

Alert

Updates on financial reporting, auditing and ethics



Issue 44 (22 February 2023)

Accounting implications of the abolition of the MPF-LSP offsetting mechanism in Hong Kong

I. The Amendment Ordinance

1. The Government of the HKSAR gazetted the [Employment and Retirement Schemes Legislation \(Offsetting Arrangement\) \(Amendment\) Ordinance 2022](#) (the Amendment Ordinance) in June 2022.
2. The Amendment Ordinance abolishes the use of the accrued benefits¹ derived from employers' mandatory contributions to a Mandatory Provident Fund (MPF) to offset² severance payment (SP) and long service payment (LSP) (the offsetting mechanism; the abolition of the offsetting mechanism is referred to as the Abolition).³
3. This Amendment Ordinance has two effects:
 - (i) The accrued benefits derived from an employer's mandatory MPF contributions may no longer be used to offset LSP/SP in respect of the employment period after a date to be determined (the transition date; expected to be a date in 2025) (post-transition LSP); and
 - (ii) The last month's salary immediately preceding the transition date (instead of the date of termination of employment) is used to calculate the portion of LSP/SP in respect of the employment period before the transition date (pre-transition LSP).
4. At the same time, the government will launch a [scheme to subsidise employers](#) for a period of 25 years after the transition date on the LSP/SP payable by employers up to a certain amount per employee per year (Government Subsidy).

¹ Accrued benefits mean the accumulated MPF contributions plus returns generated less losses incurred.

² The term 'offset' and its derivatives used in this paper should be interpreted in terms of general parlance as opposed to how the term is applied in accounting standards (in terms of which offsetting is allowed only when specified criteria are met).

³ See Appendix for a summary of the offsetting mechanism and the changes introduced by the Amendment Ordinance. Furthermore, the Abolition is also applicable to various other retirement schemes apart from the MPF, e.g. ORSO; however, this Alert focuses on the interaction of the MPF and LSP as MPF is the most prevalent retirement scheme in Hong Kong. The principles discussed in this Alert apply equally to other retirement schemes that are subject to the Abolition.

II. Impact on Hong Kong companies

5. LSP has historically been accounted for as a defined benefit plan⁴ in accordance with HKAS 19 *Employee Benefits*. The measurement of the LSP liability is subject to actuarial assumptions and estimates. Historically, many companies have accounted for the offsetting mechanism as a reduction of the LSP liability and the net LSP position may have been immaterial for the financial statements of many companies. It is also observed that many companies currently have limited or no disclosures about the LSP liability in their financial statements.
6. In light of the Amendment Ordinance, the Financial Reporting Standards Committee (FRSC) has considered it necessary to reassess the situation. This is because the Abolition has a pervasive impact – it affects all companies that are subject to the LSP provisions of the Employment Ordinance and that are required to make mandatory MPF contributions – and the impact could be material depending on factors such as the composition and salary of an entity’s workforce.

III. Discussions since June 2022

7. Certain members of the FRSC have been discussing the accounting implication of the Amendment Ordinance since it was enacted. The FRSC has also formed a technical panel comprising key stakeholders that are familiar with the issue, including experienced technical specialists from large accounting firms, preparers and actuaries to deliberate the issue with the aim of producing timely guidance for the public. Nevertheless, due to the highly complex nature of the issue, the FRSC noted in its December 2022 meeting that it was ‘expected that a considerable amount of time would still be needed for the Committee to address this issue’.
8. One of the key complexities of the matter lies in the interaction between the employer MPF contributions (which have attributes of a defined contribution plan) and the entity’s LSP obligation (which has attributes of a defined benefit plan) when the two plans have different accounting models and there is no specific guidance in HKAS 19 on how to account for such an interaction. The Abolition coupled with the arrangement of the Government Subsidy have further complicated the matter.
9. In particular, there are diverging views on how the employer’s MPF contributions subject to the offsetting mechanism should be characterised in determining how to account for the interaction. A resolution of this question necessitated a detailed analysis of the historical development of the MPF and LSP legislations including a thorough review of the related government policy papers and communiques with the aim of obtaining clarity on the policy objectives of these legislations.
10. After multiple rounds of extended deliberations in earnest, two broad tentative approaches to analysing the issue have emerged, each of which requires further deliberation to address outstanding issues before it could be concluded as relevant and practicable in the circumstances.

⁴ SP is a termination benefit and is subject to different requirements under HKAS 19. It is not subject to the same level of actuarial assumption and estimation uncertainty as the LSP and is not covered in this Alert.

IV. The two tentative approaches

11. As the two tentative approaches characterise the nature of the employer's right to the accrued benefits arising from its MPF contributions differently, they would result in different recognition, measurement, as well as presentation and disclosure outcomes in an entity's financial statements. In particular, the two approaches could result in a different extent and direction of change to the LSP liability before and after the transition date.
12. Under the first approach, the amounts subject to the offsetting mechanism are viewed as deemed employee contribution towards the LSP and the offsettable MPF accrued benefits are accounted for as a reduction of the LSP liability.
13. Under the second approach, the amounts subject to the offsetting mechanism are viewed as a right for the employer to be reimbursed upon payment of the LSP, which results in the recognition of an asset under the defined benefit plan accounting. The asset is measured at fair value at the reporting date based on the composition of the MPF plan assets of the individual employees without taking into account any projection of future expected returns on the assets.

V. Publishing guidance

14. The rigorous debate around the accounting for the Abolition has shed new light on how the offsetting mechanism could be analysed. Details of the deliberation may therefore provide additional insights that could change an entity's understanding and application of the principles and requirements of HKAS 19, specifically how the interaction between the LSP and MPF could be accounted for under HKAS 19.
15. Accordingly, the FRSC considered it would be in the public interest to provide guidance to stakeholders to promote consistency when accounting for the Abolition and to provide an orderly transition for affected entities. The FRSC commits to continue deliberating the outstanding issues and to publish comprehensive guidance to stakeholders following due process.
16. The FRSC acknowledges that given the highly complex nature of this issue and the lack of specific guidance in extant literature, an entity should be entitled to sufficient time to determine its accounting policy and implement any necessary policy change when the final decision on the accounting is made by the FRSC (for example, an entity may need to obtain new information, estimates or adapt its systems to implement a change).⁵ Determining how much time is sufficient to implement the change is a matter of judgement that depends on an entity's particular facts and circumstances. Furthermore, consistent with Sue Lloyd's article titled [*Agenda decisions—time is of the essence*](#), an entity is not automatically considered to have an error simply because its current accounting for this issue is inconsistent with any further guidance that the FRSC is going to issue.


⁵ By analogy to the time allowed for entities to implement changes resulting from agenda decisions published by the IFRS Interpretations Committee (paragraph 8.6 of the [IASB and IFRS Interpretations Committee Due Process Handbook](#)).

17. In the meantime, entities would need to exercise judgement in determining an appropriate accounting policy for the Abolition based on relevant facts and circumstances. An entity should change its accounting policy only if the change would result in the financial statements providing reliable and more relevant information about the effects of the Abolition on the entity's financial position, financial performance or cash flows (paragraph 14(b) of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). If material, entities should provide relevant financial statements disclosures including significant judgements, accounting policies and any changes thereto. Entities should also seek professional advice where appropriate.

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Appendix

The offsetting mechanism

1. HK employers are obliged by law to:
 - a) make monthly contributions to a MPF for their employees to provide for the latter's retirement benefits; and
 - b) make a LSP to employees when they are dismissed by the employer (conditions apply), resign at age 65 or above or on grounds of ill health, or die.
2. An employer's mandatory MPF contribution is calculated as: 5%* employees' relevant income
 The contribution is capped at \$1,500/employee/month.
3. The LSP is calculated as: Last month's salary × 2/3 × no. of years of service
 Last month salary is capped at \$22,500. The amount of LSP payable per employee is capped at \$390,000.
4. The Employment Ordinance and the Mandatory Provident Fund Schemes Ordinance provide that an employer can offset the accrued benefits derived from an employer's MPF contributions against the LSP.

For example, assume an entity dismisses an employee and needs to pay him a LSP of \$100 applying the formula in point 3 above (i.e. before applying the offset). Assume further that the accrued benefits from the employer's MPF contributions to date for this employee is \$75. The employer only needs to pay the employee a LSP of \$25 and the employee can claim the remaining \$75 from the MPF trustee. Alternatively, the employer can pay the employee the full LSP of \$100 and claim a reimbursement of \$75 from the MPF trustee. No top-up needs to be made to the MPF trustee after the 'withdrawal' of the \$75 used as part-payment for the LSP.

Changes introduced by the Amendment Ordinance

5. The Amendment Ordinance introduces the following two key changes:

	Pre-amendment	Post-amendment
1st change The amount of accrued benefits derived from employer MPF contribution that may be used to offset LSP	Accrued benefits derived from both mandatory and voluntary contributions made by the employer before, on and after the transition date may be used to offset LSP	Accrued benefits derived from mandatory employer contributions may not be used to offset post-transition LSP <i>Note:</i> <ul style="list-style-type: none"> • <i>accrued benefits derived from mandatory employer contributions made pre-, on or post-transition may continue to be used to offset pre-transition LSP</i> • <i>accrued benefits derived from voluntary employer contributions and gratuities made pre-, on or post-transition may continue to be used to offset pre- and post-transition LSP</i>
2nd change Calculation basis for last month's salary	Last month's salary immediately before termination of employment	Pre-transition LSP: last month's salary immediately preceding the transition date Post-transition LSP: last month's salary immediately before termination of employment