

## **Subsurface Rights – ASC 842 and IFRS 16 Convergence Gone Amuck**

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Companies across the globe have adopted – or will shortly be adopting – new lease accounting guidance promulgated by ASC 842, *Leases* or IFRS 16, *Leases*.

Although the FASB and IASB acknowledged that there were some differences between their respective leasing standards, the definition of what constituted a lease was thought to be converged. After all, the two Boards used nearly identical wording in ASC 842 and IFRS 16 when describing the types of contracts that should be accounted for as leases.

However, discussions at a recent IFRS Interpretations Committee (IFRIC) meeting highlighted that for certain fact patterns, international and U.S. practitioners may be interpreting the U.S. GAAP and IFRS guidance differently.

### **Subsurface Rights**

IFRIC discussed a fact pattern in which a pipeline operator obtains the right to place a pipeline underneath agricultural land for 20 years. In exchange, the pipeline operator will make monthly payments to the land owner.

The contract specifies the exact location and dimensions – including the pathway, width, and depth – of the underground space where the pipeline will be placed. The land owner retains the right to use the agricultural land (surface area) above the pipeline but the pipeline operator holds all decision-making rights over the use of the specified subsurface space during the term of the contract. For example, the pipeline operator has the right to perform inspection and maintenance work, as well as replace damaged sections of the pipeline, whenever necessary.

### **IFRIC View**

IFRIC determined that the contract described in the fact pattern meets the definition of a lease in IFRS 16.

Of note, IFRIC concluded that the underground space represents an **identified asset**. This because the underground space is physically distinct from the remainder of the land, as the contract specifies the location, width and depth of the pipeline.

Additionally, the land owner does not have the right to substitute the underground space throughout the term of the contract.

IFRIC also determined that the customer had the right to obtain substantially all the economic benefits from the use of the identified underground space during the contract term (i.e., via operating the pipeline that will be buried in that space). Finally, the customer has the “right to operate the asset”, as it was granted all decision-making rights over the use of the specified subsurface space during the term of the contract.

Importantly, IFRIC established that the underground space identified in the contract is a **tangible asset**. This means that none of the scope exceptions in IFRS 16 would apply, including the prohibition against intangible assets being the subject of a lease.

### **Diversity in Accounting under US GAAP**

In contrast, certain U.S. GAAP practitioners do not believe that the conveyance of subsurface rights represents a lease under ASC 842.

Similar to IFRS, ASC 842 does not apply to licenses of intangible assets. But unlike the conclusions reached by IFRIC, some U.S. GAAP experts feel that subsurface rights may in fact be an intangible asset and therefore excluded from the scope of ASC 842. In an April 2018 publication, PwC indicates that many arrangements that provide for underground or subsurface rights are similar to **air-use rights** – which are specifically identified as an example of an intangible asset under ASC 805, *Business Combinations*. PwC elaborates that “rights to any spaces that cannot be inhabited or accessed by human beings, such as air rights or rights to construct a pipeline underground, could be accounted for as intangible assets outside the scope of ASC 842”.

Others believe that the subsurface space cannot be separated from the land above it. That is, the underground space subject to the contract cannot be a **unit of account** by itself because – for example – it cannot be accessed without also accessing the surface land. Under this view, the pipeline operator would not have the ability to control the entire asset under the contract, as the land owner retains surface rights. This means that the contract conveying the subsurface rights to the pipeline operator would not be considered a lease.

Not all U.S. GAAP practitioners share these views. Some U.S.-based IFRIC members appear to support the overall conclusion reached by IFRIC. At this time, it is uncertain whether U.S. standard setters will provide additional guidance on this topic, and it is expected that continued diversity in practice – and differences with IFRS – may result.