Grant Thornton

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Commentary, opinion and intelligence for the New Zealand business community

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Holidays Act 2003: Is your business compliant?

The Holidays Act 2003 is one of the single hardest pieces of legislation for businesses to comply with and using a major system or outsourcing this function doesn't necessarily guarantee compliance.

Some payroll providers are still non-compliant many years later, while others have taken shortcuts and pushed extremely manual compliance processes to their clients. Miscalculations have led to back payments ranging from a few dollars to well into tens of millions; for example:

- District Health Boards owe $1.15 billion in underpayments
- NZ Police identified $39 million in underpayments across 15,000 staff
- Hamilton District Council was caught out by the complexity of the legislation to the tune of $560k
- The list goes on. Even the Government agency tasked with ensuring compliance with the Act miscalculated its holiday pay and had to backpay employees.

MBIE is now focussing on SMEs struggling with the rules

MBIE's Labour Inspectorate has been focused on Holidays Act non-compliance since 2016. It started by reviewing the largest employers first and is now looking at SMEs in industries struggling with the Act. Over the past three years, non-compliance cases brought before the courts have resulted in tighter definitions of the rules. Add to that the configuration issues for payroll systems and processes, and the result is substantial non-compliance.

Who is likely to be affected?

The holiday pay calculation is straight-forward for staff consistently working 9-to-5, especially when they don't have allowances, commissions or bonuses. Underpayments in those situations are unlikely or immaterial. But this is where the simplicity stops.

Where employee work patterns vary, the calculation becomes harder, and non-compliance is much more likely.

Similarly, if an employee usually works overtime, gets a commission, or a periodic bonus, in most cases the Act requires inclusion of these additional payments in the calculation for annual leave payments. Shortcuts often cause non-compliance when a staff member doesn't have set hours or often changes their hours.

It's important to note some payroll systems can't calculate holiday pay accurately without consistent working hours.

What to look for

Here are the major root-causes of non-compliance.

1. Accruing annual leave at 8% or at Standard rate

These situations represent major divergence from the calculation defined in the Act and almost certain non-compliance. Holiday pay must be paid based on an employee's gross earnings and proportional to their work pattern. This method values the leave at the time it is taken, not when it is accrued. Annual leave value, as outlined in the Act, may be significantly more than a calculation of Standard rate x typical hours.

2. Recording leave balances in hourly or daily units

Recording annual leave entitlements in hours or days (or accruing over the year) is a common root-cause of non-compliance. While it is possible to stay compliant to the Act when recording leave in hours or days, the Act defines entitlement in weeks, making it difficult to remain compliant when calculating using these alternative methods. Really robust processes, monitoring and significant manual effort is required to avoid any breaches when leave units are recorded in hours or days.

3. Complex or variable renumeration structures

The more pay components an employer or staff member has, the more likely it is there is non-compliance. The Act tries to ensure employees

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are not disadvantaged by taking leave, no matter their remuneration structure. If an employee has allowances, commissions, bonuses or overtime these probably need to be included in the holiday pay calculation; they can only be excluded in a few defined circumstances. In these cases, the holiday pay calculated will be higher than an employee's Standard rate. Configuration of payment codes in payroll systems is therefore important for compliance. Even changing the use or setting of a payment type can result in non-compliance.

4. Variable work patterns

Industries with variable work hours or completely inconsistent work patterns have had the largest underpayments. These industries have also been the focus of the Labour Inspectorate's recent reviews. Annual leave must be valued as a portion of a typical working week. Mistakes here include averaging actual hours over a full year, assuming a five-day working week, or using actual hours for that period. Many system providers have taken shortcuts to try and comply with the Act. These often require customers to manually update work patterns and entitlement balances whenever a pattern changes to stay compliant. For some companies this is a massive compliance overhead and for others it is impossible.

5. Weekend shifts and working public holidays

Even companies with dedicated HR and payroll teams struggle to accurately determine statutory holidays and alternate days entitlements. Many also don't have a policy in place to define what an 'otherwise worked day' actually is, so statutory holiday entitlements can be determined, leaving accuracy to chance. The devil is in the detail. Alternate holidays must be recorded as whole days, and the day it is taken in lieu must be relevant daily pay on the day taken, not the public holiday.

Take action now to minimise risks in your payroll

If this sounds overly complicated, that's because it is. Grant Thornton's payroll assurance experts have conducted many payroll reviews using a streamlined process that makes the resolution of any potential errors as quick and painless as possible. Talk to us if you feel there may be systematic areas of non-compliance in your payroll or you'd like more confidence in your current set up.

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Government's interest deductibility rules the most controversial tax policy to date

Back in March the Government announced a range of measures in an attempt to address runaway house prices in New Zealand. Key amongst these were changes to the tax system to counter what it saw as favourable treatment for investors in residential housing.

New Zealand is one of the few countries in the OECD that does not have a capital gains tax. While there are already a number of tax rules that tax gains from property (essentially a loosely disguised capital gains tax), the new measures went much further.

The first of these was to tax any gain from the sale of residential property, other than the main home, where the property was sold within 10 years. This is known as the "bright-line" test. It was originally brought in by National with effect from 1 October 2015 and was initially only for sales within two years. It was then extended to a five-year period by Labour from 29 March 2018. And for property bought after 27 March 2021, the bright-line period is now 10 years.

There were also a number of other tweaks to the bright-line rules, making it harder to game the system using the main home exemption. Previously, the main home exemption applied where the property was used as a main home for more than half of the time it had been owned. Under the new rules, any gain on sale is only reduced for the proportion of time the property is used as a main home.

The second measure announced in March was a phased in denial of interest deductions for money borrowed to purchase residential property. The idea behind this was to prevent tax deductions for interest when a lot of the anticipated returns were expected to be from tax-free capital gains. The interest denial rules hadn't actually been developed when they were announced, even though they applied from March for new purchases and would be phased in for all other residential investment properties from 1 October 2021.

75%

For property acquired before 27 March 2021, 75% of the interest claimable from 1 October 2021 to 31 March 2023

Advice from Inland Revenue at the time said the changes would bag the Government $1.82 billion in additional revenue over the years 2021-2025, depending on interest rates.

Roll forward to late September 2021 and finally the Government has introduced draft legislation covering the interest denial rules – just in the nick of time.

These rules are probably some of the most controversial tax changes in recent years.

Most taxpayers who invest in residential property to derive rental income will no longer be able to claim a tax deduction for the interest they incur earning the income.

Under the interest denial rules, no interest may be claimed from 1 October 2021 for residential property purchased on or after 27 March 2021.

For property acquired before 27 March 2021, these rules are phased in with:

- 75% of the interest claimable from 1 October 2021 to 31 March 2023
- 50% claimable from 1 April 2023 to 31 March 2024
- 25% claimable from 1 April 2024 to 31 March 2025; and
- no deduction at all for interest incurred in borrowing to acquire residential property from 1 April 2025 onwards.

As with any tax rule, the devil is in the detail which is now finally before Parliament. The detail is chiefly in setting out the exemptions from the rules.

The first of these is that the new rules don't apply to the same extent to "new builds". A new build is a property that received its code compliance certificate on or after 27 March 2020. Interest relating to new builds is eligible to be deducted for up to 20 years from the time the property's code compliance certificate is issued. This exemption will apply to both the initial purchaser of the new build and any subsequent owner within the 20-year period.

The bright-line period for new builds (again using the same definition based on the issue of a code compliance certificate) is reduced from 10 years to five years.

Under this definition it is the issue of the code of compliance that makes it a new build, not the age of the building. So, an office building that is converted into dwellings, or an existing dwelling converted into multiple new dwellings, could qualify.

There are also exemptions for certain types of residential property such as houses on farms, certain Māori land, retirement villages, hotels, hospitals, social housing, employee or student accommodation, and land outside New Zealand. Owner-occupiers who rent rooms of their main home to tenants are also excluded.

Companies that own residential houses will also generally be exempt from the rules, provided their main business does not involve residential land. Unless that is, five or fewer individuals or trustees own 50% or more of the company.

If a property has both residential property and non-residential property on the same title, only the portion of the interest that relates to the non-residential property can be deducted.

Property developers can generally still claim interest on houses they develop for sale.

Where interest is denied, it can still be claimed if the property ends up being taxed under the bright-line rules. The deduction is allowed in the year of disposal.

Interestingly, advice from Inland Revenue warns that the proposed legislation could risk putting up rents for tenants and increase opportunities for tax avoidance. It also warns that the changes will increase compliance costs for the 250,000 taxpayers likely to be hit by the changes. It would also increase Inland Revenue's costs, as they chase down people for compliance.

The legislation will now head to select committee and is expected to pass by next March, even though the rules when enacted will apply retrospectively from 1 October 2021.

There is a lot more detail in the rules than set out above, and your specific circumstances may mean a different outcome. As such, it is recommended that you seek individual tax advice.

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Mandatory climate-related reporting on the way for some NZ businesses

The Government is establishing a standardised approach to climate-related reporting for certain entities to disclose their progress on emission reduction in a way that's transparent and consistent.

It has introduced an amendment to the Financial Markets Conduct Act (2013) to make climate-related reporting mandatory for many New Zealand organisations. These requirements come into effect from 1 January 2023, and an initial partial draft of the proposed standard was released for public comment on 20 October 2021.

Why now?

Climate change is a clear and present danger to businesses everywhere, and this poses a major risk to the stability of financial systems globally. For example, your business might experience supply chain disruptions due to adverse weather events, or your consumers' buying behaviour might change as their preferences shift to more sustainable, environmentally friendly products and services. And there's the increasing cost of obtaining insurance for climate risks to consider as well.

Therefore, the pressure on organisations to be more transparent about their exposure to climate-related financial risk is increasing. New Zealand businesses currently provide little or no information about the implications of this risk, and where disclosures are actually made, the outputs and reports are often delivered inconsistently; this reduces transparency for investors and makes accurate reporting about the country's progress towards a zero-carbon future difficult.

In addition to greater transparency, standardised climate related financial disclosure is also expected to enable climate risk to be adequately priced in capital markets and help the Government achieve its zero-carbon target by 2050.

Who is impacted?

Mandatory reporting: Regulated institutions

It's expected that the following types of entities will be mandated to report on their levels of climate related risk:

- Registered banks, credit unions, and building societies with total assets of more than $1 billion
- Managers of registered investment schemes with more than $1 billion under management
- Licensed insurers with more than $1 billion total assets under management, or annual premium income greater than $250 million
- Equity and debt issuers listed on the NZX with a market capitalisation greater than $60 million
- Crown financial institutions with more than $1 billion total assets under management

Non-mandatory reporting: Forward-thinking businesses

Privately owned businesses and other organisations are currently exempt from the proposed disclosure requirements. However, having a consistent method of reporting climate related risk against emission reduction targets is a compelling value proposition for forward-thinking entities to jump on board. There is an increasing demand from suppliers, employees and customers for businesses to be transparent about how they are managing their impact on the climate. Reporting your business's impact on the environment against a robust framework will create a competitive edge and positive engagement with your brand.

What reporting will be required?

The External Reporting Board (XRB) is tasked with developing the standard for climate-related disclosures. The standards are being developed in line with the Task Force on Climate Change-related Financial Disclosures (TCFD) recommendations. The standard will also require organisations to assess the risks and opportunities of climate to their business across four themes:

Governance

Oversight of climate-related risks and opportunities.

Recommended disclosures

a) Describe the board's oversight of climate-related risks and opportunities.
b) Describe management's role in assessing and managing climate-related risks and opportunities.

Strategy

Actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

Recommended disclosures

a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term.
b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Risk management

Process used to identify, assess, and manage climate-related risks.

Recommended disclosures

a) Describe the organisation's processes for identifying and assessing climate-related risks.
b) Describe the organisation's processes for managing climate-related risks.
c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.

Metrics & targets

Assess and manage relevant climate-related risks and opportunities where such information is material.

Recommended disclosures

a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in ine with its strategy and isk management process.
b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

When will mandatory reporting take effect?

While this new legislation still needs to be approved by Parliament, impacted organisations will be required to make disclosures for reporting periods beginning on or after 1 January 2023. We understand comparatives will not be required in the first year.

The XRB has provided the following timetable for the development of its climate related standard:

October 2021 **Governance and risk management**	**March 2022** **Strategy, and metrics and targets**	**July 2022** **Formal exposure draft**
This initial draft will be released for a 4-week consultation period, closing Monday 22 November 2021.	This initial draft will seek feedback on implementation feasibility. It will also include specific discussion about the topics of scenario analysis and GHG accounting. The draft will be released for a 4-week consultation period.	This formal exposure draft will include accompanying documents, such as transitional provisions, and will be released for a 3-month consultation period.

Next steps

At Grant Thornton we have a range of professionals dedicated to assist you through this journey. We can help your organisation formulate a request for feedback on the consultation documents, complete a gap analysis of your current climate reporting, or discuss assurance options regarding the proposed disclosures. Whatever the next steps are for your organisation, the time to start the process is now as mandatory reporting starts in just over a year.

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How should you capitalise cloud services – as an asset or expensed as occurred?

Cloud technology is fast becoming the backbone of emerging digital capabilities. As organisations migrate their IT environment from physical servers to the cloud, should this expenditure be capitalised as an asset, or expensed as incurred?

The International Financial Reporting Interpretations Committee (IFRIC) was recently asked how a customer should account for the costs of configuring or customising a supplier's application software in a cloud computing or software as a service (SaaS) arrangement. It was then discovered that there are disparate practices occurring in this area.

Intangible asset vs expense

The IFRIC realised this disparity was caused in part by confusion over the definition of an intangible asset and whether costs incurred met the criteria to be recognised as such. To clarify this differentiation, it identified two general 'buckets' of implementation cost incurred in a cloud computing arrangement.

1 Configuration costs

This has been defined as "involving the setting of various 'flags' or 'switches' within the application software, or defining values or parameters, to set up the software's existing code to function in a specified way".

2 Customisation costs

This involves modifying the software code in the application or writing additional code. Customisation generally changes, or creates additional, functionalities within the software."

An Intangible Asset has the following characteristics:

- The asset is separable and transferable from the entity, or arises from contractual or other legal rights
- The asset is a resource controlled by the entity
- The entity has the power to both obtain and restrict access to the economic benefits from the resource

On this basis, the IFRIC says the software underlying a cloud computing arrangement is typically not transferred to a customer, and the setting of flags (i.e. configuration) in third party software does not provide a separable and transferable, or contractual right to an asset as no asset that is separate from the software has been created.

IFRIC also addressed the potential for customisation costs to meet the definition of an intangible asset. It identified in certain situations, customisation costs MAY be required to be capitalised. This will be applicable where the entity retains intellectual property rights for software it has engaged internal or external resources to create. However, we note that this is generally not the case where code is created for operation 'in the cloud,' as this enhanced functionality generally remains the property of the third party cloud computing provider.

When is an intangible asset most likely created?

This occurs when an organisation invests in specific technology to bridge a gap in capability - and rights to that investment are retained by the business. Specific negotiation is generally required to retain the rights to the developed software, often at an increased cost. The transfer of rights may also be incomplete as the product might be developed using intellectual property which is retained by the supplier.

Notwithstanding this, there are certain hypothetical examples where an intangible asset may be created:

- Development of a legacy platform/SaaS integration; or
- Modification of systems to utilise SaaS output.

Where an intangible asset does not exist: The pattern of benefit

Certain entities had identified that an intangible asset did not exist for all or part of expenditure related to configuration and/or customisation of a cloud computing arrangement. Inconsistent practices have occurred as certain entities recognise the expenditure as an expense when incurred, while others were recognising the expenditure as an 'other asset' - an expense over the life of the cloud computing arrangement.

IFRIC states deferring of expenditure over the life of the cloud computing arrangement is inappropriate as NZ IAS 38.69 requires expenditure on services not capitalised be recognised as an expense when the business receives the services. The judgements then applied by the entity relate to the timing and value of these non-qualifying services.

IFRIC has concluded the nature of SaaS is exactly that – service arrangements - as suggested the name.

In a service arrangement, the benefit is generally received during the time the service is used. This period is generally the duration of the contract, which is used as a proxy for the period of benefit.

IFRIC also identified that certain contracts will contain services separate to the underlying SaaS arrangement, and can be accounted for separately to that arrangement: services that are 'distinct' – and services that are unable to be separated from the arrangement – services that are 'not distinct'.

Generally, 'not distinct' services can't be separated from the SaaS arrangement and recognised as an expense on the same pattern as the SaaS arrangement. 'Distinct' services are recognised as the benefit is received – generally as the services are delivered.

Services provided by a third party are often distinct from the SaaS arrangement as per the definition of 'distinct' in AASB 15 Revenue from Contracts with Customers, however judgement should be applied.

So, what is meant by distinct?

IFRIC has referenced concepts first introduced in NZ IFRS 15 Revenue from Contracts with Customers to provide guidance about the timing of expenditure for these services. Where the services are considered ‘distinct’ from other elements of the contract, they are addressed as a separate element and expensed as and when the services are provided – typically in a relatively short time period. Where the services are not considered distinct from other elements of the contract – i.e. other performance obligations as defined by NZ IFRS 15 – they are required to be bundled with other elements and recognised as an expense in the same pattern as those other elements.

Paragraph 27 of NZ IFRS 15 defines a good or service as distinct if both of the following criteria are met:

a the customer can benefit from the product or service either on its own or together with other resources that are readily available to the business (ie, the good or service is capable of being distinct); and

b the entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract)

Such determinations are widely covered in NZ IFRS 15 guidance; the application requires the customer to consider a transaction from the supplier’s perspective in addition to their own.

In our opinion, it is appropriate in the correction of any related recognition and measurement arising from the application of the Agenda Decision as a “Change in Policy” vs “Restatement due to Error” should be considered.

In the instance of a change in policy, the appropriate disclosures are described in NZ IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, paragraph 29 and include:

- The nature and change in accounting policy;
- The reasons why applying the new accounting policy provides reliable and more relevant information;
- For the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  - For each financial statement line item affected; and
  - If NZ IAS 33 Earnings Per Share applies to the entity, for basic and diluted earnings per share;
  - The amount of the adjustment relating to periods before those presented, to the extent practicable.

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Achieve long term digital fitness from the cloud up

Whether your organisation is exploring new possibilities, adopting new ways of working or implementing continuous cloud assurance into its digital foundation, you need support and advice designed to enhance your cloud capabilities.

Where are you on your cloud journey?

Grant Thornton offers three pillars of cloud service to supplement the existing capability of your team and your organisation's unique journey to going digital successfully – for the long term.

Advice

How can your business prepare for the deployment of cloud and realise the benefits of going digital across the entire business?

With the right advice tailored to your needs, our specialists can set you up for success through cloud strategy, design, adoption, operations and performance.

- Business readiness and economic viability
- Architecture assessments
- Application readiness assessments
- Cloud strategy review and support
- Cloud security and governance
- DevOps and CloudOps set up and training

Action

When skilled and certified talent is hard to find or expensive to retain, supplement your team with ours.

Take advantage of our ability to design, implement and migrate using cloud tooling, automated delivery and the latest cloud platforms.

- Cloud architecture and design
- Cloud implementation and design
- Cloud workload migrations
- Application migrations to cloud
- DevOps and infrastructure-as-code practices
- New tools and automation adoption

Assurance

Take control and create continuous cloud confidence by enhancing how the performance of your evolving cloud estate serves the organisation's objectives.

Independent visibility can ensure your clouds are doing what they should – and that exceptions are managed well. By adopting a cloud assurance service, your ability to mitigate, avoid and remedy risks for the entire business is greatly increased.

Your team and customers will benefit from a cloud system that performs consistently and as required.

Grant Thornton works with the leading cloud platforms
Our experts are certified and experienced with working alongside the leading cloud partners and cloud toolsets.

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Grant Thornton