Statement of Alternative Treatment (SoAT) on Reclassification of Debt Portfolio

Preface

Global and local supply disruptions caused by the COVID-19 pandemic have created colossal macroeconomic challenges to countries across South Asia. Rising energy and food prices are fueling inflation and magnifying import bills. Relief efforts and reduced tax revenues have worsened fiscal balances, while deteriorated balance sheets in the private sector have created financial sector vulnerabilities that are easily underestimated because short-term support measures by central banks have so far masked the weakening structure of many beneficiary firms. Due to the challenging macroeconomic environment, considerable inequalities have also emerged.

The impact of recent economic conditions is evolving rapidly, and its future effects are uncertain. Rapid change in the macro-economic factors would have an impact to the financial statements and a few are listed below (Please note that this is not an exhaustive list);

- Central Bank of Sri Lanka (CBSL) has allowed the floating of the Sri Lankan Rupee (LKR) and that greater flexibility in the exchange rate would be allowed to the markets. Floating of LKR has been affected immediately with LKR depreciation.
- The CBSL has significantly increased its policy rates and increased Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) by 700 bps resulting in increase in interest rates.
- The Colombo Consumers' Price Index (CCPI) has recorded Y-o-Y headline inflation as 39.10% and the National Consumers' Price Index (NCPI) recorded Y-o-Y headline inflation as 45.30% in May 2022.
- The CBSL, in its Monetary Policy Review dated 08th April 2022 stated that the Monetary Board after noting the inflationary pressures, driven by the build-up of aggregate demand, domestic supply disruptions, exchange rate depreciation and the elevated prices of commodities globally needs to be addressed through significant tightening of the Monetary Policy Stance to stabilize the economy.
- The Monetary Board decided to remove the already imposed maximum rates - caps imposed on lending interest rates applicable to credit cards, pre-arranged temporary overdrafts, and pawning facilities in order to facilitate the effective transmission of the policy adjustment. This would be resulted in increasing the cost of funds, thereby containing the expansion of money and credit; easing the pressure on the exchange rate; and containing the build-up of demand pressures in the economy among other expected results.
- The Ministry of Finance has announced the policy of the Sri Lankan Government to suspend normal debt servicing of all affected debts, for an interim period pending an orderly and consensual restructuring of those obligations in a manner consistent with an economic adjustment program supported by International Monitory Fund (IMF).
- Continuation of Debt Moratoriums which have a higher impact to the financials of Banks and Finance Companies.

Considering the above unprecedented changes in the macro-economic conditions, the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) has decided to issue the *"Statement of Alternative Treatment (SoAT) on Reclassification of Debt Portfolio".* This SoAT will provide a temporary practical expedient to permit the entities to reclassify the debt portfolio measured at Fair Value through Other Comprehensive Income (FVTOCI) to Amortised cost. This SoAT is applicable only to the debt portfolios currently classified as FVTOCI and should not be applied to portfolios classified as Fair Value through Profit or Loss.

Furthermore, in addition to the alternative treatment given in this SoAT, entities must continue to comply with all other provisions of the Sri Lanka Accounting Standards (SLFRSs/ LKASs).

Recommendation

As a result of recent unprecedented changes in the macro-economic conditions, a one off option (no further reclassification thereon) is provided to reclassify debt portfolio.

Accordingly, **the debt portfolio is reclassified to Amortised Cost from Fair Value through Other Comprehensive Income on the first day of the entity's next reporting period.**

Eg: If the entity has reported their financials as at 31st March 2022 to the public, then 01st April 2022 should be considered as the first day of the next reporting period.

References to SLFRS 9 *Financial Instruments* on Reclassification to Amortised Cost from Fair Value through Other Comprehensive Income

Extracts of Paragraph 5.6.5 of SLFRS 9

If an entity reclassifies a financial asset out of the Fair Value through Other Comprehensive Income and into the Amortised Cost**, the financial asset is reclassified at its fair value at the reclassification date.** However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at Amortised Cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment (see LKAS 1 *Presentation of Financial Statements*). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. *(See paragraph B5.6.1.)*

Extracts of Paragraph B5.6.1 of SLFRS 9

If an entity reclassifies financial assets in accordance with paragraph 4.4.1, paragraph 5.6.1 requires that the **reclassification is applied prospectively from the reclassification date**. Both the Amortised Cost and the Fair Value through Other Comprehensive Income require that the effective interest rate is determined at initial recognition. Both of those measurement categories also require that the impairment requirements are applied in the same way. Consequently, when an entity reclassifies a financial asset between the Amortised Cost and the Fair Value through Other Comprehensive Income:

(a) the recognition of interest revenue will not change and therefore the entity continues to use the same effective interest rate.

(b) the measurement of expected credit losses will not change because both measurement categories apply the same impairment approach. However if a financial asset is reclassified out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category, a loss allowance would be recognised as an adjustment to the gross carrying amount of the financial asset from the reclassification date.

Additional Requirements

The entities must also quantify and disclose the fair value gain or loss, carrying amount of the debt portfolio and the impact on the equity as at every reporting date, if the financial assets were continued in the Fair Value through Other Comprehensive Income measurement category without doing the reclassification permitted in this SoAT.