on past CSR spending reveals a clear potential to increase contributions to rightful social and environmental causes. In 2012-13, 760 firms that crossed the threshold of ₹ 5 Crore net profits spent only ₹ 33,668 million on CSR activities which amounts to less than 75% of the 2% spending as required by Section 135 (note: Section 135 was not mandated during 2012-13) (Rai and Bansal, 2014).

Second, there is a lack of clarity on whether the areas of contribution listed are only suggestive. Does the list intend to convey the message that only scheduled activities will be considered for the purpose of CSR? If not, what other social avenues being pursued by companies will be allowed as a part of CSR activities? Can companies invest in infrastructure development? The Act clearly states that CSR excludes activities undertaken in pursuance of the normal course of business of a company. However Rai and Bansal (2014) report find that the banking sector counts the 40% mandatory priority sector lending as part of its CSR activities. Since lending is a bank's core activity, can priority lending be passed off as CSR? If this is the case can (or should) companies view CSR as an area of strategic importance as suggested by Cooke (2010)? Similarly the Act stipulates that companies must engage in CSR activities that exclusively benefit external stakeholders. If a company undertakes a project primarily but not exclusively benefiting its employees, would it be fair to not consider that contribution as CSR? Does this disadvantage employees because many companies that currently invest in CSR activities that also benefit employees (e.g. health and education) may perceive a trade-off resulting from the provisions in the Act?

The third issue is one of location. The Act provides that a company should give preference to the local area in which it operates for CSR spending. It is unclear as to how this will be implemented when a company has multiple locations (Vaidyanathan and Thacker, 2014). Would the company be allowed to choose where it will locate its CSR activities or will it be obligated to distribute its CSR budget across multiple locations? While going with some locations will benefit selected local areas, spreading the activities across all locations will dilute the CSR efforts and render them meaningless.

The fourth issue pertains to the exclusion of contributions directly or indirectly made to a political party from the scope of CSR activity (Vaidyanathan and Thacker, 2014). Although this is the right move the Act is however silent on contributions made to institutions affiliated with one or more politicians or those located in a constituency represented by a politician. What if the politician has some form of regulatory supervision or leverage over that company? Would that not amount to favour for benefits in return? What about activities/institutions being run under the trusteeship or office of a politician? These are areas where there is ample scope for misuse.

A final issue is that the Act in its current version does not have any coercive provisions against defaulting companies. The only expectation is that a report must be submitted explaining the reason for failure to spend the prescribed amount for CSR activities. What kinds of reasons will be acceptable is not known; similarly not known is whether this gap will be addressed in the future. Many companies might recognize that local advocacy groups can draw the attention of their failures through social media and other means. Such a pressure might compel them to not default; however this is an open question.

Regardless of the ambiguities, issues and challenges, Section 135 is now law and must be adhered to. However it is important to recognize the implications of the section both for the companies and their prospective partners, i.e. NGOs.

Implications.

There are several implications of the new guidelines that are worthy of consideration; these implications are for companies that will invest the financial resources in CSR activities and nongovernmental organizations that will implement the activities and other general implications.

Implementation challenges for Companies.

There are at least four implications for companies. The *first* implication is capacity building within companies which begins with establishing a CSR committee. This requires companies to identify individuals competent to be part of the committee. The Act, for the first time, lays down objective qualifications for an independent director. He (or she) must be a

person who does not have any interest in the company or its affiliates and cannot have any interest with the promoters directly or indirectly. The subjective elements of the criteria include being a 'person of integrity' and possessing 'relevant expertise and experience'. One noteworthy feature is that the amendment takes care to prohibit the appointment of service providers such as accountants and legal professionals as independent directors and also lays down a maximum number of directorships an individual may hold simultaneously, namely, twenty for private companies and ten for public companies. These criteria may narrow down the list of qualified and desirable candidates who can be appointed as independent directors. A related issue is the 'independence' enjoyed by the independent director. If we believe that an important role of this director is to ensure judicious investing of CSR monies, this can be possible only when the individual has access to required information to assist them in their assessments.

The *second* implication is development of a CSR policy. A policy document will ideally contain the company's mission and vision specifically related to the company's CSR agenda, a plan outlining the strategic focus, criteria for selecting CSR activities, as well as operating guidelines. These are especially important to ensure that companies undertake activities that not only comply with the list in Schedule VII but also lead to a meaningful change along the social dimension. Currently many companies may not have clear cut statutory guidelines or policy directives to give a definitive direction to their CSR initiatives.

The lack of a clear policy can easily translate into several companies being unprepared to fulfil the stipulated 2% spending in the first few years. Probably it was this concern that has prompted the government to not include a penalty clause for those who unable to spend the 2%. For example, Coal India announced in March 2013 that it was hiring 120 people to work on CSR after it was called out for spending barely 15% of its required budget in the prior year. According to the Comptroller and Auditor General, 41 central public sector enterprises have similarly failed to spend the required amount from 2012-2013 (Francis, 2014). The lack of a clear policy direction as well as the lack of organizational capability to undertake substantial programs may be a reason why it has been observed that many companies made sporadic contributions to social causes and some made token gestures towards CSR such as offering donations to charitable trusts or NGOs, sponsorship of events, etc.

Third, companies deciding to partner with NGOs to implement their CSR plans must identify and select the right organization to work with. Companies must develop guidelines and perform their due diligence using pre-determined criteria to identify suitable NGOs to implement the CSR activities. According to a government study India has possibly the largest number of active non-governmental, not-for-profit organizations in the world (Shukla, 2010). With 3.3 million NGOs in 2009, India has one NGO for every 400 Indians, this is many times the number of primary schools and primary health centres in India. Yet many of them are only on paper with very little actual work to showcase. In such a scenario, for companies to choose a reliable partner to entrust their CSR funds with can be a challenging task. It therefore comes as no surprise that only 30% of the top 300 firms in India work with NGOs to fulfil their CSR obligations (Rai and Bansal, 2014).

A pragmatic approach in building a robust CSR agenda is therefore to make it sustainable through employee involvement (Vaidyanathan and Thacker, 2014). This entails the principles of social responsibility being incorporated into the business strategy of the company. An essential contributor to the success of CSR efforts in any company is the extent to which employees are aware about ethical business practices and principles, so as to get their buy-in into the CSR plan. Such efforts have dual benefits: not only will employees appreciate and value the intentions and contributions of the management but will likely feel encouraged to be an important part of it through employee-driven efforts. For example, Cognizant Technology Ltd. has a very successful corporate volunteering program, Outreach (Jayashankar et al., 2013). Since its inception, over 20,000 employees have cumulatively volunteered 2 lakh hours on Outreach. This is an example of a bottoms-up approach with employees taking the initiative to identify needy schools and the intervention they would offer. The company's role is limited to facilitating volunteering through administrative support and a small budget. Whether employee-driven CSR qualifies in terms of complying with Section 135 is perhaps unclear. Additionally, involving employees may pose the challenge of determining how to allocate a portion of the employee costs towards CSR activities for the purposes of reporting.

Fourth, companies must develop reporting mechanisms that will enable them to comply with the required reporting as prescribed in the section. Several important aspects underlie accurate reporting: (1) a good understanding of the requirements, (2) ability to identify and track the resources consumed for the purposes of CSR and assign a monetary value to the

resources, (3) understanding which resources qualify to be included as valid CSR expenses and which do not (e.g., if employees volunteer can a portion of their time and costs be allocated towards CSR) and (4) internal audit of CSR activities and expenses (this would be useful as part of a due diligence process and also helpful in establishing the credibility of the company's CSR claims).

Implementation challenges for NGOs.

The amendment to the companies Act has brought cheer to several NGOs and these organizations have spent the last year gearing up for higher levels of operation. For example CARE has been preparing by building internal capacity, hiring additional staff and working on strategies to attract more private sector projects (Francis, 2014). The process of building internal capacity requires consistent effort over a period of time and even beginning the process is not without hurdles.

The *main* challenge for any NGO is the availability of qualified and willing personnel (Sundar, 2014). Statistics show that younger people (between 20 and 44 years) comprise 36% of the Indian population (Census of India, 2011) which, to some extent, addresses the question of availability. However, these individuals should be qualified and willing to work in the NGO sector. Additionally several critical factors must be considered to develop a talented pool of qualified personnel. The basic hygiene factor is compensation (Herzberg et al., 1959). Although many individuals in the past may have chosen to work in NGOs as a 'matter of calling' and because they believed in contributing to a cause this may not hold in the future for at least two reasons. One is the potential number of personnel required in this sector due to the Act and the other is that although many younger individuals relate to social causes, their expectations in terms of compensation, work-life balance and other employment-related expectations may be different. A second important aspect is training and development to nurture talent. If there has to be a consistent and sustainable improvement in the number of individuals who see a career for themselves with NGOs, then it is imperative to have leadership development programs to identify and groom future leaders of the social sector. This need for education in management is accentuated by the fact that NGOs organizations cannot afford to hire consultants and change management experts to address their growth challenges. These have to be internally driven and managed. Such leadership development programs are just beginning to be offered in Indian management institutions.

A third aspect is a conducive work environment (Herzberg et al., 1959) promoting cooperation, fairness, meritocracy and a general professional working environment. The fourth aspect is about instilling the values espoused by the organization among employees; this is particularly important to maintain its reputation and establish trust among companies. NGOs must contemplate as to how a prospective employee's individual aspirations and the organizations values can be aligned. As Herzberg et al. (1959) noted decades ago basic pay and office environment can only be hygiene factors and anyway have limitations in their role to attract a prospective employee. Motivating factors such as creative work, sense of accomplishment, responsibility and growth opportunities, respect and recognition must be highlighted for attracting and retaining worthy employees. NGO employees must transform into becoming ambassadors of the cause they espouse and *live* their organizational values. This is especially important because having such individuals can significantly enhance the NGO's reputation. The final aspect pertains to the retention of employees, particularly because of the growing NGO sector. With CSR being mandatory, several NGOs will likely consider scaling up their operations to benefit from the tide of opportunities that are now hitting their shores (Francis, 2014). This, in a way, will worsen the problem of staff retention. Greater number of opportunities does mean more movement of personnel across NGOs, at least in the foreseeable future.

A *second* challenge is on the strategic side especially in the case of newer NGOs that are likely to face significant growth in a short time-frame. Organizations must undertake the exercise of establishing their mission and vision and establish policies, strategies and guidelines to run the organization. One outcome of such an exercise is that it provides a roadmap to NGOs to think about the developmental areas that they will focus on. This, in turn, will help them determine which types of projects they will accept and which ones they will not (note: smaller NGOs may not have too many choices). Another outcome of such an exercise is that it helps NGOs establish operating guidelines and procedures, which are essential when an organization experiences growth.

The *third* challenge, following from above, is one of governance, management control and operational control. Regardless of whether an NGO is registered as a trust, society or a section 8 company, it is expected to maintain a basic governance structure (PwC, 2013). Establishing a strong governance mechanism is critical to ensure smooth functioning of the

organization both from an operational side and the financial side (especially to avoid fraudulent activities). This may include developing (1) a formal organizational structure so as to clarify communication channels and establish accountability patterns, (2) formal policy manuals with respect to human resource management, finance and accounting (including budgeting, cash management and internal controls), purchasing and other operating guidelines (including standard operating procedures and decision making criteria), (3) performance criteria to assess performance at the individual, project and organizational level and (4) mechanisms to address the reporting requirements of various stakeholder groups.

In the current scenario, marketing and branding exercises are the need of the hour for NGOs to create visibility among companies so to enable them access company funds. In a way, the mandatory CSR has brought to the fore a paradox of sorts. On the one hand, we have several NGOs vying for funds while several companies that are keen to invest their profit into CSR are unable to choose among the various NGOs or know which ones are credible enough to hand over funds. Companies are now approaching consulting organizations like Ernst and Young who offer advisory services that include development of CSR policy and a roadmap to operationalize it as well as help build a monitoring mechanism to ensure implementation of plans. Organizations like the Indian Institute for Corporate Affairs (IICA) and the Tata Institute of Social Sciences (TISS) have been tasked with the responsibility of creating ‘CSR hubs’ to facilitate the companies and NGOs to connect with each other (Francis, 2014). The hub carries out activities in a partnership mode i.e. TISS, civil society organizations, and the concerned Public sector Enterprises, and offers capacity building, and advocacy services. Additionally several prominent private consulting companies such as Credibility Alliance, Give India and CSO Partners offer help with the implementation process. Regardless there is potential for bridge organizations to emerge that can connect companies with the financial resources and NGOs who can be their implementation partners. Such a win-win arrangement currently seems farfetched with 34% of the top 300 Indian firms working through their own foundations and trusts (Rai and Bansal, 2014).

Finally, with companies having to explain their CSR spending and assess the impact of their expenditure, the need for accrediting NGOs who will be the implementation partners is being felt acutely. CRISIL, India's leading rating agency has recently evolved an NGO-specific evaluation process for accreditation. NGOs will now be accredited based on their

performance and financial proficiency. The objective is to assess the NGO's capacity to deliver based on their profile, process and programmes. The accreditation process will also verify training of field staff or a grievance mechanism for beneficiaries and lastly conduct an impact analysis of flagship programs (Kably, 2014).

Although the NGOs face many challenges these are not insurmountable. In fact the CSR scenario provides an opportunity to the larger and more established NGOs, as well as some of the large foundations established by companies, to mentor the smaller ones in an effort to share the social development responsibility. This, of course, requires an attitudinal shift among the larger NGOs and foundations.

Conclusions

The introduction of Section 135 in the Companies Act (2013) has wide-ranging implications for nation's social, environmental and economic development. This paper outlines the implications of the provisions of the section on companies and NGOs. Although Schedule VII lists the focus areas, i.e., education, environment, health, hunger, gender equity and women empowerment, it is important to note that they are not mutually exclusive. Therefore it is also important that a coordinated approach is adopted to develop a national level framework such that investments made by individual companies align with the overall framework. For example Prime Minister Modi identified 'women empowerment' as an important focus area. It may be useful for a national level body made up of members representing different sectors to develop an agenda that further elaborates 'women empowerment'. Such an exercise will accomplish a few outcomes: (1) it will inform companies (and NGOs) of priority areas within 'women empowerment', (2) it will help in identifying local-level projects that complement each other, (3) it will contribute to increased collaboration/coordination among the different companies adopting that as a focus area and (4) it will likely result in meaningful outcomes that can create significant impact at the broader national level. However, developing such an approach will require establishing concrete national-level objectives, conducting research to establish the lay of the land in these areas which, in turn, will help in identifying gaps and developing specific strategies to address the gaps. As a final note it is important to recognize that there is ample opportunity to conduct empirical research in order to examine, analyze and understand practice as the country moves ahead in implementing Section 135.

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