Liabilities for unused time off mount as pandemic lingers

During the pandemic, many employees have postponed using their allotted paid time off until COVID-related restrictions are lifted and safety concerns subside. This situation has caused an increase in accruals for certain employers. Here's some guidance to help evaluate whether your company is required to report a liability for so-called "compensated absences" and, if so, how to estimate the proper amount.

Balance sheet effects

Compensated absences include:

- Paid vacation,
- Paid holidays,
- Paid sick leave, and
- Other forms of time off earned by employment.

Accruals for compensated absences are classified as *other liabilities* on companies' balance sheets. The liability also creates a *deferred tax asset* equal to the accrual times the effective tax rate, because companies can't deduct paid time off until it's actually paid under U.S. tax law.

When to book an accrual

Before quantifying the compensated absences liability, review your company's policies and procedures related to paid time off. Does your company allow employees to *accumulate* unused paid time off, beyond year end, for use in future years? Does the company provide *vesting rights* to accumulated paid time off balances that require payout after employment is terminated? If you answered "yes" to either question, you may be required to record a compensated absences accrual.

Specifically, under U.S. Generally Accepted Accounting Principles (GAAP), employers should accrue a liability for an employee's right to receive compensation for a future absence if these four conditions are met:

1. The employee has earned the right to time off, but they've not taken that time off.
2. The employee's rights accumulate or vest.
3. It's probable that employees will exercise their rights to paid time off, triggering payment.
4. The employer can reasonably estimate the amount of benefits the employee will receive.

You also must consider applicable laws in the states and countries where your employees live. In some cases, these laws may supersede your company's policies and practices.

Calculating the accrual

For an employee who's paid *hourly*, the compensated absences liability equals the hourly pay rate times the number of hours per day times accumulated days off. The hourly rate includes benefits and employer taxes your company will incur while the employee isn't at work.

The calculation for a *salaried* employee involves dividing annual compensation (including benefits and employer taxes) by the number of days worked per year to arrive at the employee's daily pay rate. This amount is then multiplied by the accumulated days off.

You must also adjust the accrual for the probability that employees will fail to exercise their rights to accumulated time off. Often employers support this adjustment with historical data on how employees have behaved in the past.

Hidden costs

Mounting paid time off accruals have brought accounting issues related to compensated absences to the forefront. While companies don't want to report higher liabilities, there's also an intangible cost to consider: When employees forego time off, their well-being often suffers, which can lead to lower productivity and increased turnover. We can help you comply with the financial reporting requirements under GAAP, as well as brainstorm ways to remind employees about the importance of maintaining a healthy work-life balance.

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