

STAFF PAPER

February 2021

IASB® meeting

Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Disclosures: Potential refinements—Priority on liquidation		
CONTACT(S)	Angie Ah Kun	aahkun@ifrs.org	+44 (0) 20 7246 6418
	Uni Choi	uchoi@ifrs.org	+44 (0) 20 7246 6933
	Riana Wiesner	rwiesner@ifrs.org	+44 (0) 20 7246 6412

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in the IASB® *Update*.

Purpose of this paper

1. In this paper the staff recap some of the key concerns raised and suggestions made by stakeholders on proposals related to information about priority on liquidation set out in the 2018 Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP) and then present potential refinements to address some of these concerns and suggestions. The staff also provide feedback from additional outreach conducted with stakeholders to discuss these potential refinements. Based on the additional feedback and the staff's analysis, the staff then present their views on the way forward.
2. This paper is structured as follows:
 - (a) 2018 DP proposal and feedback (paragraphs 3–5);
 - (b) potential disclosure refinements, which include a summary of feedback from further outreach with stakeholders (paragraphs 6–34);
 - (c) next steps (paragraph 35); and
 - (d) question for the Board (paragraph 36).

2018 DP Proposal and feedback

3. The Board's preliminary view was that disclosure of information about the priority of financial liabilities and equity instruments on liquidation of the entity, either in the statement of financial position or in the notes, would provide useful information to users of financial instruments. The objective of these disclosures was to help the users of financial statements assess how any potential surplus or deficit in economic resources and returns on liquidation will be allocated among claims—that is, to the extent that an entity has insufficient economic resources to satisfy the amount of a claim, which claim-holder bears the cost of a shortfall will depend on each claim's priority relative to other claims. This disclosure would provide information about the relative ranking of financial liabilities and equity instruments on liquidation of the entity and is not meant to depict the value of those instruments in a hypothetical liquidation.
4. The 2018 DP provided examples of information that an entity could disclose to meet the objective:
 - (a) a list of all financial liabilities and equity instruments in the order of their priority on liquidation of the entity and their carrying amounts or fair values;
 - (b) terms and conditions that apply on the liquidation of the entity for each group or category of financial liability and equity instrument; and
 - (c) the reason(s) for any changes in the priority of any group of financial instruments.
5. The following challenges were raised in the 2018 DP feedback:
 - (a) disclosure of information about liquidation on the face of the statement of financial position would clutter the statement of financial position and be inconsistent with preparing financial statements on a going concern basis. Therefore, disclosure in the notes is preferred.
 - (b) concerns over providing disclosure on a consolidated basis because the level of priority on liquidation is specific to individual entities.

- (c) laws often also affect the priority of claims, for example the application of insolvency and bankruptcy law could result in a different order of priority compared to the contractual terms of the respective instruments. The expected priority of claims in a bankruptcy situation could also change based on what is decided through negotiation between the entity and creditors.
- (d) requiring the fair value of financial instruments to be disclosed, would be costly, would not reflect the real distributions at liquidation and may present significant challenges for non-listed entities. Users of financial statements preferred the disclosure to be based on carrying amounts at the reporting date which tie back to the statement of financial position.
- (e) information can be misleading if non-financial liabilities are excluded. In some jurisdictions for example, obligations to tax authorities have a preferential status over other creditors.
- (f) information is unlikely to reflect the financial position at the point of liquidation which, in such a stressed situation, is likely to be very different from the current reporting date position.
- (g) in the context of a financial institution, financial regulation often requires a resolution process to take place before (or instead of) liquidation of the entity and this is often the trigger for loss absorption by the holder of some financial instruments, eg through a conversion to ordinary shares of the entity or a write down of the obligation. The usefulness of additional disclosures on resolution/liquidation would be limited if similar information is already required by regulators and disclosed in regulatory submissions, eg in Basel III Pillar 3 reports.

Potential disclosure refinements

6. Based on the feedback on the 2018 DP, the staff developed the following disclosure refinements for the additional outreach conducted in 2020:

- (a) priority information by individual entity (parent and each subsidiary that has issued financial instruments that are material to the group) with a reconciliation to the group consolidated amounts.
- (b) disclose carrying amounts of financial liabilities and equity instruments in the notes showing the order of priority on liquidation based on contractual terms.
- (c) disclose qualitative information about contractual terms and conditions affecting priority and details of any parent-subsiary guarantees or other intra-group arrangements.
- (d) proposed simplifications through narrative descriptions:
 - (i) if an entity is subject to regulation that specifies a resolution process (eg a bank), provide information about priority on that basis
 - (ii) if relevant, disclose the fact that legal priority on liquidation differs from contractual priority and the effect of this on liquidation (to the extent possible).
- (e) disclose the effect of non-financial liabilities and financial instruments scoped out of IAS 32 on the priority on liquidation (to the extent possible).

7. A simplified example of the potential disclosure refinements is as follows:

The following table shows priority of financial instruments on liquidation of each individual entity based on contractual terms of the instruments, disclosed in the notes to the consolidated financial statements.

Order of priority on liquidation	Company X (Parent)	Subsidiary A	Subsidiary B	Other group entities and amounts eliminated on consolidation	Consolidated
Carrying amount at reporting date (£'000)					
Trade payables	500	2,200	120	55	2,875
Bank loans	-	1,000	750	200	1,950
Medium-term notes	2,000	3,000	-	-	5,000
Perpetual bonds	3,500	5,000	-	-	8,500
Preference shares	2,000	-	-	-	2,000
Ordinary shares	15,000	10,000	7,000	(17,000)	15,000

- Entities within the group also have other liabilities that are not presented in the table, which are required to be settled in liquidation. They include tax liabilities and employee benefits. Tax and employee benefits are generally required to be settled prior to settlement of financial liabilities included in the table above.
- The order of priority in the event of liquidation is subject to bankruptcy law of the relevant jurisdiction. The actual order of payments may also be subject to negotiations amongst creditors, and may differ from contractual priority.
- The perpetual bonds issued by subsidiary A are guaranteed by Company X.

Disclosure on an individual entity basis versus consolidated basis

8. The staff observed that many of the concerns raised in relation to the 2018 DP proposals relate to the difficulties with, and the usefulness of, providing priority information on a consolidated basis. Doing so would require assuming the entire group will be liquidated at the same time, which is unlikely in real life. If a group was in financial distress, it is more likely that claims would be settled by disposing of assets, operations or investments in subsidiaries within the group. Disclosure on a consolidated basis would be complex in large groups with multiple entities as the claims are against different pools of assets within the group. Complexity also increases with the number of subsidiaries, the number of intragroup agreements and the need to consider structural subordination.
9. The staff have therefore sought views on whether providing the information about priority on liquidation on an individual entity level ie for the parent and each subsidiary that has issued material financial instruments, with a reconciliation to the group consolidated amounts will alleviate the concern.
10. Users of financial statements generally supported providing the disclosures on an individual entity level with a reconciliation to the amounts presented in the

consolidated financial statements. A few of them said that it is useful to know which entity within the group has issued a particular financial instrument.

11. Preparers and standard setters acknowledged the relevance of providing the disclosures on an individual entity level rather than on a consolidated basis but said that scoping was important. Most of them were concerned the requirement to disclose priority on an individual basis per subsidiary might be difficult and cumbersome especially for a large group due to the number of subsidiaries and potential volume of information that would need to be disclosed. A standard setter said that consolidated financial statements are not designed to provide separate information about the assets and liabilities of any particular subsidiary. Further, preparers questioned whether the instrument's materiality is considered at the subsidiary or the consolidated level.
12. The staff believe materiality should be assessed from the group perspective, ie financial instruments material to the consolidated financial statements. The staff think this will help alleviate the concern about the cost and complexity of this disclosure for a large group with numerous subsidiaries. As another simplification, the disclosures presented at the individual entity level should only include instruments that are held by parties external to the group. In addition, an alternative approach to provide a reconciliation to the consolidated financial statements could be for an entity to disclose the line item within which the particular financial instruments are included. The staff set out further analysis on the scope of this disclosure in the section below.

Scope

13. Some users of financial statements said it was very important to see the priority order and ranking of all instruments to assess the quality of capital on an individual entity level. Others acknowledged this information is more important to credit analysts and investors in distressed debt. An investor who believes such information is useful for analysing distressed debts questioned whether the focus should be on such a small part of the credit market for such a potentially large disclosure and said it would be important to restrict the scope so that the disclosure is relevant.

14. Some preparers suggested limiting the scope of the instruments, for example to only those that have a change in priority or change in contractual terms upon the occurrence of particular event such as liquidation. Some standard-setters questioned the usefulness of including short-term financial instruments such as trade payables.

15. As described in paragraph 3 of this paper, the objective of this disclosure is to enable users of financial statements to understand how an entity's shortfall in economic resources would be allocated amongst claims on liquidation of the entity. The staff acknowledge that such an objective would best be met by an entity providing a relative ranking of all claims against it. Therefore, by limiting the scope of disclosure to particular types of financial instruments, the resulting information might be less useful in understanding the priority of all claims. However, given the challenges in providing such extensive disclosures, the staff think the Board could consider possible approaches that would provide users of financial statements with information about priority on liquidation for particular types of financial instruments. Although such approaches may not meet the original objective of the intended disclosure, it could achieve a balance between the costs for preparers and the benefits to the users of financial statements.

16. If the Board wishes to explore potential ways to reduce the scope of the disclosure to particular types of financial instruments, it might be worth considering whether the Board should revise the objective of this disclosure to be more targeted.

17. In light of the feedback on the scope, the staff could consider and analyse possible approaches to limit the scope of this disclosure to particular types of financial instruments, using one of the following:
 - (a) financial instruments that can change priority on liquidation, or on the occurrence of a specified event, eg resolution.

 - (b) financial instruments other than ordinary shares (or the most residual claim against the entity) that are classified as equity. Assuming the information about priority is more useful for investors in relatively lower ranking-financial instruments, this approach aims to capture such financial instruments.

- (c) financial instruments that arise from financing activities as described by IAS 7 *Statements of Cash Flows*, which represents claims against the entity by providers of capital. This approach aims to exclude financial liabilities that arise from operating activities of the entity, which tend to be shorter-term. It should be noted that this approach would still result in a fairly board scope.
18. Another alternative could be to define the scope of financial instruments that are excluded from, rather than included in, the scope of the disclosure. This could be for example, excluding particular types of financial instruments for which the priority on liquidation is widely well understood such as trade payables, senior secured claims and ordinary shares.
19. The Board could also consider an approach that would provide the ranking by groups of financial instruments instead of by individual instruments or claims. For example, an entity would categorise financial liabilities and equity instruments into one of the following groups without ranking the instruments within each group: senior secured claims, senior unsecured claims, junior and subordinated claims and ordinary shares.

The effects of laws and regulations

20. Priority of claims on liquidation may be subject to the application of the laws and regulations in the relevant jurisdiction. To provide information on priority taking into account the legal framework relevant to each individual entity, the reporting entity may need to obtain legal opinions which potentially could be challenged in court by instrument holders. In light of the feedback that it would be challenging to incorporate uncertainties arising from legal effects in priority information, the staff considered how best to provide this information. The staff sought views on whether it would be useful to base the order of priority on contractual terms and as a simplification, provide narrative descriptions of the effects of laws and regulations on priority of financial instruments.
21. Some users of financial statements said narrative information would be useful, for example to understand how tax liabilities interact or legal participation. An

investor said that some narrative information may create more questions than being useful and if a debt contract is set up correctly, then subordination details should be in the legal basis of the contract.

22. Preparers and standard-setters generally said that priority disclosure should consider legal rights and obligations that are created by the contract. Some preparers and standard setters highlighted concerns regarding the cost and complexity of the disclosure if entities were required to obtain legal opinions and provide disclosures covering different scenarios where there is uncertainty over legal outcomes.
23. In the staff's view, the contractual priority should be in line with the applicable laws and the legal framework that the contract is subject to, and the disclosure should reflect such priority. However, the application of relevant laws or regulations may result in uncertainty in how the priority will be determined at liquidation. In such cases, entities should not be required to predict what legal outcomes at liquidation may be in providing this disclosure. The staff think that if relevant, an entity should disclose information about such uncertainty in preparing the disclosure. This will allow entities to prepare the disclosure without having to obtain legal opinions or predict the likely outcomes of bankruptcy court ruling. We think this will provide users of financial statements with sufficient information or at least a starting point from which they can perform further assessments.

Carrying amounts versus fair values

24. The 2018 DP noted that the Board discussed but did not reach a preliminary view on whether the amounts included for financial liabilities should be the carrying amounts presented in the statement of financial position, the fair value amounts required by IFRS 7, or both. Some feedback on the 2018 DP was received in favour of carrying amounts. The staff sought views on whether quantitative disclosures should be provided and if so, which measurement basis was preferred.
25. Most of the users of financial statements were in favour of providing carrying amounts rather than fair values taking into consideration that recoverable amounts

on liquidation would be impossible to determine with certainty at the reporting date. They find the carrying amounts useful because they will be able to tie them back to the financial statements.

26. Preparers also favoured carrying amounts over fair values. Some standard setters supported carrying amounts if amounts are required to be disclosed, citing the difficulty for entities to estimate fair values or recoverable amounts. However, some standard setters said they would prefer qualitative disclosures rather than quantitative disclosures. A preparer from the banking industry expressed a view that notional amounts should be disclosed because that is what may be written down in the case of a resolution event. The staff note that the BASEL III Pillar 3 disclosures requires notional amounts to be disclosed for its creditor ranking disclosure.
27. The staff are of the view that the disclosure should be provided based on the carrying amounts. Carrying amounts would help reconcile the amounts disclosed to the statements of financial position. Depending on the scope of this disclosure, the staff think that the disclosure could also be provided based on the notional amounts. Notional amounts would help understand the principal amount at risk and are used to calculate any coupons. We do not think the additional costs would be too burdensome because we note that companies often use the notional amount to identify the financial instruments issued, for example, €1,000 million Reset Perpetual Subordinated Notes. The staff will consider this aspect further as part of the scoping analysis.

Non-financial liabilities

28. In light of the feedback that information would be incomplete without considering non-financial liabilities (which are not within the scope of IAS 32), the staff sought views from stakeholders on providing narrative disclosures about the impact of non-financial liabilities and financial instruments which are scoped out of IAS 32 on the order of priority on liquidation.
29. An investor said that information on tax liabilities and employee benefits may be useful but may not be material in large institutions.

30. A few standard-setters said that priority information would still be incomplete if only narrative explanation is provided while other standard-setters were concerned providing disclosure on non-financial liabilities would be burdensome to preparers even if they are narrative explanation.
31. On balance, the staff are of the view that including non-financial liabilities and financial instruments which are scoped out of IAS 32 would add complexity and is beyond the scope of this project. The staff also note that priority of tax liabilities and employee benefits are a matter of law and not specific to an individual entity. Furthermore, if the Board decides to limit the scope of this disclosure to particular types of financial instruments, the staff do not think it would be useful to include information about non-financial liabilities while some financial liabilities would be excluded.

Financial institutions subject to a resolution regime

32. In light of the feedback on the 2018 DP highlighting that in the context of a financial institution, financial regulation often requires a resolution process to take place before (or instead of) liquidation of the entity, the staff sought views about providing priority information in the case of a resolution. In the case of a bank, the aim of resolution is to restructure a bank in order to safeguard public interests, including the continuity of the bank's critical functions and financial stability in the market. Losses are borne by banks' shareholders and creditors rather than by taxpayers.
33. A preparer said they appreciate that the staff have considered the resolution process for banks because it is relevant to disclose the terms of resolution. Another preparer questioned disclosure especially for unlisted entities in other sectors where resolution is not the only pre-liquidation process that affects ranking for example, change in control, insolvency, administration, etc.
34. Based on the feedback, the staff think it is more relevant for financial institutions to provide information about priority on a resolution basis rather than on a liquidation basis. If relevant, the disclosure should be made based on a resolution group rather than an individual entity. As mentioned in Agenda Paper 5A of this

meeting, some G-SIB banks provide disclosure of creditor ranking on resolution in their Basel III Pillar 3 reports so the information is already available on that basis. The staff will consider developing a principle to clarify when an entity should provide this disclosure on a basis other than at liquidation.

Next steps

35. Subject to the Board’s feedback provided in this meeting, the staff plan to further analyse some aspects of the disclosure set out in the previous section for the Board’s discussion at a future meeting. In particular, the staff plan to analyse potential ways to reduce the scope of this disclosure.

Question for the Board

36. The staff would like to ask the Board the following question.

Questions for the Board

Do Board members have any comments or questions on the staff’s analysis and views on potential disclosure refinements and next steps set out in this paper?