Highlight

January 2024

Abolition of the MPF-LSP Offsetting Mechanism in Hong Kong

On 9 June 2022, the HKSAR Government announced the abolition of the use of accrued benefits derived from employers' mandatory MPF contributions in offsetting the Long Service Payment ("LSP") and Severance Payment ("SP") effective 1 May 2025 ("Transition Date").

Under the new legislation, employers would no longer be granted the right to adopt the existing mechanism for offsetting the post-transition portion of LSP/SP after the Transition Date. However, employers may continue to use the accrued benefits derived from employers' mandatory MPF benefits for offsetting the pre-transition portion of LSP/SP.

Eligibility and Calculation of LSP and SP:

According to the Employment Ordinance Chapter 57 of the HKSAR, the conditions and requirements of LSP/SP entitlement have been summarized below.

Entitlement	Long Service Payment	Severance Payment
Under a continuous contract	Over 5 years	Over 2 years
Conditions / Requirements	• The employee is dismissed not due to his/her serious misconduct; • The employee is dismissed not due to redundancy; • The employee's fixed-term employment contract expires without being renewed; • The employee dies during employment; • The employee resigns on the ground of ill health; • The employee, aged 65 or above, resigns.	• The employee is dismissed due to redundancy; • The employee's fixed-term employment contract expires without being renewed due to redundancy; • The employee is laid off.
Calculation	**Monthly-paid employee** *(Final monthly salary x 2/3) x Reckonable years of service **Daily-rated / piece-rated employee** *(Any 18 days' wages chosen by the employee out of his last 30 normal working days) x Reckonable years of service	
Notes	• *The sum should not exceed 2/3 of $22,500 (i.e. $15,000); • Service of an incomplete year should be calculated on a pro rata basis; • The maximum amount of LSP or SP is $390,000; • An employee will NOT be simultaneously entitled to both LSP and SP.	

WeValue Advisory Limited is a professional valuation advisory company. We provide valuation and valuation support for a variety of applications to business owners, senior management as well as other professional parties. Our valuation analysis serves different purposes, including financial reporting, corporate development transactions, strategic planning, tax planning, dispute support, etc.

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Calculation of LSP under the abolition of the MPF-LSP Offsetting Arrangement:

LSP Calculation (based on full time employment)		Can it be offset?		
Employment Period		Derived benefits from Employers' Mandatory MPF Contribution	Derived benefits from Employers' Voluntary MPF Contribution	Gratuities based on length of service
Employed and terminated before the transition date	Last full month's wage × 2/3 × years of service	Yes	Yes	Yes
Employed before the transition date but terminate after the transition date	**Pre-Transition portion** Last full month's wage preceding the transition date x 2/3 x years of service up to the transition date	Yes	Yes	Yes
	Post-Transition portion Last full month's wage preceding the end of contract x 2/3 x years of service after the transition date and up to the end of the contract	No	Yes	Yes
Employed and terminated after the transition date	Last full month's wage preceding the end of contract x 2/3 x years of service after the transition date and up to the end of the contract	No	Yes	Yes

At the same time, the Government has indicated that it would launch a scheme to subsidize employers for 25 years after the Transition Date on the LSP/SP payable by employers up to a certain amount per employee per year.

It is observed that many entities currently have limited or no disclosures about the LSP liability in their financial statements because many entities have accounted for the expected offset arising from the offsetting mechanism as a reduction of the LSP liability and the net LSP position may have been immaterial for their financial statements.

In light of the Employment and Retirement Schemes Legislation (Offsetting Arrangement) (Amendment) Ordinance 2022, the Financial Reporting Standards Committee of the Hong Kong Institute of Certified Public Accountants ("HKICPA") recommended that all entities reassess the accounting for the offsetting mechanism. A LSP assessment would be required to determine the extent of LSP liability, which involves sophisticated programming techniques to handle massive data and determine various actuarial and financial assumptions, so that the accounting provision for LSP obligations is made under the requirement of Hong Kong Accounting Standards ("HKAS") 19.

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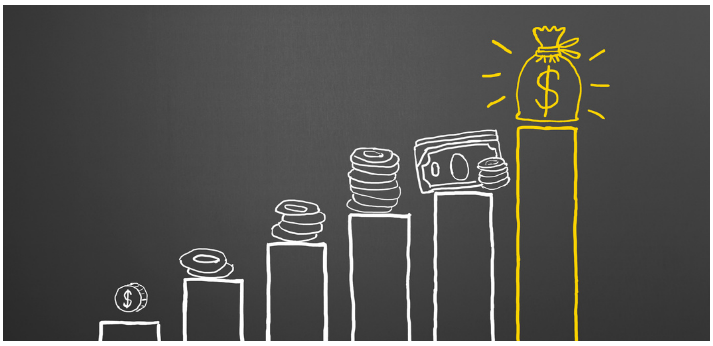

Actuarial and Financial Assumptions need to be considered in assessing the LSP Liability:

- Employee Turnover rate
- Annual salary adjustment rate
- Mortality rate
- Early retirement rate
- Disability rate
- Investment return rate
- Discount rate

Accounting Implications:

According to the educational guidance published on 4 July 2023 and “Financial Reporting Alert 44” issued on 22 February 2023 by HKICPA, employers may choose either one of the two approaches to account for LSP liability in reflection of the change.

Under Approach 1, employers’ portion of accrued benefits in MPF shall be accounted for as a reduction of the LSP liability, while the portion of LSP subject to offsetting mechanism before the Transition Date shall be deemed as a contribution towards the LSP. An immediate expense shall be recognized in the profit and loss during the exact date of the change.

Under Approach 2, instead of a direct offset of the employer’s contributions in MPF against the LSP, the contributions previously made shall be recognized as an asset, with subsequent remeasurement at fair value. As a result, the impact of the change in the LSP liability would be amortized on a straight-line basis over the period in which the LSP is earned throughout the period.

Under either Approach, nonetheless, employers would need to determine the present value of the LSP, which is estimated with the Projected Unit Credit Method. The table below compares the two approaches on steady state scenarios.

Comparison between Approach 1 and Approach 2:

Aspect	Approach 1	Approach 2
Employer MPF contributions	Expensed as incurred	Recognized as a reimbursement asset upon payment (cap at LSP liability), any further contributions are recognized as an expense
LSP – current service cost (P/L)	Same – both are recognized in P/L	
LSP – negative service cost (P/L)	Represents the deemed employee contribution to the LSP as if he is using ‘his own money’ to fund his own LSP benefits	N/A
Defined contribution plan expense (P/L)	Reflects the employer MPF contributions	Reflects the employer MPF contributions exceeding the amount of reimbursement asset that can be recognized to P/L
Defined benefit plan expense (P/L)	Smaller than approach 2 due to the deduction of negative service cost	Bigger than approach 1 as no negative service cost
LSP liability – defined benefit liability	Smaller than approach 2 as it is measured on a ‘net’ basis in that the amount is determined after deducting the negative service cost arising from the offsetable accrued benefits	Bigger than approach 1 as it is measured on a ‘gross’ basis in that the offsetable accrued benefits are recognized separately as a reimbursement asset
Reimbursement asset (B/S)	N/A	Represents the entity’s right to claim reimbursement from the MPF trustees for the offsetable accrued benefits when settling a LSP liability
LSP liability minus LSP-related assets	Generally bigger than approach 2; however,	Generally smaller than approach 1; however,
	Both will converge to the same amount at the time the LSP liability is expected to be settled	

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Projected Unit Credit Method:

According to HKAS 19 Employee Benefits, the Projected Unit Credit Method ought to be adopted in determining the present value of the LSP, current and past service costs of employees.

The Projected Unit Credit Method involves projecting each unit of benefit entitlement that is attributed to employees and then discounting these to arrive at the present value of the defined benefit obligation, as well as the related current and past service costs. The method generally involves the following steps in determining the LSP:

1. Determining the future LSP benefits

To determine the future benefits attributable to each employee, various actuarial assumptions (including employee turnover rates, mortality rate and future salary increment, etc.) shall be determined and adopted in the projection. The variables are generally not readily available and usually require a high degree of modelling and technical knowledge from valuation/actuary professionals.

2. Attributing LSP benefits to the relevant periods of services

After determining the future LSP benefits throughout the projected periods of services for each employee, the gross amount is then allocated to each period of service as a unit credit. As such, the LSP benefits earned by an individual is effectively spread over the relevant period during which employment services are provided to the employer.

3. Discounting the allocated LSP benefits to assessment date

After the allocation of LSP benefits to each relevant period, the benefits shall then be discounted back to a single value (generally to the assessment date) with a single discount rate. The discount rate, according to HKAS 19, shall generally be either the yield of high-quality corporate bond, or alternatively if such data is not reliable, the risk-free rate.

4. Attributing LSP benefits to the relevant periods of services

The current (past) service costs represent the increase in the present value of the LSP arising from the employment services provided by employees during the current (past) periods. The past service costs will be amortized on a straight-line basis over the remaining employment period of the employee, while the current service costs will be added to the LSP obligation balance during the relevant period.

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How WeValue can assist?

The process of LSP liability assessment involves sophisticated programming techniques to handle massive data and determine certain actuarial and financial assumptions, which vary greatly between different entities.

Our team of professional specialists is experienced in assisting clients in performing tailor-made LSP liability assessments. Please do not hesitate to contact us for more information.

WeValue Advisory Limited
21/F, 14 Taikoo Wan Road, Taikoo Shing, Hong Kong
Tel: +852 2196 2730
enquiry@wevalue.com.hk
www.wevalue.com.hk

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