NEWSLETTER
KPMG LLP (UK)

Financial Reporting Update

December 2014, Issue 2

Holiday pay to include overtime

Areas for immediate note

Employment Appeal Tribunal (EAT) concluded that holiday pay should reflect 'normal pay'

Amounts for compulsory guaranteed overtime have always been included in holiday pay. The EAT has now decided that payments for non-guaranteed overtime that the employer can contractually oblige the employee to work – i.e., compulsory non-guaranteed overtime – and that the employee regularly works, should also be included. In other words, the holiday pay should reflect the employee's 'normal' pay.

Many employers expected to be liable for payments under this decision

Affected employers will need to consider both obligations arising from past underpayments as well as implications for future remuneration arrangements.

Individual employers should determine whether they are liable, taking legal advice as necessary

In addition to the implications for future pay arrangements employers are encouraged to seek legal advice to understand the obligations arising from past underpayments. Such legal advice will help to form the basis for the calculation of an accounting provision as well as disclosures for contingent liabilities.

Holiday pay to include overtime

Our November edition of *Breaking News UK* highlighted the issue of the Employment Appeal Tribunal's (EAT) decision on 4 November 2014 on whether, and to what extent, overtime pay should be included in calculating holiday pay.

In this second issue of our new-look *Financial Reporting Update*, we consider the EAT's decision in more detail as well as the accounting implications and actions for employers.

Background

While both the Working Time Directive and the UK Working Time Regulations give workers (which includes employees) the right to be paid statutory holiday pay, neither specifies how this should be calculated. UK law sets out that the payment should reflect certain kinds of variable pay and case law has been evolving in an increasingly complex and employee-friendly way.

Payments for compulsory guaranteed overtime have always been included.

EAT decision

The EAT has now decided that payments for non-guaranteed overtime that the employer can contractually oblige the employee to work – i.e., compulsory non-guaranteed overtime – and that the employee regularly works, should also be included. In other words, the holiday pay should reflect the employee's 'normal' pay.

However, the EAT's decision relates only to the statutory minimum holiday of 20 days required by EU law (EU holiday): it does not apply to payments for any holiday entitlement given in excess of this (non-EU holiday).

In principle, an employee can claim for the underpaid holiday pay back to the later of starting employment and the implementation of the Working Time Regulations in 1998. However, the EAT limited the potential for retrospective claims with some complex restrictions that employers will need to understand and apply to their workforce in detail.

In summary, the EAT decided that if an employer can show a period of three months in which correct payments were made, then this would break the 'series' of incorrect deductions and employees may be prevented from making claims any further back than the end of that period. Therefore, if employers have recently corrected how they calculate holiday pay to take account of compulsory non-guaranteed overtime and/or there has been a period of three payroll months in the past when the employee did not take EU holiday (and therefore no incorrect payments were made), then employees may not be able to bring a claim. The EAT also decided that employees are effectively 'deemed' to have taken EU holiday as the first part of their holiday entitlement, making this three month break much easier for employers to show.

This means that an individual assessment will be required for each employee.

Appeal against the EAT decision

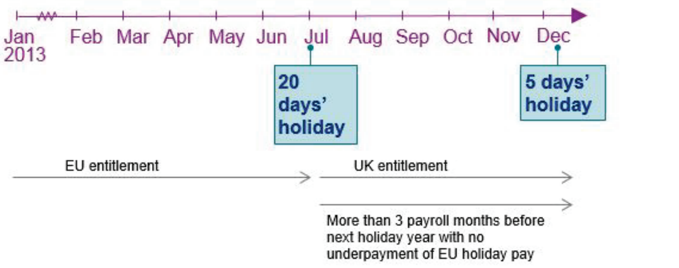
Leave to appeal was granted to both sides in the case, and it was widely expected that Unite, the union representing the claimants would appeal to the Court of Appeal. However, in a surprise decision, Unite announced that it is not going to appeal any part of the decision, including the meaning of 'series of deductions' which has such a significant impact on the potential value of retrospective claims. Whilst that brings an end to the question in the particular case, there are many stayed holiday pay cases waiting to appeal. It is likely that one of the cases will appeal on this point in the future. However, for the time being, the potential value of backdated claims is limited by this judgement.

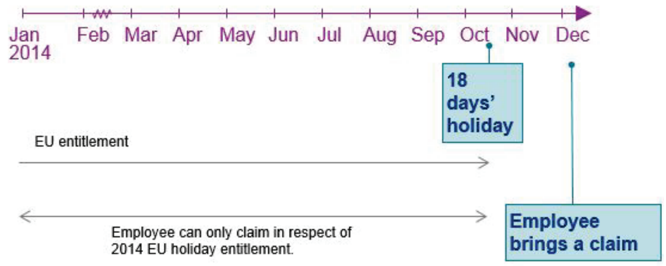
Example 1

An employee entitled to 25 days' holiday in a calendar year might have taken 20 days of that holiday for 2013 by the end of July 2013 and the remaining five days over the Christmas period.

In 2014 the employee has taken 18 days of holiday by the end of October, evenly during that period. Since the EAT's decision relates only to EU holiday, the employer might designate the first 20 days taken in any holiday year as the employee's EU holiday.

On this basis, from 1 August 2013 to the date the employee first took holiday in 2014 there was a period of more than three months' payroll runs during which there was no underpayment of (EU) holiday pay, because there was no EU holiday pay due at all, and the employee would be able to claim for additional holiday pay only back to the first holiday taken in 2014.





Example 2

Following on from example 1 above:

If now we assume that the employee has not yet claimed for the 2014 underpayment and takes no further holiday until March 2015 they will have had three months of unbroken correct pay (from November 2014 to March 2015). As a result of that three months period of correct pay the employee will not be able to claim for any back pay.

Effect on other types of variable pay and pensions

It is important to note that the potential impact of this decision extends beyond overtime. Other types of variable but regular pay, such as shift and place-of-work allowances, may also now have to be taken into account in calculating holiday pay. Some employers will find that the decision also affects their employees' pension entitlement, depending on their definition of pensionable pay.

A separate legal case is considering whether certain commission payments should also be included in calculating holiday pay. Employers will need to consider, in conjunction with their legal advisers, whether additional provision is required at this stage or whether this remains for now a contingent liability.

Accounting implications

For any financial year end prior to 4 November 2014 the EAT's decision represents a post-balance sheet event. Since it clarifies the way in which holiday pay should be calculated when there is compulsory non-guaranteed paid overtime, which had previously become increasingly uncertain, we believe that it is an adjusting event. While appeal may be made in future in a separate case against the limits on retrospective claim, the decision represents the current interpretation of the existing law.

EU-IFRS

Under EU-IFRS, both holiday pay and pension entitlements are dealt with under IAS 19 *Employee benefits*. Holiday pay is either a short-term or an 'other long-term' benefit, depending on how long the holiday can be carried forward and when the employer expects it to be taken. If it is a short-term benefit, the amount expected to be paid should be recognised as an additional cost; if it is a long-term benefit, the additional cost will be calculated based on actuarial assumptions. The standard does not give any 'no reliable estimate' exemption from recognising a liability and any employer affected by the EAT's decision will therefore need to make a reasonable best estimate of its impact.

The employer will need to assess the possibility of an appeal being brought in a separate holiday pay case to challenge the limitation on retrospective claims, which could result in a longer look-back period, in deciding whether there is also a contingent liability to be disclosed under IAS 37 *Provisions, contingent liabilities* and *contingent assets* (IAS 19.152).

Current UK GAAP

Under old UK GAAP, holiday pay is dealt with under FRS 12 *Provisions*, *contingent liabilities* and *contingent assets*. Provision should be made when the employer has a present legal or constructive obligation as a result of a past event, it is probable that there will be a cost as a result, and a reliable estimate can be made of the amount of the obligation. Their analysis of employment data and legal advice should enable employers to determine whether there has been a 'past event' in their case. If so, we would expect them to be able to make a reliable estimate, based on that analysis and advice, since there will be no inherent uncertainty about the amount but only an investment of management time to estimate it. As for IFRS, disclosure should be made of any additional contingent liability. Any pension implications will be considered under FRS 17 *Retirement benefits*.

'New' UK GAAP

New UK GAAP is similar to EU-IFRS, with all employee benefits covered in FRS 102.28 *Employee benefits*.

Actions for employers

Employers should be reviewing urgently the detail of their employment arrangements to determine the extent of any provision to be made for past underpayment of holiday pay or top-up of pension benefits. This consideration is likely in many cases to involve taking legal advice about whether, and if so how, they are affected by the EAT's decision.

Designed and produced by Create Graphics
Document number: CRT031849A