



## **Lease Accounting Guidance**

In February 2016, the Financial Accounting Standards Board (FASB) issued an accounting standards update on the accounting for leases, which subsequently became Accounting Standards Codification 842 (ASC 842). ASC 842 became effective for NW Natural on January 1, 2019. Key aspects of the analysis regarding how rent expense is to be measured and recorded for the 250 Taylor building lease under ASC 842 are outlined below.

### ***Lease commencement under ASC 842 vs lease commencement and rent commencement per the contract***

ASC 842 defines the lease commencement date as the date on which the lessor makes an underlying asset available for use by a lessee, as further defined by ASC 842-10-55-10, as follows:

*“In some lease arrangements, the lessor may make the underlying asset available for use by the lessee (for example, the lessee may take possession of or be given control over the use of the underlying asset) before it begins operations or makes lease payments under the terms of the lease. During this period, the lessee has the right to use the underlying asset and does so for the purpose of constructing a lessee asset (for example, leasehold improvements).”*

The lease contract defines two commencement dates: lease commencement and rent commencement. Lease commencement under the lease is described in Article 3 of the contract and begins the 20-year term of the lease. Article 3 defines the commencement date as the later of substantial completion of the landlord’s work and the earlier of either seven months after the Tenant’s Delivery Status or the date the tenant first conducts active business operations. Exhibit E “Landlord’s Obligation to Construct Building” defines many of these terms, as follows:

1. Substantial Completion of the Landlord’s work is defined as the work has been substantially completed, subject to typical punch list items, and a certificate of occupancy is obtained and tenant has uninterrupted access to the premises.
2. Tenant Delivery Status is defined as the building is structurally completed, tenant’s contractor has access to all floors for the construction of tenant’s work (Exhibit L Work Letter), tenant’s contractor has use of elevator, utilities, etc.

Exhibit L “Work Letter” of the lease states the landlord shall deliver to the tenant physical possession of the ground floor and the second floor of the building (Turnover Date) when the landlord has achieved substantial completion of those spaces, subject to typical punch list items, for the tenant to begin Tenant’s Work.

Rent commencement under the lease is described in Article 4 of the contract. Article 4 defines the rent commencement date as the later of the lease commencement date or June 1, 2020. Therefore, the earliest that cash rent will begin to be paid is June 1, 2020.

Per discussion with NW Natural’s facilities management, the following is the Company’s current estimates of the following:

- the landlord is expected to make available to NW Natural access to the building in the fourth quarter of 2019 (ASC 842 commencement date);
- the date on which NW Natural expects to conduct active business operations is expected to be late in the first quarter of 2020 (lease commencement); and
- based on the lease commencement date in the preceding bullet point, cash payments would begin on June 1, 2020 (rent commencement).

### ***Lease Accounting – Initial Measurement – Lease Liability and Right of Use Asset***

Per ASC 842-20-30-1, the lessee should record the following upon the commencement date of the lease:

*At the commencement date, a lessee shall measure both of the following:*

1. *The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)*
2. *The right-of-use asset as described in paragraph 842-20-30-5.*

ASC 842-20-30-2 through 30-4 continue on, saying:



*The discount rate for the lease initially used to determine the present value of the lease payments for a lessee is calculated on the basis of information available at the commencement date. A lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate.*

ASC 842-20-30-5 describes the initial measurement of the right of use asset, noting that “*at the commencement date, the cost of the right-of-use asset shall consist of all of the following:*

- a. The amount of the initial measurement of the lease liability*
- b. Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received*
- c. Any initial direct costs incurred by the lessee (as described in paragraphs 842-10-30-9 through 30-10).*

Currently, NW Natural’s preliminary calculations result in the recognition of a Right to Use asset and a Lease Liability of approximately \$100 million on the lease commencement date under ASC 842 (expected in Q4 2019).

### ***Lease Accounting – Subsequent Measurement***

Operating lease expense is to be recorded as a single line item in operating expense on a straight-line basis over the lease term. The right of use asset and lease liability created upon commencement noted above are reduced by the operating lease expense and the cash rental payments made over the term of the lease.

We consulted ASC 842-20-25-6 which states the following:

*After the commencement date, a lessee shall recognize all of the following in profit or loss, unless the costs are included in the carrying amount of another asset in accordance with other Topics:*

- a. A single lease cost, calculated so that the remaining cost of the lease (as described in paragraph 842-20-25-8) is allocated over the remaining lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset (see paragraph 842-20-55-3), unless the right-of-use asset has been impaired in accordance with paragraph 842-20-35-9, in which case the single lease cost is calculated in accordance with paragraph 842-20-25-7*
- b. Variable lease payments not included in the lease liability in the period in which the obligation for those payments is incurred (see paragraphs 842-20-55-1 through 55-2)*
- c. Any impairment of the right-of-use asset determined in accordance with paragraph 842-20-35-9.*