From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

October 17, 2017

Bridging the "New GAAP" in Q3:

SEC Guidance to Issuers

PCAOB Guidance to Auditors

Insights from Reporting Companies

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For most calendar-year reporting companies, there is only one Form 10-Q to go before FASB's sweeping new revenue recognition accounting standard, Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers*,[1] becomes effective. Through speeches, announcements and comment letters, the SEC staff has offered detailed guidance on the pre-adoption disclosures they believe companies should be providing in accordance with Staff Accounting Bulletin No. 74 (SAB 74),[2] as well as factors they believe companies should be considering in determining whether and how internal control over financial reporting (ICFR) should be changed to meet the demands of the new standard and, if such changes are material, disclosed. The SEC staff has also emphasized the important roles that audit committees and outside auditors should play in the transition process.

The impact of these messages has been reinforced by PCAOB Staff Audit Practice Alert No. 15, *Matters Related to Auditing Revenue from Contracts with Customers*,[3] issued on October 5, 2017. While addressed to auditors, the Staff Practice Alert lets financial management and audit committees know what to expect – and therefore what to prepare for – as their auditors evaluate the company's pre-adoption transition disclosures, implementation and related ICFR matters in upcoming reviews and year-end audits.

Companies should note that the transition to ASC 606 is a prelude to other transition challenges. SEC and PCAOB staff scrutiny has been expanding beyond revenue recognition to cover the transition to other important U.S. GAAP standards whose effective dates loom on the near horizon – leases, equity investments and credit losses – all of which SEC Chief Accountant Wesley Bricker has termed the "New GAAP."[4] While it is permissible to adopt the New GAAP standards one by one, in accordance with their staggered effective dates, the SEC staff has cautioned that "purely sequential implementation" may leave companies without adequate time to implement those of the standards that come later in the timeline. At least one company we know of – Microsoft Corporation – opted for dual (and early) adoption of the new revenue recognition and lease accounting standards and thus was able effectively to communicate the combined financial statement impact to investors and analysts.

I. New GAAP in a Nutshell

We begin with a brief discussion, in the order of their effective dates, of each of the New GAAP standards called out by the SEC's accounting staff as particularly important from a company readiness perspective: revenue recognition (ASC 606); financial instruments – equity investments (ASC 825-10)[5]; leases (ASC 842)[6]; and financial instruments – credit losses (ASC 326)[7]. Companies now wrestling with complex New GAAP implementation issues should note that the SEC's Office of Chief Accountant (OCA) has expressed its continued willingness to engage in non-public, pre-filing consultations with individual companies, and has stressed that the staff has and will continue to accept reasonable judgments made by management in the application of these standards.

Revenue Recognition – Effective January 1, 2018 for Calendar-Year Reporting Companies

ASC 606 creates a comprehensive new revenue recognition accounting model based on a core principle: "an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[8] Superseding most (if not all) of FASB's previous, sometimes industry-specific revenue recognition guidance, the new standard establishes five general criteria for recognizing revenue in accordance with this core principle: (1) identify the contract with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the customer obtains control of that good or service. Extensive new quantitative and qualitative footnote disclosure also will be required.

ASC 606 must be applied retrospectively under one of two basic transition methods: (1) full retrospective, requiring restatement of revenues (and expenses) for all historical reporting periods presented in the financial statements, subject to election of certain transitional "practical expedients" permitted by FASB; and (2) modified retrospective, which dispenses with restatement of prior-period revenue but requires a cumulative adjustment for the effects of the new standard upon adoption on the effective date. As discussed under "*Post-Adoption Relief and Guidance from the SEC and its Accounting Staff*" below, various types of relief, including relief to facilitate use of Form S-3, may be available to companies choosing the full retrospective method.

Financial Instruments/Equity Investments –Effective January 1, 2018 for Calendar-Year Reporting Companies

ASC 825-10, a new accounting standard relating to the classification and measurement of financial instruments, applies to both equity and debt investments. Companies appear to be most concerned about the impact on net income of the equity portion of the new standard.[9] Equity investments, other than those accounted for using the equity method of accounting or those that result in consolidation of the equity investee, will be measured under ASC 825-10 at fair value on the balance sheet, with changes in fair value recognized through net income. Companies whose minority equity investments do not have a readily determinable fair value may elect a practicability exception allowing measurement of the value of these investments at cost minus impairment and plus or minus observable price changes.

Leases – Effective January 1, 2019 for Calendar-Year Reporting Companies

The expansive new lease accounting standard set forth in ASC 842 "will result in lessees recognizing most leases on the balance sheet."[10] Companies will have to evaluate as a potential lease, for accounting purposes, any arrangement that conveys control over the use of an identified asset by one party (lessor) to another (lessee). Some leases are specifically excluded from the scope of ASC 842, such as those with terms of less than one year and certain leases involving, for example, intangible assets and natural resources.

Financial Instruments/Credit Losses – Effective January 1, 2020 for Calendar-Year Reporting Companies

Under ASC 326, companies will be required "to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts."[11] As SEC Chief Accountant Bricker noted in a recent speech, the scope of this New GAAP standard "crosses industries, consistent with the variety of financing arrangements businesses provide."[12] By way of example, Mr. Bricker cited credit cards and other forms of financing retailers typically offer to customers who buy their merchandise. Banks and other financial institutions that extend credit anticipate a major impact on accounting for loan losses, given the shift away from the current "incurred loss" model permitting deferral of credit loss recognition until deemed "probable."[13]

II. SEC Staff Guidance for Pre-Adoption Transition Disclosure

During a September 2016 meeting of FASB's Emerging Issues Task Force (EITF), SEC Assistant Deputy Chief Accountant Jenifer Minke-Girard announced the staff's position on the application of SAB 74 to disclosures in the financial statement footnotes regarding the potential impact of adopting the new revenue recognition standard in a future period.[14] Since last fall, this guidance has been expanded to cover leases and financial instruments – the rest of the triumvirate of what the SEC accounting staff views as the most significant of the New GAAP standards.[15]

SAB 74 disclosure guidance recognizes that, at a given reporting date, company management may not know, or may not be able to estimate reasonably, the financial statement impact of adopting a new accounting standard. Where this is the case, however, the guidance calls for this fact to be disclosed in the footnotes to the financial statements and, as necessary or appropriate, in

Management's Discussion and Analysis (MD&A); for example, as a "known material trend or uncertainty" and/or critical accounting estimate.

In addition, the guidance calls for the following qualitative disclosures:

- The date of mandatory adoption of the new standard, and the date on which the company plans to adopt it, if earlier.
- Where there are alternatives (in the case of revenue recognition, full retrospective and modified retrospective), which transition method will be selected, if decided, and why that method has been chosen.
- The status of the company's implementation process.
- A description of any significant implementation issues that have not yet been addressed.
- The anticipated impact of the accounting policies the company plans to adopt, if known, and an explanation of how these new policies may differ from current accounting policies (e.g., in terms of timing of revenue recognition; impact on particular revenue streams, such as licenses, gift cards, etc.).
- The potential impact of other significant matters the company believes might result from adoption (e.g., tax accounting implications; planned or intended changes in business practices).

The staff has expressed skepticism regarding the basis for blanket statements made by many companies to date that the financial statement impact of ASC 606 "is not expected to be material." Noting that "the changes in the new revenue standard will impact nearly all companies," the staff has emphasized that the requisite materiality analysis must take into consideration ASC 606's expansive new footnote disclosures. This is because, "[e]ven in situations where the extent of change on the balance sheet or income statement is not deemed to be material, the related disclosures may be material." As the staff has explained:

> The scope of the new standard addresses not only amounts and timing of revenue but also new, comprehensive [financial statement footnote] disclosure about contracts with customers, including the significant reasonable judgments the registrant has made when applying the guidance. Accordingly, the basis of any statement that the impact of the new standard is immaterial should reflect consideration of the full scope of the new standard, which covers recognition, measurement, presentation, and disclosure.[16]

The SEC's Division of Corporation Finance has been applying OCA's SAB 74 disclosure guidance in the context of its review of periodic reports filed by individual companies. In this excerpt from a representative comment letter quoted in a report published by Deloitte in early September 2017, for example, the staff challenged the sufficiency of a company's statement that it was still in the process of evaluating the impact:

> "You state that you continue to make progress in evaluating the impact that the amended revenue recognition guidance in Topic 606 will have on your future consolidated financial statements. We further note your disclosures in the Form 10-Q appear to describe the approach you are undertaking in

> your analysis of the standard, without providing an understanding of any known potential impact or the current status of your evaluation. Please revise to provide qualitative financial statement disclosures of the potential impact that this standard will have on your financial statements when adopted. In this regard, include a description of the effects of the accounting policies that you expect to apply, if determined, and a comparison to your current revenue recognition policies. Describe the status of your process to implement the new standard and the significant implementation matters yet to be addressed. In addition, to the extent that you determine the quantitative impact that adoption of Topic 606 is expected to have on your financial statements, please also disclose such amounts. Please refer to ASC 250-10-S99-6 and SAB Topic 11.M. [i.e. SAB 74]."[17]

In late September 2017, OCA Deputy Chief Accountant Sagar Teotia delivered a speech underscoring the staff's expectation that SAB 74 disclosures will "become more informative to the users of the financial statements" as the New GAAP effective dates draw inexorably closer:

> As SAB 74 intended, we expect companies to be transparent in their disclosure as to where the company is in its implementation progress. The SAB 74 disclosures are intended to inform a reader where the company is in its implementation progress. As the effective date nears, and for companies that have not made sufficient progress, this fact will become clear in the SAB 74 disclosures. This will allow relevant stakeholders such as audit committee members, auditors and investors to hold management accountable for determining how the company is going to implement the new standards timely.[18]

Along with the disclosure implications of adopting a new standard itself, SEC staff accountants have also emphasized that companies need to keep a watchful eye on the disclosure implications of changes made to ICFR in anticipation of adopting the standard. As the effective date of ASC 606 or other New GAAP nears, these changes may rise to the level of a "material change" in ICFR that must be disclosed in Item 4, Part I of Form 10-Q or Item 9A, Part II of Form 10-K. On the other hand, it is entirely possible that some companies that got an early start on evaluation and implementation of one or more of the New GAAP may not have found it necessary to make related ICFR changes rising to a disclosable level within any given quarterly reporting period. For more on the staff's views in this area, *see* "*Internal Control Considerations Related to Implementing New GAAP*" below.

III. Internal Control Considerations Related to Implementing New GAAP

SEC Chief Accountant Bricker and other OCA staff members have identified factors that they believe companies should consider in determining whether and how to update their ICFR systems as they prepare for adoption of ASC 606. Companies should keep in mind that their outside auditors also will be considering these factors in conducting the integrated audit of their clients' fiscal 2017 financial statements and ICFR. *See* "*What to Expect from the Outside Auditor,*" below.

- ***Accounting Resources*** **–** Employees charged with applying ASC 606 must have the professional competence to evaluate revenue arrangements and apply the principles of ASC 606 properly. To ensure this, companies "need to assess and continually reassess the impact [of the new standard] to their existing accounting and financial reporting competencies and make adjustments as appropriate to their training, retention and recruitment programs."[19]
- ***Management Judgment*** **–** ASC 606 will require the application of significant management judgment,[20] thus "highlight[ing] the importance of a company's control environment – setting the right 'tone at the top' and expectations for responsible conduct throughout the organization."[21] Under the oversight of the audit committee (*see* "*The Audit Committee's Role in the Transition to New GAAP*"), "[m]anagement should consider whether [ICFR] changes to support the formation of sound judgments are needed in applying the new standard[s]." It goes without saying that management should document the evidentiary support for judgments made in respect of the company's transition to all of the New GAAP standards, in anticipation of the next integrated audit of the annual financial statements and ICFR. Recognizing the inherent complexity of this task, OCA Deputy Chief Accountant Teotia suggested taking a holistic approach to implementation and post-adoption application of ASC 606, explaining that

  > there are so many areas demanding managerial judgment that "it may be most effective and efficient to think about the accounting, [footnote] disclosures, and ICFR concurrently, including the disclosure of disaggregated revenue and the disclosure of remaining performance obligations. For example, while a registrant is determining the accounting impact – that is, identifying its performance obligations and estimating and allocating the transaction price – a registrant should also consider how it plans to disaggregate revenue in order to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. As a result of this important judgment, a registrant may determine that the data will have to be disaggregated in a manner different than has previously been disclosed. This could require system changes or obtaining data from different personnel – all of which could be subject to new or different internal control. It takes time of course to implement internal control changes. This is one of the many reasons it is critical to stay on top of raising and resolving implementation and application issues.[22]

- ***Technology*** **–** Mr. Bricker pointed out, in a September 2017 speech focusing on the new credit losses standard, that there are more technology options than ever to help companies prepare their books and records and operate internal accounting control processes as they transition to the New GAAP. He went on to note that "automated, preventive controls can offer certain benefits versus manual, detective controls." Along with the obvious benefits of technology, however, "there can also be a shift in the nature of risk to be identified and addressed through internal controls."[23] The recent spate of corporate cyber-hacking attacks underscores the vulnerability of automated financial reporting control systems, and the concomitant need for heightened security measures.
- ***Documentation*** **–** Mr. Bricker also reminded management that "[d]ocumentation can facilitate the retention or transfer of knowledge useful in resolving discussions more quickly related to things like the identification and assessment of risks, control design, testing strategy, and evaluation of deficiencies." To illustrate, he observed that "sufficiently detailed control descriptions can support the quality and consistency of control operation, particularly where there is judgment in the execution."[24]
- ***Internal Communications*** **–** Companies also should assess the financial reporting implications of changes that may be made to their established business practices during the transition period, such as changes to customer contracts. Because of the unprecedented level of disaggregated footnote disclosure that will be required, application of ASC 606 may call for the collection, sharing and analysis of new and different types of information throughout the entire organization. Accordingly, "it will be important to take a fresh look at the information and communication component of ICFR and the related controls over a company's information technology."
- ***Identification and Mitigation of New or Changing Risks*** **–** Finally, management must consider whether the potential for management bias in formulating the reasonable judgments required by ASC 606 will trigger "new risks, or changes in previously identified risks, including fraud risks."[25] Specific examples of areas susceptible to management bias cited by the staff include "identification of performance obligations, the estimation of standalone selling price for distinct goods and services, as well as the estimation of variable consideration when determining the transaction price." According to OCA staff, "[i]t is important for management to consider whether new or changes in internal controls are warranted to reduce the risk associated with management bias."

The private sector Anti-Fraud Collaboration, whose members include individuals serving on corporate audit committees, financial executives, internal auditors and external auditors, has also sounded a cautionary note about the potential for fraud in the application of ASC 606 – and therefore the importance of instituting robust controls.[26] In a March 2017 report, the Collaboration identified certain characteristics of the new revenue recognition standard that, in the Collaboration's view, make the standard particularly vulnerable to earnings management. Among these characteristics are the close ties between revenue recognition and certain key metrics – earnings, margins and revenue itself – that are crucial to the market's valuation of a company's stock and often form the basis for employee compensation performance targets and decision-making within the C-suite. The Collaboration also cited as fraud risks the complexity and latitude for judgment inherent in the new revenue recognition standard, and the communication and training challenges facing multinational companies that derive a significant percentage of revenues from overseas activities and may be required to address changes in both U.S. GAAP and International Financial Reporting Standards (IFRS).

Finally, senior OCA staff members have emphasized the perils to ICFR stemming from serial adoption of each of the New GAAP standards according to its future effective date, with the company potentially running out of time to achieve full and timely compliance with all such standards. SEC Chief Accountant Bricker has cautioned against taking a "purely sequential implementation" approach to the mandatory transition to New GAAP, whereby a company might defer implementation of the new accounting standards for leases (2019) and credit losses (2020), for example, until after meeting the 2018 deadline for adoption of ASC 606.[27] OCA Deputy Chief Accountant Sagar Teotia has similarly warned that, while not prohibited, "sequential implementation of the revenue recognition standard followed by the leases standard may leave a company in a situation where it finds that it has potentially limited its time to adopt the new leases standard and has limited its time to formulate reasonable judgments and assess potential changes needed in ICFR."[28] For lessons from one company that chose to adopt the new revenue recognition and lease accounting standards concurrently, see *"Insights from Transition Disclosures by Three Reporting Companies"* below.

IV. Insights from Transition Disclosures by Three Reporting Companies

To give readers some idea of the type of transition disclosures companies have been providing in periodic reports before adopting one or more of the New GAAP, we selected three large public companies – Microsoft Corporation, Ford Motor Company and General Electric Company. As we discuss below, the level of granularity of each company's disclosure appears to be tailored to the anticipated magnitude of the impact on that company's financial statements.

Microsoft

An excellent example of detailed SAB 74 and ICFR-related disclosure can be found in Microsoft Corporation's Form 10-K for the fiscal year ended June 30, 2017, filed with the SEC on August 2, 2017. Based on Audit Analytics' research, Microsoft has the distinction of being the only large-cap "double early adopter" of both the new revenue recognition and lease accounting standards through the second quarter of 2017. As Microsoft's Chief Accounting Officer explained during a subsequent investor/analyst conference call, "'[w]e chose to adopt … [ASC 606 and ASC 842] early, primarily to simplify the communication of our results by eliminating the need for non-GAAP revenue reporting …. [and] to provide one set of restated financial statements to investors.'"[29] Microsoft's Form 10-K contains an expansive financial statement footnote presentation (in Note 1, Accounting Policies) -- in both narrative and tabular format -- of the expected quantified effects of the company's adoption of these New GAAP standards on July 1, 2017. Moreover, while disclaiming any reportable material ICFR changes during its fiscal 2017 fourth quarter, Microsoft disclosed in management's annual ICFR report in the body of the fiscal 2017 Form 10-K that, "[d]uring fiscal year 2017, we implemented internal controls to ensure we have adequately evaluated our contracts and properly assessed the impact of the new accounting standards related to revenue recognition and leases on our financial statements to facilitate the adoption on July 1, 2017. We do not expect significant changes to our internal control over financial due to the adoption of the new standards."

Microsoft chose the full retrospective transition method upon ASC 606 adoption, which will entail recasting historical revenues and expenses for comparable prior interim periods pending the company's filing of audited, restated annual financial statements for fiscal years 2017 and 2016. In light of this, the company seemed to anticipate investor and analyst questions on the implications of such adoption for previously reported revenues and costs and fiscal 2018 earnings guidance. Shortly after filing its 2016 Form 10-K, as discussed in greater detail in "*Anticipating Post-Adoption Challenges*," Microsoft published unaudited, restated historical financial information designed to facilitate its contemporaneous webcast explanation to the market of the expected effects of post-adoption application of the new revenue and lease accounting standards rather than waiting for its Form 10-K for the fiscal year ending June 30, 2018.

Ford

Ford Motor Company, a calendar-year registrant, disclosed in the financial statement footnotes in its fiscal 2016 Form 10-K filed with the SEC on February 9, 2017 that it planned to adopt ASC 606 early -- effective January 1, 2017 – and would apply the modified retrospective transition method. The company further indicated that it expected the total adjustment to the opening balance of retained earnings to be less than $100 million, and that there would be "an immaterial impact to its net income on an ongoing basis." Ford also disclosed, in the body of the Form 10-K (in response to Item 9A), that there were no reportable ICFR changes for the quarterly period preceding ASC 606 adoption. However, Ford had this to say, in its Q1 2017 Form 10-Q filed in late April 2017, about the ICFR effects of ASC 606 adoption, without describing any of the enumerated changes as "material":

> Beginning January 1, 2017, we implemented ASC 606, Revenue from Contracts with Customers. Although the new revenue standard is expected to have an immaterial impact on our ongoing net income, we did implement changes to our processes related to revenue recognition and the control activities within them. These included the development of new policies based on the five-step model provided in the new revenue standard, new training, ongoing contract review requirements, and gathering of information provided for disclosures.

In the footnotes to the interim financial statements included in this Form 10-Q (for the quarter ended March 31, 2017), Ford explained that because it had recognized the cumulative effect of applying ASC 606 (on January 1, 2017) as an adjustment to the opening balance of retained earnings, the company was not required to restate the prior-period comparative information. Note 3 to these financial statements provides interesting insights into how a large U.S. automotive company is addressing the new disaggregated revenue disclosure requirements.

GE

Robust SAB 74 and/or ICFR change-related disclosure has not been confined to periodic reports filed by early adopters of New GAAP. GE, which plans to adopt ASC 606 on January 1, 2018 pursuant to the full retrospective method, disclosed in the body of its fiscal 2016 Form 10-K filed February 24, 2017, under the caption "Other Items," that it will update prior-period results for fiscal 2016 and 2017, respectively, upon adoption.

The company went on to state that it "expect[s] significant changes in the presentation of [its] financial statements, including: (1) timing of revenue recognition; and (2) changes in classification between revenue and costs." Although application of ASC 606 "will have no cash impact and, as such, does not affect the economics of [GE's] underlying customer contracts[,] [t]he effect of applying the new guidance to our existing book of contracts will result in lower reported earnings in 2018 (and comparative periods previously reported) and in the early years after adoption. However, we expect to experience an increase in reported earnings, on that existing book of contracts, as they mature." Following a largely qualitative technical discussion of the anticipated impact on customer contracts involving specific lines of business, GE disclosed that it expects a non-cash charge to its restated January 1, 2016 retained earnings balance of approximately $4 billion, with about $1 billion related to commercial aircraft engines and $3 billion to Services businesses (predominantly Power and Aviation), as well as a reduction in restated fiscal 2016 EPS of approximately $0.10. Turning to the potential dilutive effect of the new standard on 2018 earnings, GE stated that its estimates indicate that EPS will be lower by approximately $0.05 compared with results that would have been calculated under current GAAP.

Without identifying the expected adoption date for the new lease accounting standard, and with the caveat that the company "continue[s] to evaluate the effect of [ASC 842] on its ongoing financial reporting," GE also disclosed in the 2016 Form 10-K that "adoption of … [this standard] may materially affect our Statement of Financial Position."

V. Anticipating Post-Adoption Challenges

Communicating with the Market – A Case Study

Market observers are predicting that the application of ASC 606 will result in substantial differences in the accounting for contractual revenues and costs by companies in certain industries, which in turn could wreak havoc with established financial performance trendlines and pre-adoption earnings forecasts. A recent Morgan Stanley research study reportedly concludes, for example, that the computer software sector "'is likely to be the most impacted due to relatively conservative revenue recognition rules currently in practice[.]'"[30] In addition to presenting the quantitative and qualitative effects of New GAAP adoption in their SEC-filed financial statements, companies in a variety of sectors thus are now considering how best to communicate these effects to their analysts and investors outside the four corners of their SEC-mandated periodic reports.

Microsoft decided to meet these challenges head-on, opting for simultaneous early adoption of the New GAAP relating to revenues and leases and an investor-friendly preview of the historical and future financial-statement impact under the full retrospective transition method. Depending on which retrospective transition methodology it has chosen, a company contemplating a January 1, 2018 adoption date may find helpful the following summary of Microsoft's multi-pronged approach to disclosure.

On August 3, 2017, one day after filing its fiscal 2017 Form 10-K with the SEC as discussed above – and slightly more than a month after adopting ASC 606 and ASC 842 -- Microsoft submitted a "furnished" Item 7 Form 8-K (Regulation FD Disclosure) that announced a webcast investor/analyst conference call to be held later that day, and attached the company's financial results for fiscal years 2017 and 2016 as restated to reflect such adoption. In the body of this Form 8-K, Microsoft disclosed the material effects (or lack thereof) of the adoption of each of these new accounting standards on the company's historical consolidated financial statements. That afternoon (August 3, 2017 at 1:30 p.m. Pacific time; 4:30 p.m. Eastern time), Microsoft Chief Accounting Officer Frank Brod and his colleague Chris Suh together "walked" analysts and investors through these restated results with the aid of a power-point slide deck. The Microsoft officers also discussed the expected impact of adoption on fiscal 2018 earnings. Along with the slides, the archived webcast, a transcript of the conference call and an Excel spreadsheet are available on Microsoft's Investor Relations website at http://www.microsoft.com/en-us/investor.

Among the most interesting aspects of Microsoft's approach to communicating with the market via the August 3 conference call was its inclusion of an explanatory "bridge" between the company's pre-adoption non-GAAP earnings guidance practices and the prospective use of GAAP-only results as a medium for disclosure of past and future earnings. Put another way, Microsoft seemed to be using this call to ease its investors, and the analyst community, toward acceptance of the company's decision to jettison the use of non-GAAP earnings measures. If the Q&A session that followed management's presentation is any guide, the audience seemed to understand the intended message.

Implications for Use of Non-GAAP Measures

Not all companies will decide, as Microsoft did, to drop the use of non-GAAP earnings measures in response to significant changes in the timing and/or amount of revenue and costs recognized under ASC 606. Companies that, like Ford (another early adopter of ASC 606), choose to apply the modified retrospective transition method, and otherwise do not anticipate a material impact on future financial statements, may not find it necessary to modify their earnings communications practices in light of this or any of the other New GAAP standards. But corporate managers facing ASC 606's January 1, 2018 deadline should be thinking about these issues now, and discussing them with the audit committee.

Implications for Compensation Plans

Another important issue, for management as well as the audit and compensation committees, is the expected impact of the new revenue accounting standard on existing and future executive (and other employee) incentive compensation arrangements. Some employee benefit plans have pay-out provisions linked to achieving specific GAAP or non-GAAP performance targets over a multi-year period. Will a company with such a plan that finds itself mid-way through a revenue-based performance cycle on January 1, 2018, have to amend the plan, or should the company instead maintain financial statements prepared under both the old and new GAAP standards (one for compensatory purposes, and the other for GAAP compliance purposes)? With respect to the company's ICFR system, will any ASC 606-driven variations in the timing or amount of management compensation give rise to new or different fraud risks that will be subject to enhanced auditor scrutiny during the integrated financial statement/ICFR audit? These are just a few of the many complex issues that audit and compensation committees may be confronting between now and the January 1, 2018 effective date.

VI. The Audit Committee's Role in the Transition to New GAAP

On several occasions this year, members of the SEC's accounting staff have highlighted the central role of audit committees in overseeing effective implementation of the New GAAP. Audit committees should understand management's "implementation plans and … the status of progress, including any required updates to [ICFR]."[31] In discharging their oversight responsibilities, audit committees also have been "encouraged" by OCA "to anticipate, and require, dialogue with the [outside] auditor about the auditor's views of implementation progress."[32] In late September, OCA Deputy Chief Accountant Teotia noted that "the importance of the audit committee in promoting an environment for management's successful implementation of the [N]ew GAAP standards cannot be overstated." Audit committees should "set the tone for the adoption of" these standards by "actively monitoring [management's] … implementation efforts, including taking the time to understand and assess the quality and status of implementation."[33]

From OCA's perspective, management is well-advised to engage audit committees "early and often" in the risk assessment process to help ensure successful implementation of the New GAAP. The audit committee's oversight of management's risk assessment, along with its oversight of the internal controls that mitigate the identified risks, not only helps management in "[g]etting the accounting and disclosures right … [, which] include[s] providing timely disclosure about the anticipated effect of transition," but also "serves as a potential deterrent to fraudulent activity."[34]

After complimenting those companies that have made substantial implementation progress as they near the end of the third fiscal quarter, Mr. Teotia had this message for companies that have "potentially fallen behind on their revenue implantation plans." Specifically, he urged their audit committees and management "to take note of this and focus on creating an implementation plan in order to provide sufficient time and resources to implement the new GAAP standards."

Korn Ferry International, which has a FYE of April 30 and will adopt ASC 606 on May 1, 2018 (the first day of its 2018 fiscal year), recently filed a definitive proxy statement that offers interesting insights into the role its audit committee has been playing in overseeing the company's implementation of ASC 606. According to this disclosure, which is substantially similar to the SAB 74 disclosure Korn Ferry later made in a Form 10-Q filed September 8, 2017 (in a footnote to the quarterly financial statements):

> The Audit Committee is playing an active role in overseeing the Company's implementation of the new revenue recognition standard. Under the oversight of the Audit Committee, Company management has developed a project plan that includes working sessions to review, evaluate and document the arrangements with customers under its various reporting units to identify potential differences that would result from applying the requirements of the new standard. The Audit Committee meets regularly with management to discuss the outcome of such working sessions and the Company's progress toward implementing the new standard.
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> The Audit Committee is also very much focused on how the new standard will affect the Company's businesses, processes and financial reporting and how the Company's processes and controls will be affected or will need to be changed. Company management is in the process of developing an updated accounting policy (which has been discussed with the Audit Committee). The Company is utilizing a bottoms-up approach in reviewing its current contracts with customers by various revenue streams, evaluating new disclosure requirements and identifying and implementing appropriate changes to business processes, systems and controls to support revenue recognition and disclosure under the new standard. The Company is still evaluating the impact of ASU No. 2014-09 [ASC 606, as amended] on its financial statements. Based upon its evaluation to date, capitalization of costs associated with obtaining contracts will have an impact upon adoption of the new standard. The Company expects to finalize the evaluation in upcoming quarters and will provide updates on its progress in future filings.

VII. What to Expect from the Outside Auditor

SEC Chief Accountant Bricker recently reminded auditors of their PCAOB-mandated duty to "communicate with the audit committee about concerns identified by the auditor regarding management's anticipated application of a new accounting pronouncement that, while it is not yet effective, might have a significant effect on future financial reporting."[35] As previously noted, moreover, the SEC staff has encouraged auditors, audit committees and responsible management alike to discuss with one another both the status of New GAAP readiness and any accompanying ICFR issues – including whether any change to ICFR has occurred during a given reporting period "that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting."[36]

Staff Practice Alert

On October 5, 2017, the PCAOB itself published more specific guidance to registered public accounting firms – in the form of the Staff Practice Alert -- on how best to discharge their "gatekeeper" responsibilities in connection with auditing (or reviewing, as the case may be) the financial statements of corporate clients now in the process of implementing the new revenue recognition standard. Beginning with the proposition that "revenue is one of the largest accounts in the financial statements and is an important driver of operating results[,]" the Alert highlights six major areas for focus by auditors when addressing ASC 606 implementation and/or post-adoption application in their upcoming interim reviews and year-end audits:

- Management's SAB 74 transition disclosures in financial statement footnotes, including "when the transition disclosure asserts that the impact of the standard is not expected to be material to the [company's] financial statements." More on this below.
- Transition adjustments, or adjustments made by the company in applying ASC 606 pursuant to the full retrospective or modified retrospective transition method, and in electing optional practical expedients that must be consistently applied and disclosed in the financial statements.
- ICFR – the PCAOB cautioned that client management's "[i]nadequate or ineffective design or implementation of changes to [the company's] systems, processes, and controls can pose heightened risks of material misstatement, including the risks of material misstatement due to fraud…."
- Identifying and assessing fraud risks – "the auditor should presume that there is a fraud risk involving improper revenue recognition and evaluate which types of revenue, revenue transactions, or assertions should give rise to such risks." In particular, auditors are required "to make certain fraud-related inquiries of management, the audit committee (or the equivalent), and others within the company."
- Whether a client company's implementation of ASC 606 might affect the auditor's evaluation of whether revenue is being recognized by the company, upon adoption, in conformity with the applicable financial reporting framework.
- Whether the financial statements include the required footnote disclosures regarding revenue, once the transition to ASC 606 has been made.

In light of the approaching filing deadline for calendar-year reporting companies' Q3 Form 10-Qs, perhaps of most immediate interest to the financial management and audit committees of the vast majority of companies that have not yet adopted ASC 606 are the procedures the PCAOB staff recommends that auditors apply in the context of their review of companies' interim financial statements:

- Inquire about the company's implementation progress and the anticipated effects of the new standard, when adopted. These inquiries may extend to non-accounting personnel.
- Obtain evidence as to whether the disclosures agree or reconcile with other information in the company's records – including management's reports to the audit committee about the anticipated effects of the new standard.
- Upon identifying a concern regarding management's anticipated application of ASC 606, communicate with the audit committee.

The Staff Practice Alert echoes the skepticism expressed by the OCA staff about management's assertions that the impact of ASC 606 is not expected to be material. It emphasizes the need for auditors to perform procedures to test the accuracy of these assertions, reminding auditors of SEC Chief Accountant Bricker's own reminder to companies that the basis for an assertion of immateriality "should reflect consideration of the anticipated effect of the full scope of the standard, which covers recognition, measurement, presentation and disclosure for revenue transactions."[37]

Staff Inspection Brief

In dealing with their reviews and audits of public clients' financial statements, outside auditors are also likely to be influenced by the latest PCAOB Staff Inspection Brief, issued in late August 2017. The Staff Inspection Brief outlines the priorities of the PCAOB's Division of Registration and Inspections in connection with the 2017 inspections cycle.[38] One of the key areas of inspection focus this year is what changes audit firms may have made, or plan to make, in their audit processes and/or procedures in response to their corporate audit clients' implementation and adoption of the new revenue recognition and lease accounting standards. For certain selected issuer audit engagements, the PCAOB Inspections staff is discussing the following with individual audit firms subject to inspection: (1) how is the firm addressing pending accounting changes with the issuer client; (2) how/what is the audit firm communicating to the audit committee regarding management's readiness and technical ability; and (3) what process has the audit firm followed to ensure that it maintains its independence with respect to the issuer client's implementation of the New GAAP.

Other Insight

Former OCA Deputy Chief Accountant Brian Croteau, speaking at a July 11, 2017 webinar co-sponsored by the Center for Audit Quality, expressed the view that preparers of corporate financial statements and outside auditors should communicate throughout the New GAAP implementation process to avoid surprises. Citing SEC and PCAOB authority, Mr. Croteau stated that an outside auditor may furnish advice or assistance to management in this context *without* impairing its independence or otherwise improperly performing a management function.[39] To the contrary, as OCA stated in a 2005 release endorsed by the SEC:

> Investors benefit when auditors and management engage in dialogue, including regarding new accounting standards and the appropriate accounting treatment for complex or unusual

> transactions. The staff believes that as long as management, and not the auditor, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement is appropriate and is not [in and] of itself indicative of a deficiency in the registrant's internal control over financial reporting. Further, timely dialogue between management and the auditor may positively impact audit quality and the quality of financial reporting.[40]

VIII. Post-Adoption Relief and Guidance from the SEC and its Accounting Staff

Form S-3 and Other Relief for Companies Adopting ASC 606 Via the Full Retrospective Method

As part of a broad initiative to facilitate capital formation, SEC Chair Jay Clayton[41] and senior accounting staff have urged registrants choosing the full retrospective method of ASC 606 adoption that plan to file a new Form S-3 in 2018 to consider seeking relief on "impracticability" grounds under Rule 3-13 of Regulation S-X. Rule 3-13 states that the SEC, which would include the staff acting by delegated authority, "may, upon the informal written request of the registrant, and where consistent with the protection of investors, permit the omission of one or more of the financial statements herein required or the filing in substitution therefor of appropriate statements of comparable character." In this regard, as detailed in our previous alert, Division of Corporation Finance officials have encouraged these companies to consult with the staff on a pre-filing basis as to the availability of relief from Form S-3's Item 11.b. requirement to provide audited restated financial statements for fiscal year 2015 as well as 2016 and 2017 (rather than the two years' worth of required restatements, for fiscal years 2016 and 2017, that otherwise would be called for in the fiscal 2018 audited financial statements). In addition, the Division has indicated that companies applying the full retrospective transition method are permitted to provide three, rather than the five, years of selected financial data in the tabular format required by Item 301 of Regulation S-K.[42]

Revenue Recognition and Leases: Extended Adoption Deadlines for Certain Equity Investees of Reporting Companies

Certain non-reporting companies fall within the definition of "public business entity" (PBE) – which also includes SEC registrants -- solely because their financial statements and/or other financial information must be filed with the SEC by a reporting company that itself is a PBE. A key example is where a private company is a "significant" equity method investee of a registrant within the meaning of Rule 3-09 or Rule 4-08(g) of Regulation S-X. According to reports from attendees at an EITF meeting held on July 20, 2017, an SEC staff observer announced that the staff would not object if such private companies elect to defer adoption of the new revenue and lease accounting standards until the more distant effective dates permitted for private companies that are not PBEs.[43] OCA's announcement, which has been codified by the FASB,[44] comes as welcome news to registrants required to include financial statements or summarized financial information of non-consolidated investees that would not otherwise qualify as PBEs and over which, by FASB's own definition, these registrants may lack the degree of control that would be necessary to compel accelerated adoption of the new standards.

Recent SEC Interpretive Guidance on Revenue Recognition

On August 18, 2017, the SEC and its accounting staff published interpretive guidance on the post-adoption application of ASC 606 in certain very specific circumstances. We discuss each below.

- ***SAB No. 116*** **–** Staff Accounting Bulletin (SAB) No. 116[45] updates the Staff Accounting Bulletin Series to bring existing staff interpretive guidance into conformity with ASC 606. Specifically, SAB Topic 8 (retail companies) and SAB 13 (general guidance on application of the current revenue recognition standard, ASC 605), no longer apply once a company adopts ASC 606. In addition, SAB Topic 11.A (miscellaneous disclosure) has been modified to make clear that revenues from operating-differential subsidies (under the Merchant Marine Act of 1936, as amended) should be present either under a separate revenue caption from ASC 606 revenues, or as a credit in the costs and expenses section.
- ***Bill-and-Hold Arrangements*** **–** The SEC issued interpretive guidance indicating that once a registrant adopts ASC 606, it no longer may rely on a previous SEC interpretive position allowing deferral of revenue recognition, in a situation where the registrant bills a customer while retaining physical possession of the product, until that product is transferred to the customer at some point in the future. With respect to these "bill-and-hold" arrangements, ASC 606 "acknowledges that, for some customers, a customer may obtain control of a product even though that product remains in … [the registrant-seller's] physical possession."[46]
- ***Certain Vaccine Sales to the Federal Government*** **–** The SEC updated a 2005 interpretive release intended to address questions about the timing of revenue recognition by vaccine manufacturers who sold vaccines to the federal government for placement in the nation's Vaccines for Children Program and the Strategic National Stockpile. Under the revised SEC interpretation, vaccine manufacturers must recognize revenue and provide the required disclosures under ASC 606 "when [certain] vaccines are placed into Federal Governmental stockpile programs because control of the enumerated vaccines will have been transferred to the customer and the criteria to recognize revenue in a bill-and-hold arrangement under ASC Topic 606 will have been met."[47]

Division of Corporation Finance Comments Already Being Issued to Early ASC 606 Adopters

Division of Corporation Finance staff accountants have begun to issue comments to early adopters of ASC 606, asking very specific technical accounting questions. To illustrate, we call your attention to the correspondence, available here, generated by the staff's review of First Solar, Inc.'s periodic reports, including its post-adoption Form 10-Q for the second fiscal quarter ended June 30, 2017.

IX. What to Do Now

1. SAB 74 disclosures provided by calendar year companies in their upcoming Q3 10-Qs should be more specific and quantitative as to the anticipated financial statement effects of adopting ASC 606, given the rapid approach of the new standard's effective date. Don't forget to assess the obligation to disclose any ICFR change made during the quarter "that has materially affected, or is reasonably likely to materially affect," the company's ICFR (S-K 308(c)).
2. If your company has a calendar fiscal year-end, remember that the outside auditor will be scrutinizing with a gimlet eye your remaining SAB 74 transition disclosure about the new revenue recognition standard and possibly, despite the longer time horizon, your transition disclosures about the new lease accounting and credit loss standards. Expect that scrutiny to

be particularly rigorous in light of the PCAOB Staff Practice Alert and Staff Inspections Brief (discussed above). In this connection, it is very important that the company's accounting, IT and SOX 404 compliance teams work together and have a meeting of the minds with respect to the company's readiness for timely adoption of at least ASC 606. Above all, make sure that the audit committee is fully informed about the company's progress and any remaining implementation issues. Recognize that the committee is likely to be hearing a lot on this subject from the auditors in their required communications, in light of the PCAOB staff's guidance.

3. For companies anticipating that the adoption of ASC 606 or any of the other New GAAP will have a material impact on their financial statements in future periods, either alone or in the aggregate, disclosure committees and investor relations personnel should evaluate the most effective timing and means of communicating that impact to the market. Both timing and content considerations may turn on such factors as early adoption, sequence of adoption of multiple New GAAP standards and transition methods chosen, and the implications for use of non-GAAP financial measures to report historical and/or future earnings. Keep the audit committee in the informational loop.

4. Consider the impact that adoption of the new revenue recognition standard will have on tax accounting prescribed by rules of the U.S. Treasury Department and the Internal Revenue Service. The accounting profession is calling attention to the question of whether changes in GAAP, or "book," accounting for revenue may necessitate a change in income tax accounting methods that could require advance IRS approval.[48] Some companies that plan to adopt ASC 606 via the full retrospective method may find that modifications in the timing or amount of revenue recognition will compel retrospective adjustments to deferred income tax amounts reflected in the financial statements.

5. Assess the anticipated effects on executive/employee compensation – how are multi-year revenue-focused performance plans affected? Consider the ICFR impact of management incentives as well.

6. In preparing the next periodic report, do not overlook the SAB 74 and ICFR disclosure implications of another, less sweeping New GAAP standard with a January 1, 2018 deadline: accounting for non-consolidated equity investments below a 20% ownership threshold (other than those accounted for under the equity method). Examples include investments in partnerships, unincorporated joint ventures and limited liability companies.

ENDNOTES

[1] FASB Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (May 2014), as revised and updated in 2015 and 2016, available here.

[2] *See* SAB 74, Topic 11.M, *Disclosure of the impact that recently issued accounting standards will have on the financial statements of a registrant when such standards are adopted in a future period*, available here.

[3] The Staff Practice Alert is available on the PCAOB's website here.

[4] SEC Chief Accountant Wesley R. Bricker, *Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: Advancing the Role of Credible Financial Reporting in the Capital Markets* (Los Angeles, California, June 8, 2017) ("Bricker, June 2017 Speech"), available here.

[5] *See* FASB Accounting Standards Update (ASU) 2016-01, *Accounting for Financial Instruments – Overall (ASC Subtopic 825-10)—Recognition and Measurement of Financial Assets and Financial Liabilities* (Jan. 5. 2016), available here.

[6] *See* FASB Accounting Standards Update (ASU) 2016-02, *Leases (ASC 842)* (Feb. 25, 2016), available here.

[7] FASB Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (ASC 326)* (June 13, 2016)("ASU 2016-13, Credit Losses"), available here.

[8] ASC 606-10-10-2.

[9] *See* Denise Lugo, *Companies Fear Earnings Volatility From New Equity Accounting*, Bloomberg BNA Corp. Law & Accountability Report (Aug. 28, 2017).

[10] Bricker, June 2017 Speech, above.

[11] ASU 2016-13, Credit Losses, above, Overview at 1.

[12] Bricker, June 2017 Speech, above.

[13] SEC Chief Accountant Wesley R. Bricker, *Remarks before the AICPA National Conference on Banks & Savings Institutions: Advancing High-Quality Financial Reporting in Our Financial and Capital Markets* (Wash. D.C., Sept. 11, 2017)("Bricker, Credit Losses Speech"), available here.

[14] *See* Minutes of the September 22, 2016 Meeting of the FASB's EITF (Oct. 24, 2016), available on FASB's website here.

[15] Bricker, June 2017 Speech, above.

[16] Sylvia E. Alicea, Professional Accounting Fellow, Office of the Chief Accountant, *Remarks before the Bloomberg BNA Conference on Revenue Recognition* (Wash., D.C., May 8, 2017)("Alicea Speech"), available here.

[17] E. Knachel & C. Sachtlebein, Deloitte & Touche LLP, *The New Revenue Standard – Are You Still Assessing the Impact?* Vol. 24 Deloitte Heads Up (Sept. 5, 2017)(quoting from Division comment letter issued to unidentified company). *See also* Audit Analytics Blog, *Six Months to New Revenue Standard Deadline* (June 6, 2017)(quoting from a Division comment letter to unidentified company), available here.

[18] Sagar Teotia, Deputy Chief Accountant, Office of the Chief Accountant, *Addressing Implementation Matters to Improve Financial Reporting* (San Diego, CA, Sept. 21, 2017)("Teotia Speech"), available here.

[19] Bricker, June 2017 Speech, above.

[20] Committee of Sponsoring Organizations of the Treadway Commission (COSO), 2013 Internal Control – Integrated Framework (2013), available here.

[21] Bricker, Credit Losses Speech, above.

[22] Teotia Speech, above.

[23] Bricker, Credit Losses Speech, above.

[24] *Id.*

[25] Alicea Speech, above.

[26] *See* The Anti-Fraud Collaboration, *Addressing Challenges for Highly Subjective and Complex Accounting Areas* (March 2017), available on the Center for Audit Quality's website here. The Anti-Fraud Collaboration is a joint initiative of the Center for Audit Quality (CAQ), the National Association of Corporate Directors (NACD), Financial Executives International (FEI), and the Institute of Internal Auditors.

[27] Bricker, June 2017 Speech, above.

[28] Teotia Speech, above.

[29] David M. Katz, *Microsoft Scales Accounting Mountain*, CFO.com (Aug. 4, 2017)(quoting remarks made by Microsoft Chief Accounting Officer Frank Brod during "a special financial disclosure call" with analysts on August 3, 2017), available here.

[30] S. Burkholder, *Tech, Retailers Might Report Revenue Earlier Under New Rules*, Bloomberg BNA Corp. Law & Accountability Report (Oct. 2, 2017).

[31] Bricker, June 2017 Speech, above.

[32] Wesley R. Bricker, Chief Accountant, U.S. Securities and Exchange Commission, *Remarks Before the University of Tennessee's C. Warren Neel Corporate Governance Center: Advancing the Role and Effectiveness of Audit Committees* (Mar. 24, 2017), available here.

[33] Teotia Speech, above.

[34] Alicea speech, above.

[35] Bricker, June 2017 Speech, above (citing PCAOB Auditing Standard No. 1301, Paragraph (f)).

[36] Item 308(c) of Regulation S-K.

[37] Wesley R. Bricker, SEC Chief Accountant, *Remarks before the Annual Life Sciences Accounting & Reporting Congress: Advancing Effective Internal Control and Credible Financial Reporting* (Mar. 21, 2017), available here (as quoted in PCAOB Staff Practice Alert, above, at p. 4 n. 9).

[38] *See* PCAOB Staff Inspection Brief, *Information about 2017 Inspections* (Aug. 30, 2017), available here.

[39] An archived webcast of this program, entitled "*What is Your Role? When Accounting Policy Meets ICFR*" and recorded on July 11, 2017, is available on the Center for Audit Quality's website here. Mr. Croteau referred during his presentation to the Commission Statement on Implementation of Internal Control Reporting Requirements, SEC Press Release No. 2005-74 (May 16, 2005)("SEC Press Release No. 2005-74"), available here, and PCAOB Policy Statement (May 16, 2005), available here.

[40] Commission Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), available here (issued by the SEC pursuant to SEC Press Release No. 2005-74, cited above in Note 39).

[41] SEC Chair Jay Clayton, *Remarks at the Economic Club of New York* (New York, NY, July 12, 2017), available here.

[42] *See* Division of Corporation Finance, Financial Reporting Manual Section 11110.1, available here.

[43] *See* Deloitte, *Crisis Averted*, Vol. 24 of Deloitte Heads Up (July 20, 2017); PwC, *In Brief: SEC extends revenue and leases effective dates for certain PBEs*, No. US2017-22 (July 21, 2017), available here. *See also* T. Whitehouse, *SEC relieves certain entities from revenue recognition, lease adoption dates,* Compliance Week, Aug. 4, 2017, available here.

[44] *See* FASB ASU 2017-03 (Oct. 2, 2017), available here.

[45] SAB No. 116, available here.

[46] *Commission Guidance Regarding Revenue Recognition for Bill-and-Hold Arrangements*, SEC Release Nos. 33-10402; 34-81428 (Aug. 18, 2017), available here.

[47] *Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile,* SEC Release Nos. 33-10403; 34-81429 (Aug. 18, 2017), available here.

[48] See EY Technical Line, *How the new revenue standard may affect a company's income tax accounting* (July 13, 2017); T. Whitehouse, *Add tax to the growing list of revenue recognition crises*, Compliance Week, July 11, 2017, available here.

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