IFRS

STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Subsurface Rights (IFRS 16)**		
Paper topic	Initial Consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about whether IFRS 16 *Leases*, IAS 38 *Intangible Assets* or neither Standard applies in accounting for a particular contract for subsurface rights. Based on the contract terms and conditions, a pipeline operator obtains the right to place a pipeline underneath agricultural land for 20 years in exchange for payments to the land owner.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) outreach;

(c) staff analysis; and

(d) staff recommendation.

4. There are two appendices to this paper:

(a) Appendix A—proposed wording of the tentative agenda decision.

(b) Appendix B—submission.

Background information

The fact pattern

5. In the fact pattern described in the submission, a pipeline operator (entity) enters into a contract with a farmer for the right to place its underground crude oil pipeline underneath agricultural land. The terms and conditions of the contract are as follows:

(a) the entity obtains the right to place a crude oil pipeline in underground space (subsurface right) for 20 years.

(b) the contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed.

(c) the entity is obliged to make upfront and annual payments to the farmer.

(d) only the entity can access the pipeline, and the underground space within which it will be placed, throughout the 20-year contractual term. The farmer retains the right to use the agricultural land (surface area) above the pipeline but has no decision-making rights over the use of the underground space specified in the contract throughout the contractual term.

(e) the entity has the right to perform inspection, repairs and maintenance work and replace damaged sections of the pipeline when necessary.

6. The submitter asks whether the entity applies IFRS 16, IAS 38 or neither of these Standards in accounting for the contract.

   (a) Appendix A to IFRS 16 defines a lease as:

      A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

   (b) Paragraph 8 of IAS 38 defines an intangible asset as:

      An identifiable non-monetary asset without physical substance.

7. Based on the definition of a lease in IFRS 16 and the definition of an intangible asset in IAS 38, the submitter has identified four different views:

   (a) **View 1:** The contract contains a lease (and thus IFRS 16 applies) on the grounds that:

      (i) there is a physically distinct identified asset (the underground space occupied by the pipeline);

      (ii) the entity has the right to obtain substantially all the economic benefits from use of the identified asset; and

      (iii) the entity has the right to direct the use of the identified asset.

   (b) **View 2:** The contract does not contain a lease, and IAS 38 applies. According to this view, the identified asset in the contract is a vertical slice of land (including the surface area used by the farmer). Consequently, the contract does not contain a lease on the grounds that the entity has neither:

      (i) the right to obtain substantially all the economic benefits from use of the identified asset; nor

      (ii) the right to direct the use of the identified asset.

      Applying this view, the entity concludes that the subsurface rights meet the definition of an intangible asset in IAS 38 and therefore applies IAS 38 in accounting for those rights.

   (c) **View 3:** The contract meets neither the definition of a lease in IFRS 16 nor that of an intangible asset in IAS 38. The entity therefore accounts for the contract as a service. The submission supports this view by saying only that the provision of access rights is a service—there is no reference to requirements in IFRS Standards in support of this view.

(d) **View 4:** The accounting for subsurface rights is an accounting policy choice. According to this view, IFRS 16 does not specifically address unit of account for the identified asset in contracts for underground space. Consequently, it is unclear whether the entity considers:

(i) only the area of underground space occupied by the pipeline; or

(ii) a vertical slice of land that includes the surface area above the pipeline.

8. Appendix B to this paper reproduces the submission and provides further details regarding each of the views.

Outreach

9. We decided not to perform outreach on this request for a number of reasons:

(a) Through informal research and consultation, we are aware that entities (particularly in the oil and gas, mining, telecoms and utilities industries) enter into contracts that contain subsurface rights. Those contracts can have long contractual terms. Consequently, we are already aware that the fact pattern is widespread and that, if there are differing reporting methods, they could have a material effect on those affected.

(b) The question mainly relates to the application of the definition of a lease in IFRS 16. For this reason, we considered it to be urgent in nature and thus proceeded to bring it to the Committee's March 2019 meeting. In addition, in the light of the effective date of IFRS 16 (annual reporting periods beginning on or after 1 January 2019), there is likely to be little observable practice at this time. The definition of a lease requirements in IFRS 16 are not the same as those in IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease*. In particular, IFRS 16 includes requirements regarding portions of a larger asset, whereas IFRIC 4 explicitly stated that ‘this Interpretation does not address how to determine when a portion of a larger asset is itself the underlying asset for the purposes of applying IAS 17’. Accordingly, practice applying IAS 17 and IFRIC 4 may not be the same as that applying IFRS 16 for the fact pattern described in the submission.

Staff analysis

Which Standard does an entity consider first?

10. In the light of the differing views described in the submission, it is important to assess which Standard an entity considers first—ie does an entity consider IFRS 16 or IAS 38 first?

11. Paragraph 3 of IFRS 16 requires an entity to apply the Standard to all leases, with limited exceptions. Furthermore, paragraph 9 of IFRS 16 states:

> At inception of a contract, an entity shall assess whether the contract is, or contains, a lease...

12. Consequently, we think the entity is required to consider whether the contract described in the submission meets the definition of a lease in IFRS 16. If the contract contains a lease, the entity applies IFRS 16 (see paragraph 13 below). If the contract does not contain a lease, the entity then considers which other Standard applies (including whether IAS 38 applies).

13. In our view, none of the scope exceptions in paragraphs 3 and 4 of IFRS 16 apply to the fact pattern described in the submission. The contract in the submission gives the entity rights to underground space within which a crude oil pipeline will be placed. The contract does not give the entity:

    (a) rights to explore for or use oil (paragraph 3(a) of IFRS 16);

    (b) rights to biological assets (paragraph 3(b) of IFRS 16);

(c) a service concession arrangement (paragraph 3(c) of IFRS 16)[1];

(d) rights held under a licensing agreement (paragraph 3(e) of IFRS 16); or

(e) rights to an intangible asset (paragraph 4 of IFRS 16). The underground space is tangible.

14. Consequently, if the contract contains a lease, the entity applies IFRS 16.

15. The staff analysis below adopts this approach. Consequently, our first step in analysing the fact pattern described in the submission is to apply the definition of a lease in IFRS 16.

Applying the definition of a lease

16. Paragraph B9 of IFRS 16 sets out application guidance on the assessment of whether a contract is, or contains, a lease. The paragraph states:

> To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:
>
> (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and
>
> (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

17. Accordingly, applying the definition of a lease in IFRS 16, an entity assesses the following:

(a) Is there an identified asset? (Paragraphs 18–26 of this paper)

[1] The scope exception in paragraph 3(d) of IFRS 16 applies only to lessors; this paper discusses the accounting applied by the customer (possible lessee).

(b) Does the customer have the right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use? (Paragraph 27–30 of this paper)

(c) Does the customer have the right to direct the use of the identified asset throughout the period of use? (Paragraphs 31–37 of this paper)

Is there an identified asset? (paragraphs B13 –B20 of IFRS 16)

18. The first element of the lease definition in IFRS 16 is that an underlying asset must be identified. Paragraph B13 states:

> An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

19. In the fact pattern described in the submission, the underground space occupied by the pipeline is explicitly specified in the contract, including its exact location and physical dimensions (path, width and depth).

20. The explicitly defined underground space however represents only a portion of the land owned by the farmer. Paragraph B20 of IFRS 16 requires an entity to assess whether a portion of an asset is physically distinct.

21. Paragraph B20 of IFRS 16 states (emphasis added):

> *A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building).* A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

22. Paragraph BC116 explains the Board's rationale when developing the requirements in paragraph B20:

> IFRS 16 also clarifies that an asset must be physically distinct to be an identified asset. The IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20 per cent capacity portion of a pipeline). The customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level. Widening the notion of an identified asset to possibly capture portions of a larger asset that are not physically distinct might have forced entities to consider whether they lease assets used to fulfil any contract for services, only to conclude that they do not. Consequently, the IASB concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit.

23. Applying the requirements in paragraph B20, we think that the underground space is physically distinct from the remainder of the farmer's land because the contract specifies the exact space that the pipeline will occupy. The contract's specifications include the path, width and depth of the pipeline, thereby defining a 'physically distinct' underground space.

24. We think the defined underground space is physically distinct in exactly the same way that an underground carpark space or an underground retail space is physically distinct. Similarly, a defined area of space on the surface of land would be physically distinct from the remainder of the land (including subsurface space). The space being underground (as opposed to on the surface of the ground) does not in isolation change whether there is an identified asset. Accordingly, in the fact pattern described in the submission, we conclude that the physically distinct underground space occupied by the pipeline is an identified asset.

Substantive substitution rights

25. Paragraph B14 of IFRS 16 states that, even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A right to substitute an asset is substantive only if the supplier has the practical ability to substitute alternative assets and would benefit economically from the exercise of its right to substitute.

26. In the fact pattern described in the submission, we think the farmer does not have a substantive substitution right. This is because the farmer does not have the practical ability to substitute alternative assets. The practical ability to substitute may exist if, for example, the farmer were permitted (and had the practical ability) to divert or change the path of the pipeline (ie change the specified underground space) throughout the period of use. However, in the fact pattern described in the submission, the path, width and depth are determined in the contract and the farmer has no right to access the pipeline or the underground space throughout the period of use. Consequently, applying IFRS 16 to the fact pattern submitted, we conclude that there is no substantive substitution right that would prevent the entity from having the right to use the underground space.

Does the customer have the right to obtain substantially all the economic benefits from use of the asset throughout the period of use? (Paragraphs B21-B23 of IFRS 16)

27. Having established that there is an identified asset, the entity considers whether it has the right to control the use of the asset for a period of time (paragraph B9 of IFRS 16).

28. The entity first assesses whether it has the right to obtain substantially all the economic benefits from use of the defined underground space throughout the 20-year period of use. The assessment is limited to the identified asset being only the defined underground space and not the entire area of land (or any other portion thereof).

29. Paragraph B21 states:

> To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for

> example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

30. Applying this paragraph, we think the entity has the right to obtain substantially all the economic benefits from use of the defined underground space throughout the 20-year period of use. This is because the entity has exclusive use of the defined underground space throughout that period. Based on the fact pattern submitted, the farmer has neither access to the pipeline nor the right to change the entity's use of the defined underground space throughout the 20-year period of use.

Does the customer have the right to direct the use of the identified asset throughout the period of use? (Paragraphs B24-B30 of IFRS 16)

31. Finally, the entity considers whether it has the right to direct the use of the identified asset throughout the period of use. Paragraph B24 of IFRS 16 sets out a framework for an entity to make that assessment. Paragraph B24 states:

> A customer has the right to direct the use of an identified asset throughout the period of use only if either:
>
> (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or
>
> (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
>
>> (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or

(ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

32. Accordingly, the entity could have the right to direct the use of the defined underground space in a number of ways—either (i) by having the right to change how and for what purpose the underground space is used throughout the period of use (paragraph B25); or (ii) if the relevant decisions about how and for what purpose the underground space is used are predetermined, by having the right to operate the underground space throughout the period of use, without the farmer having the right to change those operating instructions.[2]

33. Identifying a lease, including identifying the relevant decisions about how and for what purpose an asset is used, depends on the particular facts and circumstances of the contract. The assessment requires consideration of all contractual terms and conditions, and we are aware that contracts for subsurface rights can take different forms giving the parties to the contract differing decision-making rights. It is important to consider not only the customer's decision-making rights but also those of the supplier. If the supplier has no ability to make any decisions about the use of the identified asset throughout the period of use and the customer can make such decisions, then the customer has the right to direct the use of the asset throughout the period of use. This is regardless of whether the customer's decision-making rights relate to changing how and for what purpose the asset is used or relate to operating the asset throughout the period of use.

34. In the fact pattern described in the submission, the identified asset (defined underground space) is used to hold the pipeline, which transports crude oil to the entity's customer(s).

[2] The entity has not designed the underground space and therefore paragraph 24(b)(ii) is not applicable in the fact pattern described in the submission.

35. Based on the simplified facts described in the submission, we think the relevant decisions about how and for what purpose the asset is used are predetermined on the grounds that:

(a) the location and dimensions of the pipeline (path, width and depth), which determine the pipeline's operating capacity, are determined in the contract;

(b) the contract specifies that the pipeline occupying the underground space will transport crude oil for the duration of the contract. Consequently, decisions about how the defined underground space will be used are predetermined; and

(c) the entity has the right to perform inspection, repairs and maintenance work and replace damaged sections of the pipeline when necessary—we view this right as a right to operate the asset, and not a right to change how and for what purpose the asset is used. Paragraph B27 of IFRS 16 states that 'examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating or maintaining the asset'. No other party is permitted to access the pipeline or make decisions about the use of the defined underground space throughout the 20-year period of use. Consequently, neither the entity nor any other party has the ability to change how and for what purpose the underground space is used throughout the period of use.

36. We think the entity has the right to operate the asset throughout the period of use (without the farmer having the right to change those operating instructions) on the grounds that:

(a) the entity has the right to perform inspection, repairs and maintenance work and replace damaged sections of the pipeline when necessary. We view the entity's right to maintain the pipeline occupying the defined underground space as a right to operate the asset as described in paragraph B24(b)(i) of IFRS 16. Paragraph B27 states that 'rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph B24(b)(i))'; and

(b) the farmer can neither access the pipeline nor make any other decisions about the use of the underground space throughout the period of use.

37. Accordingly, we conclude that the entity has the right to direct the use of the underground space because the requirements in paragraph B24(b)(i) are met.

Staff Conclusion

38. In the fact pattern described in the submission, we conclude that:

(a) the defined underground space occupied by the pipeline is an identified asset because:

(i) it is explicitly specified in the contract;

(ii) it is physically distinct from the remainder of the farmer's land; and

(iii) the farmer has no substantive substitution rights.

(b) the entity has the right to control the use of the defined underground space (ie the identified asset) throughout the 20-year period of use because:

(i) the entity has the right to obtain substantially all of the economic benefits from use of the underground space throughout the 20-year period of use. The entity has exclusive use of the underground space (and the associated pipeline) throughout the period of use.

(ii) the entity has the right to direct the use of the underground space because the requirements in paragraph B24(b)(i) are met. The relevant decisions about how and for what purpose the asset is used are predetermined, and the entity has the right to operate the asset throughout the 20-year period of use, without the farmer having the right to change those operating instructions.

39. Therefore, the contract described in the submission meets the definition of a lease in IFRS 16, and no scope exclusion applies as discussed in paragraph 13 of the paper. Accordingly, the entity applies IFRS 16 in accounting for the lease.

40. Importantly, we highlight that we reached this conclusion considering the particular facts and circumstances of the contract described in the submission. Differing terms and conditions could result in a different conclusion. As noted within the objective of IFRS 16 (paragraph 2 of IFRS 16):

> An entity shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

Question 1 for the Committee
Does the Committee agree with our analysis of the application of IFRS 16 to the fact pattern described in the submission, summarised in paragraphs 38–40 of the paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[3]

41. Based on our analysis, we think the requirements in IFRS 16 provide an adequate basis for an entity to determine whether a contract for subsurface rights is, or contains, a lease, and accordingly whether it applies IFRS 16 in accounting for the contract.

Staff recommendation

42. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 41 of this paper), we

[3] Paragraph 5.16(b) of the *Due Process Handbook.*

recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend that the Committee publish an agenda decision that explains how an entity applies the requirements in IFRS 16 to the fact pattern described in the submission.

43. Appendix A to this paper outlines the proposed wording of the tentative agenda decision. In the tentative agenda decision, we have focussed on what we view as the main aspect of the question submitted—ie whether the defined underground space is physically distinct. Many of the illustrative examples accompanying IFRS 16 illustrate the assessment of whether the customer has the right to control the use of an asset; accordingly, we see little benefit in discussing this aspect of the analysis of the specific fact pattern submitted. However, only one illustrative example explicitly illustrates a physically-distinct portion of a larger asset, and thus we view it as helpful to provide explanatory material in this respect. Focussing on only that aspect of the question also avoids answering a highly-specific fact pattern when we think it is not needed to achieve a common understanding of the definition of a lease in IFRS 16.

Questions 2 and 3 for the Committee

2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A—Proposed wording of the tentative agenda decision

Subsurface Rights (IFRS 16 *Leases*)

The Committee received a request about a particular contract for subsurface rights.

In the contract described in the request, a pipeline operator (customer) obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The land owner retains the right to use the surface area of the land above the pipeline, but has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use.

In assessing whether the contract contains a lease, the request asked whether the specified underground space is an identified asset as described in paragraphs B13-B20 of IFRS 16.

Paragraph 9 of IFRS 16 states that a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Consequently, a necessary element of the definition of a lease is that there is an identified asset.

Paragraphs B13-B20 of IFRS 16 provide application guidance on an identified asset. Paragraph B20 states that a capacity portion of an asset is an identified asset if it is physically distinct. An asset is not an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use (paragraph B14).

In the contract described in the request, the Committee observed that the specified underground space is physically distinct from the remainder of the land. The contract's specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. That space being underground does not in isolation change whether it is an identified asset—the specified underground space is physically distinct in the same way that a specified area of space on the surface of land would be physically distinct.

The land owner does not have the right to substitute the underground space throughout the period of use. Consequently, the Committee concluded that the underground space specified in the contract is an identified asset as described in paragraphs B13-B20 of IFRS 16.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine whether the contract described in the request conveys the right to use an identified asset. Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.

Appendix B—Submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

The issue:

Application of IFRS 16 *Leases* or IAS 38 *Intangible Assets* to subsurface rights

Scenario:

A pipeline operator enters into a contract with a farmer to situate an underground pipeline through a field to transport crude oil for 20 years and is obliged to make upfront and annual payments to the farmer. The contract specifies the path that the pipeline will take including the width of the pipeline and the depth at which it is situated. No one except the pipeline operator is permitted access to the pipeline, but the farmer can use the land above it for farming or other purposes. The pipeline operator has the right to perform inspection, repairs and maintenance work and replace damaged sections of the pipeline where necessary.

Question:

Does IFRS 16 or IAS 38 apply in this arrangement?

View 1: The arrangement contains a lease and IFRS 16 applies.

Proponents of this view believe that underground space by itself can be an identified asset for the purpose of IFRS 16, similar to designated underground carparks or storage areas. In this case, the underground space which is exclusively accessed by the pipeline operator is explicitly referred to in the contract and is physically distinct from the rest of the underground space. Since the underground space is defined, there is physical substance and, thus, it is a tangible asset and not an intangible asset.

The pipeline operator's right to access the land to perform inspection, repairs and maintenance work, and replace damaged sections of the pipeline where necessary (surface right in respect of the land) is non-exclusive in nature, since the farmer can use the surface of land for farming or other purposes. The surface right does not give rise to a lease of the land as the non-exclusive surface right does not derive substantially all of the economic benefits from use of the land surface under IFRS 16.B21. The surface access right is a non-lease component and thus, in accordance with IFRS 16.15, should be accounted for outside IFRS 16 by applying other applicable standards.

IFRS 16.B22 requires an entity to consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset when assessing the right to obtain substantially all of the economic benefits from use of the asset. Given that the contract allows the pipeline operator to situate an underground pipeline in the defined space and the pipeline operator will have exclusive access to the defined space to install a pipeline to transport crude oil, the pipeline operator obtains substantially all of the economic benefits of the defined space.

Since the scenario does not provide for any substitution rights, it is not necessary to evaluate if substantive substitution rights exist in this case. Hence the requirement in IFRS 16.B9(a) is met.

Under IFRS 16.B25, a customer has the right to direct how and for what purpose the asset is used if it can change how and for what purpose the asset is used throughout the period of use within the scope of its right of use as defined in the contract. In making this assessment, an entity is required to consider the decision-making rights which are most relevant in affecting the economic benefit to be derived from use. The pipeline operator can change its decisions throughout the period of use about whether to transport crude oil along the pipeline and the volume of crude oil to be transported along the pipeline. If the pipeline operator operates a network of pipelines for a number of customers, it can also decide which customer will receive the crude oil. This means that the pipeline operator has the right to direct how and for what purpose the defined space in which the pipeline is situated is used[4]. It follows that the requirement in IFRS 16.B9(b) is met.

It is further observed that the right to perform inspection, repairs and maintenance work and replacement of damaged sections of the pipeline are not the most relevant decision-making

[4] In this fact pattern, the pipeline operator is able to change the relevant decisions about how and for what purpose the defined underground space is used. There may be other fact patterns in which, throughout the period of use, the relevant decisions about how and for what purpose the defined underground space is used could be predetermined. In these situations, the pipeline operator has the operating right of the defined underground space as it controls the pipeline which occupies all the defined underground space. The farmer is not allowed access to the pipeline and is unable to change any operating instructions. It follows that IFRS 16.B24(b)(i) is met and thus the pipeline operator also has the right to direct the use of the defined underground space under these circumstances.

rights in assessing whether the pipeline operator has the right to direct the use of the defined space.

In conclusion, as the requirements in both IFRS 16.B9(a) and B9(b) are met, the arrangement conveys the right to control the use of the defined space for 20 years pursuant to IFRS 16.9 and thus contains a lease.

View 2: The arrangement does not contain a lease and is accounted for as an intangible asset under IAS 38.

Proponents of this view believe that the pipeline occupies space underground which cannot be separated from the land above. Thus, the underground defined space cannot be a unit of account by itself and the unit of account should include both the underground space and the surface of the land. When assessing whether the pipeline operator obtains substantially all the economic benefits from the land access right throughout the period of use, it is necessary to consider whether the pipeline operator can realistically obtain substantially all the economic benefits from the use of the land as a whole.

The farmer will be able to use the surface of the land for farming or other purposes (except for accessing the pipeline), and use the other subsurface space not occupied by the pipeline. In some cases, the pipeline operator does not obtain substantially all of the economic benefits from the land as most of the economic benefits related to the land still belong to the farmer. These economic benefits may include agricultural produce, proceeds from the use of the remaining underground space or from sale or lease of the land or underground space or components thereof. The benefits from the exclusive access rights to the defined underground space only represent a relatively small portion of the total economic benefits that can be derived from the land. Hence, in this situation, IFRS 16.B9(a) is not met.

In other cases, the exclusive access rights to the defined underground space are worth much more than any other benefits from use of the land and thus the pipeline operator is able to obtain substantially all the economic benefits from the land, and thus IFRS 16.B9(a) is met. However, since the farmer can continue to use the surface for farming or other purposes, could sell or lease the surface of the land separately, or could grant access to other areas of underground space (e.g. to other utility providers), the farmer's lack of access to the underground pipeline does not significantly affect how and for what purpose the land is used throughout the period of use, as long as it does not affect the pipeline operator's exclusive access to the pipeline. This means that the farmer generally has the relevant decision-making rights that affect the economic benefits to be derived from the use of the land. For example, the farmer can change when the types of farming activities occur or lease the land. Thus, the farmer has the right to direct the use of the land and IFRS 16.B9(b) is not met by the pipeline operator.

Proponents of this view believe that the arrangement meets the definition of an intangible asset under IAS 38. Under IAS 38.8, an intangible asset is defined as "an identifiable non-monetary asset without physical substance". The arrangement is considered identifiable as it provides the pipeline operator with a contractual right (IAS 38.12(b)) and the probability recognition criterion in paragraph 21(a) is met because it is a separate acquisition (IAS 38.25). Under this view, the right to access the land surface is closely related to the right to the defined underground space. Had the pipeline operator not acquired the right to the defined underground space, it would not have negotiated and acquired the right to the land surface. The right to the land surface is necessary for the pipeline operator to perform inspection, repairs and maintenance and replace damaged pipeline during the contract period. It supplements and protects the pipeline operator's power to obtain economic benefits from, and hence control of, the right to the defined underground space which is the dominant element of the overall arrangement. Furthermore, it is observed that the pipeline operator is able to exercise effective control without the need to rely on any future services from the farmer or another party.

The scope exceptions in IAS 38 do not apply to these arrangements and no other standards prescribe the accounting for this type of intangible asset. Consequently, the pipeline operator is required to apply IAS 38. In this fact pattern, since the cost, in the form of upfront and annual cash payments, can be measured reliably, the intangible asset should be recognised when the pipeline operator takes control of the asset (which is likely to be close to, or the same as, the commencement date in View 1).

View 3: No, the arrangement does not contain a lease and is accounted for as a service contract.

Proponents of this view believe that, for the same reasons in View 2, the arrangement does not contain a lease. Nor do they believe that the arrangement should be accounted for under IAS 38, because providing access rights is a service and the contract is therefore executory in nature, given that access is made available throughout the period of the contract[5]. Therefore, no capitalisation of an asset is required.

View 4: Accounting policy choice

As the guidance in IFRS 16 does not clearly address the issue of the unit of account of the identified asset, entities should develop an accounting policy for the unit of account and apply it consistently. To the extent it is determined that the arrangement does not contain a lease, entities are required to apply IAS 38 to consider whether there is an intangible asset or a service contract.

Current practice:

This question has arisen on application of IFRS 16. Under IAS 17 these arrangements were generally treated as operating leases or service contracts.

This question has been discussed in the US under ASC 842 and the arrangements will often be determined not to be in the scope of the lease guidance or not meet the definition of a lease. Specifically, some US GAAP constituents are of the view that underground space, which is not inhabited or generally accessible and subject to an easement can be analogised to air-use rights. Air-use rights are explicitly identified in US GAAP as an example of a contract-based intangible asset (ASC 805-20-55-37[6]); therefore, such rights (or a lease of such rights) are outside the scope of ASC 842 which excludes leases of intangible assets. Consequently, under this view, these easements are considered to be substantially equivalent to air-use rights and, as such, they are considered to be outside the scope of ASC 842[7]. Furthermore, rights to use

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[5] Proponents of View 1 and View 2 believe that the arrangement in the scenario provides the pipeline operator with more than access rights and the arrangement is not executory in nature, given that the pipeline operator is able to, at inception of the contract, install the pipeline which will stay underground throughout the contractual period.

[6] ASC 805-20-55-37 states that "[u]se rights such as drilling, water, air, timber cutting, and route authorities are contract-based intangible assets to be accounted for separately from goodwill. Particular use rights may have characteristics of tangible, rather than intangible, assets. For example, mineral rights are tangible assets. An acquirer should account for use rights based on their nature". In contrast, under IFRS 3.IE38, use rights "include rights for drilling, water, air, timber cutting and route authorities. Some use rights are contract-based intangible assets to be accounted for separately from goodwill. Other use rights may have characteristics of tangible assets rather than of intangible assets".

[7] Under IFRS 16.3(e), "rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights" are outside the scope of IFRS 16. A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described in IFRS 16.3(e) in accordance with IFRS 16.4.

underground space for a retail or other similar store (e.g. in an underground station), which will be accessible, are not analogous to air-use rights. Others may point out that an entity does not control the use of subsurface space if it does not also control the surface above it (the opposite is not necessarily true for rights to use the surface area). Nonetheless, some may also believe that similar to View 1 above, a view that a subsurface right is in the scope and meets the definition of a lease is also reasonable so there may be acceptable diversity in practice. The discussion and subsequent conclusion to accept judgement and thus diversity in practice in the US has highlighted this issue among IFRS reporters.

Reasons for the IFRIC to address the issue:

a. Is the issue widespread and has, or is expected to have, a material effect on those affected?

The fact pattern outlined is a typical example of the arrangements that exist. However, there are numerous other examples and we believe this issue is widespread in a number of industries, including oil and gas, mining, telecommunications and power and utilities that may enter into arrangements to run pipes and networks underground.

Under current IFRS, these arrangements have generally been treated as either operating leases or service contracts. Whether these arrangements are treated as service contracts instead of as leases of underground space under IFRS 16 or as intangible assets may have a material effect on those entities as they may have numerous similar arrangements. Whether the arrangements are treated as leases or intangible assets may also affect how certain aspects of the contracts are treated, for example termination options, variable consideration, contract modifications and disclosures.

Beyond application to these specialised industries, whether an arrangement that does not meet the definition of a lease should be accounted for under IAS 38 (as opposed to remain off-balance sheet) affects all entities across industries.

b. Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

In light of the potential material impact to many entities across a variety of industries, we believe that clarity is needed so that a consistent approach can be taken amongst IFRS reporters.

c. Can the issue be resolved efficiently within the confines of IFRS Standards and the Conceptual Framework for Financial Reporting?

Yes. We believe that consideration by the Committee is needed in this instance and that it can be resolved efficiently within the confines of IFRS Standards and the Conceptual Framework for Financial Reporting.

d. Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS Standards?

We believe this issue is sufficiently narrow in scope that it can be addressed in an efficient manner.

e. Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.

We are unaware of any current or planned IASB project that will directly address this issue.