

# Severance payments: A guide for the public sector

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# Contents

Auditor-General’s overview	3
Part 1 – Introduction	4
Why severance payments are sometimes made	4
Difference between contractual entitlements and severance payments	6
Part 2 – Getting severance payments right	9
The right process	9
Mediation	10
Terms of settlement	11
Amount of the payment	13
Part 3 – Legal requirements to disclose severance payments	16
Confidentiality clauses	16
Legislative disclosure requirements	17
Accounting standards requirements	20
Part 4 – Common pitfalls	23
Promising confidentiality	23
Bundling payments together as a “tax-free” package	24
Figures	
1 – Summary of legislative requirements to disclose common types of severance payments.	19
2 – Accounting standards that apply to disclosing severance payments	21
3 – Examples of promises to keep a severance payment confidential	23
4 – Example of a severance payment that does not properly allow for tax	24

# Auditor-General's overview

E ngā mana, e ngā reo, e ngā karangarangatanga maha o te motu, tēnā koutou.

We all expect employers to act in good faith and follow good human resources practices to avoid employment relationship breakdowns. But sometimes when employment difficulties arise, ending the employment relationship with an agreed severance payment can be a reasonable and appropriate decision. This is particularly so when the parties are in dispute, which creates its own risks and costs.

Severance payments are payments additional to what a person is entitled to under their employment agreement, as part of an agreement to end the employment relationship.

Because severance payments are discretionary and sometimes large, they are likely to come under scrutiny and might attract media or other interest. I encourage public organisations to take a principled and practical approach to these situations. The basic principles of accountability, integrity, and fairness always need to be considered.

The risks associated with severance payments have led Parliament to include disclosure requirements in several Acts of Parliament, including the Crown Entities Act 2004 and the Local Government Act 2002. As part of the normal audit work each year, the auditors I appoint check whether required disclosures have been properly made. The auditors may also comment on severance payments that are unusual or not in keeping with public sector expectations.

Public sector employers need to make sure that they have good reasons for making a severance payment, that the level and form of the payment is appropriate, and that the decision is properly authorised. Severance payments must be based on a careful assessment of the costs, benefits, and risks of the approach, and on proper legal and tax advice. Employers need to be aware that they should not promise complete confidentiality as it can be overridden by statutory disclosure requirements.

I commend this good practice guide to all public sector employers.

Nāku noa, nā,



John Ryan  
Controller and Auditor-General

26 June 2019

# 1

## Introduction

1.1 This guide is intended to help public sector employers when considering making a severance payment to a departing employee. It replaces our 2012 publication, and has been updated to reflect more recent case law and changes in accounting standards.

1.2 In this Part, we discuss:

- why severance payments are sometimes made; and
- the difference between severance payments and contractual entitlements.

### **Why severance payments are sometimes made**

1.3 Public sector employers are expected to follow good human resources practices to avoid employment relationship breakdowns, and to follow proper processes to avoid or reduce risk. Their overriding duty under the Employment Relations Act 2000 is to act in good faith. But even the best practices cannot completely prevent problems. When employment difficulties arise, they need to be resolved in the best interests of the public organisation and the employee.

1.4 Severance payments are unlikely to be warranted when:

- problems are resolved and the employment relationship can continue;
- the parties agree to end the employment relationship on the ordinary contractual terms; or
- there is sound legal justification for the employer to terminate the employment relationship, proper process has been followed, and the termination is justified.

1.5 However, sometimes there is no readily available solution or process to follow, or the parties might disagree on the issues or the process. The problem might not be one that legislation or employment agreements have provided for. The employer might be in a situation where the relationship has broken down, or there is a complete lack of faith or confidence, but there are no valid grounds for ending the person's employment or where there may otherwise be a lengthy formal process. Alternatively, the employer might be facing a personal grievance claim. In circumstances when an employer and an employee are in dispute, or one or both are dissatisfied, an exit on agreed terms (including a severance payment) can be a sensible and appropriate solution.

1.6 Common situations that might lead to the parties considering an agreed exit include:

- the employer being dissatisfied with the employee's performance, or issues arising in the course of the performance management process;
- disciplinary processes;

- the employee raising a personal grievance about a workplace issue and/or claiming that they have been constructively dismissed;
- the board or senior management being dissatisfied with the chief executive or senior employee, resulting in a loss of trust and confidence in each other;
- a change of board members or senior management, and assessment that an employee's skills are not those required in the role;
- a dispute over renegotiation of position description, remuneration, or terms of employment;
- relationship difficulties affecting the functioning of a role or the well-being of staff;
- claims of bullying or harassment;
- stress claims;
- a restructuring situation leading to a dispute about the process or outcome; or
- a personality clash between an employee and their manager, or between managers, particularly at a senior level.

- 1.7 Typically, discussions between the parties on such matters will involve either direct negotiation between the parties and their advisers or the mechanisms available under the Employment Relations Act. These mechanisms include raising an employment relationship problem, seeking mediation assistance, and submitting a statement of problem to the Employment Relations Authority.
- 1.8 A major failing of trust and confidence can occur at any level but is more common at senior levels. Breakdowns in relationships between boards or stakeholders and chief executives or senior managers can be particularly intractable. Employers might not consider it appropriate or practicable to run a performance management process for a chief executive or senior manager. The issue might not be one of clearly identifiable poor performance or serious misconduct, but might still be causing serious risk to the public organisation or a significant distraction from the organisation's core business or operations.
- 1.9 Although the general requirements for a fair disciplinary process are well known, employers can find these processes difficult and risky and they can have a significant effect on the employee. The high-level requirements of a fair process are described in legislation (s103A(3) of the Employment Relations Act), and there is also established case law to provide guidance. The procedural requirements focus on ensuring fairness to the employee involved and, as such, can be challenging for the employer in some circumstances. They have traditionally required careful attention to detail as the process unfolds. The required standard of substantive justification for dismissal is high, and the expectations of the Employment Relations Authority and Employment Court of public sector employers are arguably higher than their expectations of private

sector employers.<sup>1</sup> One of the contextual tests for considering the fairness and reasonableness of an employer's actions is "the resources available to the employer" (s103A(3)(a) of the Employment Relations Act). A public organisation, even a relatively small agency, will be presumed to have access to resources.

- 1.10 Employees called to account for their performance or conduct can challenge the substance or process at any stage. At times this might be tactical or designed to cause delay, and make the process resource-intensive and time-consuming. This can further strain the employment relationship and risk adversely affecting how the public organisation functions and day-to-day working relationships.
- 1.11 Even a well-planned and well-implemented process can go awry and face unexpected delay or, if challenged, fail to meet the high expectations of justification or fairness and be ruled unjustified. Therefore, reaching an agreed severance arrangement can be a cost-effective and low-risk option, especially where the risk of successful legal action by the employee is assessed as high or the effects on the public organisation are becoming significant.
- 1.12 Sometimes, employees ask for exit packages that include a severance payment. This can be during the course of, or at the end of, a performance management process or a disciplinary process. The employee would rather leave on agreed terms than go through a long process or risk dismissal, and/or the employer might be willing to include a severance payment to avoid the risk, stress, and cost of the process and any legal challenge. However, this should not be the normal approach. The particular circumstances need to be carefully assessed to decide whether this is a justifiable response. Some of the factors to consider are described in the next Part (see paragraph 2.22).

## Difference between contractual entitlements and severance payments

- 1.13 Employers need to clearly distinguish between the different types of payments made to an employee when their employment ends. The relevant considerations and disclosure rules will vary depending on the type of payment (and the seniority of the employee – see Part 3).

### Contractual entitlements

- 1.14 Any payment that is **required to be made** under an employment agreement is a contractual entitlement, not a severance payment. Contractual entitlements can include:
- any specified period of notice, which can be paid out instead of worked (usually at the employer's discretion);

- any payment due if an employee's position becomes redundant;
- annual leave that has been earned but not taken at the time of termination;
- any benefits that are part of the employee's remuneration package and which they have become entitled to by the time they leave (for example, a bonus or incentive payment, or long-service leave);
- any obligation to pay out the remaining period of a fixed-term agreement (if it is ended early); and
- any disengagement payment (sometimes referred to as a "golden handshake"), if the agreement provides for it.<sup>2</sup>

1.15 If a departing employee is contractually entitled to any of these payments, the employer is under a legal obligation to make the payment and must do so. The payments cannot usually be withheld or negotiated.

1.16 An employer can pay a contractual entitlement where it has not yet accrued, or make a small payment that it is not legally obliged to make. This might be on compassionate grounds or because it is what a "fair and reasonable" employer would do in the circumstances. Long service, illness, or other personal circumstances might warrant such a gesture.

1.17 For example, an employee might resign because of family illness when she is two months short of the 20 years required for long-service leave of four weeks. The employment agreement specifies that if the employee resigns or is dismissed before 20 years, she is not paid anything for long service. The employer might decide to pay the employee's long-service leave or part of it, because the employer considers a payment to be fair and reasonable in the circumstances. There is a sound basis for the payment, but in formal terms it is a discretionary severance payment.

**Certain contractual payments for senior managers might have to be disclosed as severance payments**

1.18 We do not usually regard contractual entitlements under an employment agreement as severance payments. However, in some situations, contractual payments related to a person's departure might need to be disclosed under the broad heading of severance payments. In particular, accounting rules require the disclosure of some contractual entitlements paid to key management personnel as "termination benefits". Disclosure requirements will depend on the particular definition applying to the public organisation and situation (see Part 3).

2 Public sector employers should have prepared a reasonable business case for including such entitlements in employment agreements. Entitlements not in keeping with usual provisions in the sector can be subject to considerable public scrutiny and attract criticism. The payments are contractual, so they must be made – even if they are overly generous.

## Severance payments

- 1.19 A severance payment is any payment that is made in addition to the employee's contractual entitlements as part of an agreement to end their employment. Severance payments are made to help resolve an unsatisfactory employment situation or might be agreed to bring the employee's employment to an end for other reasons. Sometimes, the payment might not be monetary (for example, the employer might agree that the employee can keep their laptop, mobile phone, or the work car that they have been driving).

### The role of the auditor

- 1.20 Where a public organisation has made a severance payment to a departing employee, the auditor will consider whether the organisation has met public sector good practice expectations (including by looking into issues of probity and waste).
- 1.21 In particular, the auditor will need to access information to assess:
- whether the organisation has followed the correct approval process before deciding to offer a severance payment, including:
    - ensuring that approval is given by the right person within their delegated authority;
    - that the organisation has documented the process; and
    - that the organisation has taken legal advice, where appropriate; and
  - whether required disclosures have been made, as well as those required under the relevant accounting standards.
- 1.22 It is not generally the auditor's role to examine the particular circumstances of the employment relationship, or the reasons for the severance payment, to assess whether the severance payment paid by a public organisation is appropriate. However, if a severance payment appears excessive, or not in keeping with public sector norms, it is likely to attract greater scrutiny, and the auditor might include a comment on the severance payment in their audit report or report to governors and management of the organisation.

# Getting severance payments right

- 2.1 In this Part, we describe:
- getting the process right when agreeing a severance payment;
  - the advantages of using mediation services;
  - getting the terms of settlement right; and
  - getting the amount of the severance payment right.

## The right process

- 2.2 A severance payment can be agreed between the parties in an employment relationship without involving other parties or advisers. However, the risk of doing this is that the public organisation might not follow proper processes, properly assess the basis for, or amount of, a severance payment, or document it correctly. These failings can create legal and financial risks (for example, with tax, delegated authority, and disclosure requirements).
- 2.3 Many severance payments are negotiated with the help of legal or other representatives. Using experienced advisers is wise in any sensitive or difficult situation. Public sector employers will often be required to justify the terms of a negotiated exit, including any severance payment. Reasoned legal advice (in writing) will be helpful or even essential if the employer is asked to explain the basis for a severance payment.
- 2.4 Parties can also choose to use the mechanisms available under the Employment Relations Act, which are designed to support employers and employees to reach constructive agreements. These include raising an employment relationship problem, mediation assistance, and submitting a statement of problem to the Employment Relations Authority.
- 2.5 An agreement reached by private negotiation can be documented in a settlement agreement or a simple contract, or by using the same format as that used by Employment Mediation Services in the Ministry of Business, Innovation and Employment (MBIE). Employment Mediation Services has a template available online, and it can be signed by a mediator with statutory power to confirm the agreement is final, binding, and enforceable.
- 2.6 Public sector employers must make sure that the person signing an agreement for the employer has the delegated authority to settle the matter on those terms. The employee should be told that they can seek independent advice before signing it. It can sometimes be appropriate for the organisation to support an employee to obtain legal advice by making a contribution to their legal fees.

## Mediation

- 2.7 The Employment Relations Act encourages the resolution of employment disputes at a low level and by informal means. The employment institutions set up under that Act strongly encourage the parties to resolve their dispute using MBIE's Employment Mediation Services. By statute (reinforced by case law), the MBIE mediation process is confidential and without prejudice. This means that parties cannot disclose outside the mediation process what has been discussed or documented at mediation. It is a safe and efficient environment in which the parties can resolve their dispute. Any agreement reached is signed by the parties and also signed by the mediator.<sup>3</sup> The mediator's signature on the record of settlement confirms that it is final, binding, and enforceable, and cannot be appealed or challenged.
- 2.8 In all but the most urgent or exceptional cases, the Employment Relations Authority or Employment Court will expect the parties involved to attend mediation before issuing proceedings. The Employment Relations Authority and Employment Court can direct parties to mediation before they hear a case. They can also refer the parties to mediation at any time if mediation could help the parties to resolve their dispute.
- 2.9 In practice, many employers and employees now agree to attend mediation when they have a dispute. We encourage this, in the interests of early clarification of disputes and cost-effective resolution for both parties. The Crown is required to be a good employer and to act in good faith, and to be an exemplary litigant. Agreeing to attend mediation promptly is consistent with those requirements. In many instances, it will help avoid litigation. Many employers now also use mediation proactively to try to resolve disputes early and before positions become entrenched.
- 2.10 Parties can also engage private mediators or facilitators. A private mediator might be able to accommodate the parties more quickly if the Employment Mediation Services are unavailable, but the cost must be considered. Private mediation or facilitation practitioners might bring different skills to bear, or help the parties with different processes or resources, such as restorative justice or with resolving ongoing employment relationship issues.
- 2.11 The employer should also ensure that the appropriate people are available to attend mediation sessions, including a manager with the requisite delegation to reach an agreement on the day. If the appropriate people in the public organisation cannot be present, they must be otherwise accessible throughout the process. However, it is best that the manager with the authorised delegations be present at the meeting itself because it is difficult to summarise and explain

the anticipated outcome of a mediation session to someone who has not been directly involved. The MBIE mediators will ask at the outset if there is someone present with “authority to settle”.

- 2.12 Whichever process or forum is used, when signing any agreement the person signing on behalf of the employer should have:
- competent advice about the employer’s legal position;
  - a clear understanding of the risks, costs, and benefits of the proposed settlement;
  - the correct level of delegated authority; and
  - a written record of the basis for settlement.

### Terms of settlement

- 2.13 The parties to a dispute in the public sector can resolve it in any lawful, justifiable, and reasonable way. The terms of agreements reached vary considerably, and can encompass financial, practical, and intangible matters.
- 2.14 One of the main differences between private and public sector employment situations is the degree of scrutiny and accountability for severance payments. The disclosure regimes applying to public organisations are more onerous than those applying to the private sector.
- 2.15 Public sector employers need to consider their capacity to maintain confidentiality given their statutory disclosure obligations, and whether a confidentiality clause is in the public interest. Settlements are sometimes better made openly, with the agreement and understanding of all parties. It might be appropriate to agree to wording for an announcement to the rest of the public organisation and, in some circumstances, to the media.
- 2.16 Severance agreements can include some or all of:
- a specified notice period and an agreed finishing date – if a period or payment in addition to the contractual period of notice is being made, this is specified;
  - a payment for lost future earnings for a specified period (to recognise the time required to find a new job);
  - if a dispute or personal grievance has been raised and there is a basis for acknowledging hurt and humiliation, a payment of compensation under section 123(1)(c)(i) of the Employment Relations Act – these payments are often referred to as being made “without deduction” to reflect their non-taxable nature;

- any contractual entitlement the parties wish to confirm in writing, such as a bonus, long-service payment, or accrued annual leave, particularly if the employer is agreeing to pay an entitlement that has not yet fully accrued;
- a contribution towards any legal fees reasonably incurred – for audit purposes, evidence of the fees incurred will be required (for example, an invoice);
- reimbursement of other incurred costs, such as medical costs, counselling or outplacement assistance costs, or relocation or retraining costs (again, evidence of the costs will be needed);
- any equipment or other property kept (such as a car, laptop computer, or mobile phone – or an employee might want to keep their mobile phone number);
- provision of an apology for wrongdoing or distress caused to the employee by an event;
- provision of a reference or certificate of service (note that any reference given should be accurate, and with no significant omissions, to avoid the same issues arising again with another public sector employer);
- return of each party's respective property;
- an agreement about a farewell function;
- an agreed statement or communication to the rest of the public organisation and/or media;
- a mutual non-disparagement clause, stating that neither party will speak ill of the other;
- confirmation that the agreement is a full and final settlement of all claims arising out of the employment and its termination; and
- a confidentiality clause.<sup>4</sup>

2.17 Severance payment agreements, like all legal contracts, must be documented correctly. The terms must be clearly spelled out, with financial and intangible components, timing, and the parties' respective obligations carefully defined. The nature of each type of payment should be specified, and the basis for the payment should be explained so the document is self-explanatory. Any ambiguities can result in misunderstandings, interpretation arguments, or even legal proceedings.

2.18 The public organisation needs to keep a clear paper trail recording the background, risk assessment and advice obtained, basis and reason for the severance payment and terms, and evidence of the required authorisation.

2.19 Severance payments must be approved at the correct level of delegated authority. The authorisation required (that is, general manager, chief executive, board, or

<sup>4</sup> This is subject to an assessment of whether the severance payment and agreement should be confidential, and subject to legal and accounting disclosure requirements (see Part 3).

Minister) will depend on the amount of the severance payment, in keeping with the rules applying to the particular public organisation. The amount includes all financial costs, excluding Goods and Services Tax (GST).

- 2.20 For government departments, Cabinet sets specific approval procedures and financial delegations for any kind of settlement and payments that are not legally required.<sup>5</sup> Payments above the thresholds must be approved by Cabinet or the responsible Minister. Compensation and settlement payments must also be certified by either a departmental solicitor or the Crown Law Office.

### Amount of the payment

- 2.21 The amount paid as a severance payment in any given situation can vary considerably, and there are no set limits. The amount must be reasonable in the circumstances and able to be justified as a proper use of public money. In every instance, the parties will negotiate based on their assessments of the strength of their position (which can be very different). Public sector employers also need to consider their statutory good employer obligations.
- 2.22 When settling on an amount, the relevant factors will include:
- what the dispute is, how it arose, how the parties have conducted themselves, and who is (most) at fault;
  - the strength of the employee's legal claim to compensation under case law;
  - how strong the employer's position is – whether there is a clearly established basis for dismissal (if so, the employer will have the most negotiating power) and how well the employer has handled the situation;
  - the seniority of the employee;
  - the employee's length of service;
  - contractual entitlements;
  - any health (including mental health) issues that are affecting the parties' ability to resolve the situation;
  - any relevant precedent in or applicable to the public organisation or situation;
  - the likely award of damages and costs by the Employment Relations Authority or Employment Court;
  - the likely cost of defending or conducting proceedings, weighed against the strength of the legal position – a risk and cost-benefit analysis;
  - precedent value/risk – whether public resolution through a legally binding precedent would be more harmful than a private resolution (bearing in mind that it may become public);
  - the effects on the public organisation, particularly if the matter is not resolved;

5 The current procedures are set out in Cabinet Office Circular CO (18) 2, Section C.

- the effects on the employee, and the extent to which the employer might have a moral obligation in the circumstances giving rise to the departure; and
- how much each party has at stake and how much each party wants to resolve the situation.

2.23 These are complex assessments, and there are many variables to consider. People make different value judgements and weigh factors according to those judgements. The risks must be balanced against the costs. It is important that the employer has all relevant information and good advice, and that they are making a careful assessment in all circumstances. The employer also needs to follow their internal processes, including ensuring that approval is given by the right person within their delegated authority. If this is done and documented, then the employer will be in a better position to defend the severance payment as being a principled and considered decision.

2.24 The amount of any severance payment must be reasonable, although this is, by necessity, an imprecise requirement. Settlements larger than an award in comparable cases decided by the Employment Relations Authority or the courts will be given greater scrutiny, and the public organisation will need to have good reasons for the amount. Good reasons for a comparatively higher payment might include the seniority of the employee, the effect of any publicity on all the people involved, the sensitivity of the dispute, and the value of certainty and speed of resolution. These factors can justify a higher settlement because the outcome is more advantageous than a judicial outcome.

2.25 Settlements sometimes include a specific payment to compensate an employee for their hurt, loss of dignity, and injury to feelings.<sup>6</sup> Such payments can be awarded under the Employment Relations Act when the employer has made an error or wronged the employee in some way and, in doing so, has caused hurt, loss of dignity, and/or injury to feelings, as well as having created grounds for a personal grievance claim. Such payments should not be regarded as an automatic part of any settlement. It is not appropriate to make a payment of this kind if, in the view of the public organisation, there are no grounds for a personal grievance claim and the employee has not suffered any hurt, loss of dignity, and injury to feelings, so sometimes they are not an appropriate part of a severance agreement.

<sup>6</sup> These are colloquially known as section 123(1)(c)(i) payments, after the relevant section of the Employment Relations Act.

- 2.26 These compensation payments are tax free because they are not income, and they do not have to be declared in tax returns filed by the employee. For this reason, it is common for parties (and/or counsel) to attempt to direct the greater portion of the severance payment into this category. However, an unjustified or excessive payment of this kind can create risk for both parties. In particular, employers should expect the Inland Revenue Department to scrutinise such payments, including asking for evidence of a personal grievance claim and/or evidence of what hurt, loss of dignity and injury to feelings was established.<sup>7</sup>

<sup>7</sup> For more information see [www.ird.govt.nz](http://www.ird.govt.nz).

# 3

## Legal requirements to disclose severance payments

- 3.1 In this Part, we discuss:
- confidentiality clauses;
  - legal disclosure requirements; and
  - accounting standards requirements for severance payments.

### Confidentiality clauses

- 3.2 The parties to a settlement often include a confidentiality clause in the settlement agreement. As a result, public organisations can be reluctant to disclose the payments made.
- 3.3 However, most public organisations will have some kind of obligation to disclose severance payments. Accounting standards require the disclosure of some payments in the financial statements, and the governing legislation for some types of organisations contains additional requirements for what must be disclosed in the annual report. Whether a particular payment needs to be disclosed will depend on the specific wording of the relevant legislation and accounting standards. A legal disclosure requirement will override any contractual undertaking; public organisations cannot contract out of their statutory obligations.
- 3.4 The standard wording for confidentiality clauses provides that the discussions and terms of settlement are confidential, “except as required by law”. This wording should always be inserted into settlement agreements where confidentiality has been agreed. Employees and their representatives should be made aware of the public organisation’s disclosure requirements, and the limits of any promise of confidentiality. Settlement agreements might need to be tailored to reflect the circumstances, including limitations on confidentiality.
- 3.5 MBIE’s mediation processes are subject to statutory confidentiality.<sup>8</sup> That means that what is said at mediation is confidential and inadmissible in court. However, this does not mean that the terms of every settlement agreement signed at mediation are confidential or that they must include a clause stating that the settlement is confidential. The terms, including any confidentiality clause about the fact or amount of settlement, are for the parties to negotiate and agree. The statutory requirement to observe confidentiality in the mediation discussion and process does not override legal disclosure requirements.

## Legislative disclosure requirements

- 3.6 Councils and Crown entities have specific disclosure obligations under the Local Government Act 2002 and the Crown Entities Act 2004 respectively.
- 3.7 Settlement agreements usually list all the payments that will be made when the person's employment ends. Some of these will be ordinary contractual and statutory entitlements (for example, accrued annual leave), and others will be additional payments that have helped end the employment relationship on an agreed basis (such as payment of the employee's legal fees, or a compensation payment).
- 3.8 Which payments need to be disclosed will depend on the facts, the person's employment agreement, the terms of the settlement agreement, and the requirements of the relevant legislation. It is important to note that the legal requirements are the minimum. Sometimes additional explanation might be useful for the reader.

### Local Government Act 2002

- 3.9 The Local Government Act defines a severance payment as:
- ... any consideration that a local authority has agreed to provide to an employee in respect of that employee's agreement to the termination of his or her employment, being consideration, whether of a monetary nature or otherwise, additional to any entitlement of that employee to:*
- (a) any final payment of salary; or*
  - (b) any holiday pay; or*
  - (c) any superannuation contributions.<sup>9</sup>*
- 3.10 A council's annual report must:
- state the amount of any severance payments made in the year to any person who vacated office as chief executive of the council;
  - the number of employees of the council to whom severance payments were made in the year; and
  - the amount of every such severance payment.
- 3.11 This means that each severance payment needs to be disclosed separately, and not as a total for the council.
- 3.12 The definition of severance payment in the Local Government Act requires disclosure of any payments made to an employee as part of an agreement to end their employment that are additional to the employee's existing employment agreement or statutory entitlements. This does not include payments that

9 See schedule 10, clause 33, of the Local Government Act.

an employer is required to make under an employment agreement if the employment ends, including pay instead (in lieu) of notice where there is a provision in the employment agreement allowing the employer to pay part or all of the notice period in lieu. However, any payment in lieu of notice that is greater than the notice period in the employment agreement must be disclosed.

- 3.13 If the employer agrees to pay in lieu of notice without a provision allowing it to do so, then that payment must also be disclosed. It is not based on a contractual entitlement.
- 3.14 For example, redundancy entitlements in the employment agreement would not have to be disclosed if the employee was effectively made redundant. They are not a new or additional payment that has been negotiated to end the employment relationship. However, a redundancy payment higher than the employment agreement allowed for, or not based on the employment agreement, would have to be disclosed. Similarly, payments in lieu of notice would be disclosed only if they exceeded the notice period in the employment agreement or where the employment agreement does not have a provision allowing the employer to pay in lieu of notice.

### **Crown Entities and Education Acts**

- 3.15 Section 152 of the Crown Entities Act requires Crown entities to include in their annual report:
- ... the total value of any compensation or other benefits paid or payable to persons who ceased to be members, committee members, or employees during the financial year in relation to that cessation and the number of persons to whom all or part of that total was paid or payable.*
- 3.16 Under the Education Act 1989, schools also do not need to disclose individual payments. An aggregate amount for the school is enough.
- 3.17 The legislative requirement under these two Acts and the Local Government Act is to disclose the compensation and benefits that are tied to the end of employment. This means that any payment that relates to the ending of the employment relationship needs to be disclosed, whether it is based on contractual entitlements or not.

### **Companies Act 1993**

- 3.18 Companies are also required to disclose certain payments, including all remuneration and other benefits received by directors and former directors; and by any other employee or former employee if the value was \$100,000 or more a year.<sup>10</sup>

## Government departments

- 3.19 Government departments do not have an equivalent duty to disclose severance payments in their annual reports. However, they are accountable to Ministers and to Parliament and can be required to disclose this information through other accountability mechanisms (for example, when asked to do so by select committees).

## Review by auditors

- 3.20 In our annual audit work, we look at compliance with disclosure requirements. We can report the non-disclosure of a severance payment as a legislative breach in the audit report. Sometimes the appointed auditor will include the missing information in the audit report, depending on the size, nature, and circumstances of the payment.

## Summary of the legislative disclosure requirements for severance payments

- 3.21 Figure 1 summarises the disclosure requirements for common types of payments made at the end of an employment relationship. Whether a specific payment needs to be disclosed will depend on the facts, the person's employment agreement, the terms of the settlement agreement, and the requirements of the relevant legislation.

**Figure 1**  
**Summary of legislative requirements to disclose common types of severance payments**

Type of payment	Local Government Act 2002	Crown Entities Act 2004	Education Act 1989
Salary or wages	No disclosure needed	No disclosure needed	No disclosure needed
Holiday pay; time off in lieu	No disclosure needed	No disclosure needed	No disclosure needed
Employer's contributions to superannuation	No disclosure needed	No disclosure needed	No disclosure needed
Payment in lieu of notice	Disclose if the payment exceeds the notice provision in employment agreement	Disclose if the payment exceeds the notice provision in employment agreement	Disclose if the payment exceeds the notice provision in employment agreement
Redundancy compensation	Disclose payments that exceed any employment agreement provisions	Disclose	Disclose

Type of payment	Local Government Act 2002	Crown Entities Act 2004	Education Act 1989
Hurt and humiliation payments	Disclose	Disclose	Disclose
Any other compensation	Disclose	Disclose	Disclose
Legal or other fees	Disclose	Disclose	Disclose
Transfer of property (such as a car)	Depends on the facts and employment agreement	Depends on the facts and employment agreement	Disclose

## Accounting standards requirements

### Generally accepted accounting practice

- 3.22 The information in general purpose financial reports<sup>11</sup> prepared by a public organisation might be required by legislation, by founding documents (such as trust deeds), by its parent organisation, or by the responsible Minister to comply with generally accepted accounting practice.
- 3.23 Generally accepted accounting practice is the overall body of accounting standards and other guidance that sets out how an organisation should prepare general purpose financial reports. Importantly, generally accepted accounting practice is a set of objective principles and requirements that are not subject to the preparer's individual preference.
- 3.24 Since 2015, the financial reporting standards used when preparing general purpose financial reports have been determined by the External Reporting Board's Accounting Standards Framework.<sup>12</sup> The applicable financial reporting standards are determined by whether the organisation is profit-oriented or exists for a public benefit, and its size.
- 3.25 The primary objective of most public organisations is to deliver services to the public rather than to generate a commercial return for investors. These organisations are referred to as **public sector public benefit entities**. The applicable financial reporting standards for these organisations are referred to as **public sector public benefit entity accounting standards**.

<sup>11</sup> More information about general purpose financial reports can be found in our 2016 publication, *Improving financial reporting in the public sector*.

<sup>12</sup> Information about the External Reporting Board's Accounting Standards Framework is on its website, [www.xrb.govt.nz](http://www.xrb.govt.nz).

3.26 Some public organisations have a greater focus on achieving a commercial return. These organisations are referred to as **public sector for-profit entities** (for-profit entities). They include State-owned enterprises, mixed ownership model companies, and Crown Research Institutes. The applicable financial reporting standards for these entities are referred to as **NZ IFRS**.

#### Accounting standards disclosure requirements

3.27 The disclosure requirements for severance payments are similar for both for-profit entities and public benefit entities. The relevant accounting standards are summarised in Figure 2.<sup>13</sup>

**Figure 2**

#### Accounting standards that apply to disclosing severance payments

	Public benefit entities	For-profit entities
Accounting and disclosure requirements for employee benefits	PBE IPSAS 39 <i>Employee benefits</i>	NZ IAS 19 <i>Employee benefits</i>
Related-party disclosure requirements	PBE IPSAS 20 <i>Related party disclosures</i>	NZ IAS 24 <i>Related party disclosures</i>

3.28 **Key management personnel** are people who have authority and responsibility for planning, directing, and controlling the activities of the organisation, directly or indirectly, including any director (executive or otherwise) of that organisation.<sup>14</sup>

**Employee benefits** are all forms of consideration given by an organisation in exchange for service rendered by employees.<sup>15</sup> **Termination benefits** are employee benefits payable as a result of either:

- an organisation's decision to end an employee's employment before the normal retirement date; or
- an employee's decision to accept voluntary redundancy in exchange for those benefits.<sup>16</sup>

13 Small public entities that can apply the *public benefit entity simple format reporting – accrual (public sector)* accounting standard or the *public benefit entity simple format reporting – cash (public sector)* have simpler disclosure requirements. However, it is likely that public organisations following these accounting standards will produce similar disclosures as larger public organisations.

14 Paragraph 9, NZ IAS 24 *Related party disclosures* and paragraph 4, PBE IPSAS 20 *Related party disclosures*.

15 Paragraph 8, NZ IAS 19 *Employee Benefits* and paragraph 8, PBE IPSAS 39 *Employee benefits*.

16 Paragraph 8, NZ IAS 19, *Employee benefits* and paragraph 8, PBE ISAS 39 *Employee benefits*.

- 3.29 In summary, the accounting standards require the disclosure of the total employee benefits made to key management personnel (senior staff) during the financial period.<sup>17</sup> The employer should review the requirements of the applicable accounting standards in detail and apply these to the individual circumstances.
- 3.30 Total employee benefits might include:
- salary and wages;
  - holiday pay, or time off in lieu;
  - employer's contributions to superannuation;
  - payment in lieu of notice;
  - redundancy compensation;
  - hurt and humiliation payments;
  - any other compensation;
  - legal or other fees; and
  - transfer of property (such as a vehicle).
- 3.31 Organisations applying NZ IAS 24 *Related party disclosures* must disclose key management personnel employee benefits in total and by category, one of which is termination benefits.<sup>18</sup> For other organisations, the total employee benefits paid to key management personnel is enough to comply with the accounting standards.<sup>19</sup>

<sup>17</sup> Paragraph 17, NZ IAS 24 *Related party disclosures* and paragraphs 34 and 35, PBE IPSAS 20 *Related party disclosures*.

<sup>18</sup> Paragraph 17, NZ IAS 24 *Related party disclosures*. If an entity is using the Reduced Disclosure Regime (Tier 2), key management personnel compensation is not required by category (see paragraph RDR 17.1). NZ IAS 19 *Employee benefits* provides detailed guidance on what is required to be included within each category.

<sup>19</sup> Legislative requirements may require additional disclosure of individual payments. If an entity does not disclose these, it is a breach of legislation, not non-compliance with generally accepted accounting practice.

## Common pitfalls

- 4.1 Public sector employers can encounter problems (financial penalties, public or political scrutiny, or poor audit outcomes) if they fail to follow a good process or do not have a principled basis for a severance payment. This Part gives some examples of the errors public sector employers sometimes make, which can be avoided by obtaining proper advice when necessary. The examples are drawn from real experiences but do not represent particular cases.
- 4.2 We discuss:
- promises of confidentiality; and
  - bundling payments together as a “tax-free” package.

### Promising confidentiality

- 4.3 Promising complete confidentiality in a settlement agreement is a common mistake. Complete confidentiality should not be promised because it will be overridden by the statutory disclosure requirements. Figure 3 provides examples of problematic promises.

**Figure 3**  
**Examples of promises to keep a severance payment confidential**

An employer negotiates a severance payment with a senior employee, including strict confidentiality terms. A member of Parliament and a local newspaper make requests under the Official Information Act 1982 about the events that lead to the departure.

Information other than the settlement agreement (which is generally withheld because the prejudice to individual privacy outweighs the public interest in disclosure) must be disclosed under the Official Information Act, which in effect breaches the confidentiality of the severance arrangement.

The former employee claims there has been a deliberate breach and seeks damages. The employer must spend legal fees on exchanges between lawyers, so that the employee understands that there is a legal requirement to disclose and no basis for issuing proceedings.

The better course of action would have been to explicitly include in the settlement agreement the limits to confidentiality. In some circumstances, the parties might agree that the settlement cannot be confidential.

An employee suspected of fraud is dismissed after a serious misconduct process. The employee raises a personal grievance and, because of a procedural flaw in the process, has an arguable basis for a personal grievance. A settlement is reached that includes a confidentiality clause. The fraud then becomes a criminal matter, and there is public and political outcry when the employer has to disclose that a severance payment was made.

This could have been better addressed as a non-confidential settlement, to make it plain that the payment was only for the procedural failing. Alternatively, if the failing was minor and the degree of employee fault high, the employer might have been better advised to defend any proceedings and pay any award made by the Employment Relations Authority or court.

In many such cases, the Employment Relations Authority or court determines that no payment is warranted.\*

\* See section 124 of the Employment Relations Act.

## Bundling payments together as a “tax-free” package

- 4.4 A common cause of problems is the “repackaging” approach to severance payments, under which the employer agrees to treat notice periods, payments for lost income, redundancy payments, or other contractual entitlements as tax-free compensation payments. This can appear fiscally neutral for the employer and, because PAYE is not deducted at source, it maximises the payment in the employee’s hands.
- 4.5 The risk of agreeing to pay an excessively large sum or contractual entitlements as a tax-free compensation payment is that the employer can subsequently be reassessed for PAYE, penalties, and interest.
- 4.6 There is a tendency for parties to expect that the settlement agreement will never be subject to scrutiny, but this is incorrect. The Inland Revenue Department can and does request access to Employment Mediation Services’ records of settlements, and has statutory powers to compel disclosure by employers and taxpayers of all forms of settlement agreement. The employer must then justify why a payment was made without tax being deducted. Auditors will also query apparently excessive severance payments.
- 4.7 There are many examples of repackaging arrangements that cause employers problems. Some public organisations have paid a senior employee the equivalent of between six months and a year’s salary, sometimes explicitly stating in the agreement that the amount represents “[x] months’ salary”. These arrangements will be scrutinised because the payments are potentially excessive and because some part of such a payment could be seen by the Inland Revenue Department as lost income or contractual notice periods and entitlements (from which PAYE should have been deducted).
- 4.8 MBIE’s mediators are aware of these matters and might guide parties during mediation to help ensure that the agreements reached can withstand scrutiny. However, the fact that a settlement agreement is signed by a mediator does not mean it is valid from a tax law point of view.

### **Figure 4** **Example of a severance payment that does not properly allow for tax**

An employee raises a personal grievance, challenging a restructuring process. The employer agrees to “re-package” the employee’s contractual redundancy entitlements as a tax-free compensation payment. The employer pays the employee the full amount of the payment, rather than the net amount after PAYE has been deducted.

The Inland Revenue Department requests a copy of the agreement, along with any background information. The Department concludes that the payment should have been taxed. The employer is compelled to pay PAYE on the payment, but cannot recover that from the employee. The employer also has to pay a penalty and interest. The result is that the settlement costs the employer considerably more than the original redundancy entitlement.