TRANSACTION & VALUATION SERVICES

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Financial Impact of the Abolition of the MPF-LSP Offsetting Mechanism

On 9 June 2022, the Legislative Council approved the Employment and Retirement Schemes Legislation (Offsetting Arrangement) (Amendment) Ordinance 2022 (Amendment Ordinance). This ordinance abolishes (Abolition) the use of the accrued benefits from employer's mandatory contributions under the Mandatory Provident Fund (MPF) System to offset the severance payment (SP) and long service payment (LSP).

The HKICPA published an educational guidance on 4 July 2023 (Guidance), following the Financial Reporting Alert 44 issued on 22 February 2023. The Guidance discusses the accounting implications of the Abolition and proposes two corresponding accounting approaches.

While we believe the Guidance has explained the accounting matters comprehensively, this article presents 10 simple Q&As which address management's most concerned financial impact in a nutshell. For simplicity, no voluntary employer MPF contributions or gratuities are considered in the discussion below.

Q1: The Amendment Ordinance was about the abolition of the offsetting against the SP and LSP. Why most people talk about the accounting implications of the LSP only but not the SP?

SP is classified as 'termination benefits' for the purposes of HKAS 19 *Employee Benefits*. Unless an entity is committed to a termination and has a detailed formal termination plan, the recognition of SP would not be required.

Q2: Does this apply to other retirement schemes, e.g. Occupational Retirement Schemes Ordinance (ORSO)?

Yes, this applies to ORSO and other retirement schemes which are impacted by the enactment of the Amendment Ordinance. The principles and the accounting approaches discussed in the Guidance will be equally applicable to these other schemes.

Q3: Why LSP obligations are currently not often reported by entities or there are limited disclosures in their financial statements?

This is because most entities consider and assume the net LSP obligations might not significantly impact their financial statements due to the offsetting mechanism between accrued retirement benefits and the LSP. Following the Amendment Ordinance, such an assumption may no longer be valid and the offsetting mechanism needs to be accounted for explicitly.

Q4: When would entities begin to be impacted by the Amendment Ordinance?

The Abolition will officially take effect on 1 May 2025 (Transition Date). However, given the ordinance was enacted on 16 June 2022 (Enactment Date), the financial year that includes June 2022 will begin to be impacted.

Q5: What is the actuarial technique used to assess the ultimate cost to an entity for benefits accrued by employees in consideration of their services during both the current and preceding periods?

The projected unit credit method, as outlined in HKAS 19 is used. It involves the gradual accumulation of the defined benefit obligation (in our case, the LSP obligation) throughout the service period. Rather than accruing the entire amount in a single period, each year of employment service contributes a portion, i.e. service cost, to the eventual obligation.

Q6. What is the formula for calculating LSP according to the Employment Ordinance and Amendment Ordinance?

	(a)	(b)	(c) LSP
Monthly-paid employee	2/3 of last full month's wages immediately before termination of employment	Reckonable years of services	(a) x (b)
Daily-rated/piece-rated employee	Any 18 days' wages chosen by the employee out of his last 30 normal working days immediately before termination of employment	Reckonable years of services	(a) x (b)

Please note (a) should not exceed $15,000 and (c) should not exceed $390,000 according to the Employee Ordinance, both pre- and post- the Transition Date.

(c) is further divided into pre-transition LSP and post-transition LSP after the Transition Date, with pre-transition LSP being calculated using wages immediately preceding the Transition Date and post-transition LSP being calculated using wages immediately before termination of employment.

Q7: What are the major factors affecting the valuation of LSP obligations?

Determining the LSP obligation for an individual employee is contingent upon various factors, such as age, length of employment, and salary and its increment rate. At the entity level, actuarial considerations encompass company-wide metrics such as employees' resignation rates, dismissal rates, and employee mortality rates, all of which play a crucial role in valuing LSP obligations and impact the likelihood of the timing of LSPs to be made by the employer. It is also imperative to integrate anticipated interest rates/discount rates and investment returns on accrued benefits into the valuation process.

Q8: What are the primary differences between the two accounting approaches for the offsetting mechanism proposed in the Guidance?

An entity can choose from two accounting approaches, namely, Approach 1 and Approach 2. From our practical experience, the key differences between these two approaches from a management's perspective is that:

- Approach 1 reports LSP obligations on a net basis using an actuarial valuation method in accordance with HKAS 19; and

- Approach 2 reports LSP obligations on a gross basis and a separate reimbursement asset measured at fair value in accordance with HKAS 19 and HKFRS 13 *Fair Value Measurement*.

The two approaches distinguish how the employer's entitlement to accrued benefits from MPF contributions is characterised. Thus, it leads to variations in how recognition, measurement, presentation, and disclosure are reflected in an entity's financial statements.

Q9. What is the financial impact on the Enactment Date of the Amendment Ordinance?

There is a one-off adjustment to the LSP obligations determined by comparing the existing and revised LSP balances as at the Enactment Date. The magnitude and direction of the adjustment will depend on the selected accounting approach and other LSP valuation assumptions.

In the examples of the Guidance, Approach 2 results in a one-off decrement to the LSP balance as opposed to Approach 1, which results in an increment. This is primarily because pre-transition LSP is recalculated based on the last month's wages immediately preceding the Transition Date (which is comparatively lower than that of the termination of employment under the assumptions of the examples). However, in Approach 1, the corresponding impact is outweighed by the reduction in negative service costs, given the fact that mandatory employer MPF contributions may no longer offset post-transition LSP obligations.

Q10: What are the major differences between the financial impact of the two accounting approaches?

Both approaches are required to recognise LSP obligations on their financial position. Still, Approach 1 would report on a net basis, while Approach 2 would report on a gross basis plus a separate reimbursement asset. The LSP obligations under both approaches will converge to the same amount when the LSP liability is expected to be settled.

Other than financial position, there would be different impacts on the other comprehensive income of an entity. Unless a quantitative valuation exercise is performed, it is hard to compare and conclude the exact impact on the statement of comprehensive income for an entity under the two approaches. But in general, entities applying Approach 2 report a higher expense in subsequent years as compared to those applying Approach 1, especially when the accrued benefits from mandatory employer MPF contributions reach the pre-transition LSP amount.

Overall, we believe valuing LSP obligations is a challenging task. It involves building a sophisticated actuarial valuation model as well as making appropriate actuarial and valuation assumptions about the future. The above Q&As answer frequently asked questions by management and attempt to explain the key matter in a simple way. It does not aim to be complete and may contain omissions. Should you wish to assess the potential financial impact of the Amendment Ordinance, or the value of your LSP obligations for financial reporting purposes, please whatsapp +852-69389310 or contact our Director Kenneth Ma or our Senior Manager Calvin Wong.

Our Professional Service Team

KENNETH MA
Director

T +852 2738 4633
E kennethma@moore.hk

CALVIN WONG
Senior Manager

T +852 2738 4637
E calvinwong@moore.hk

For more information, please go to:
www.moore.hk/services/advisory/transaction-valuation

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