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INSIGHT: SEC Puts Supply Chain, Workforce Disclosures in Spotlight

June 1, 2020
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The SEC's focus on public company disclosure, particularly supply chain and workforce aspects, has grown during the Covid-19 pandemic. In Part 1 of a two-part series, Ballard Spahr attorneys examine SEC guidance and expectations for public companies and say companies can learn lessons from the Great Recession.

As the country continues to grapple with the financial impact of the Covid-19 pandemic, the focus on public company disclosure has become even more acute. Shortly after the pandemic hit the U.S., the SEC's Division of Corporate Finance, chief accountant, and chairman each issued statements or guidance emphasizing the importance of accurate information and transparency to market integrity.

As companies make their first financial reports since the outbreak, management must avoid the temptation to focus on earnings, profits, and revenues and the market's reaction thereto. Instead, increased regulatory scrutiny and securities litigation trends demand that firms shore up and improve upon their internal controls and accounting judgments, especially those most directly implicated by the Covid-19 crisis.

Lessons from the Great Recession are instructive here. In the years that followed the 2008 market crash, the SEC brought enforcement actions against 204 entities and individuals, including 93 senior corporate officers, leading to penalties that exceeded $1.93B, disgorgement of more than $1.47B, and additional monetary relief of more than $418M.

These enforcement actions tackled broad categories of alleged misconduct, including the concealment of losses through fraudulent accounting, incomplete disclosures, and misclassification of certain classes of assets. And shareholder litigation pursuant to Recession-era accounting violations still continues today.

In the first of this two-part series, we will examine guidance and expectations for public companies regarding supply chain and workforce disclosures. Our second article will explore accounting judgments and compliance with GAAP in the age of Covid-19.

SUPPLY CHAIN AND WORKFORCE DISCLOSURE

The SEC's recent guidance addresses many aspects of public company disclosure, but several areas are particularly implicated as a result of the crisis.

For example, disclosures relating to supply chain and workforce disruption will receive special attention. Following the passage of Sarbanes-Oxley, companies homed in on enterprise risk analysis and Section 404 disclosures regarding the operation of their internal controls. The reporting requirements prompted companies to focus on specific links within their supply chain, leading to better understanding of suppliers and their business practices, more careful quality control of goods received from those suppliers, and greater emphasis on addressing instances of contractual noncompliance.

As for workforce disruption, enterprise risk management disclosures nudged companies to assess the continued availability of their workforces in view of the aging population, as well as the intersection between current workforces and advances in technology.

Although the effects of this crisis could not have been predicted, companies have had to prepare themselves for supply chain and workforce disruptions such as cyber-attacks, tariffs, and raw material shortages become more common. Indeed, companies have begun to include the possibility of natural disasters, outbreaks, and other catastrophes among the risk factors in their financial reporting.

As a recent *Harvard Business Review* article noted, however: “Many companies continue to rely on human intelligence from top-tier and a select few lower-tier suppliers. But the information collected via personal relationships is typically anecdotal and often mere conjecture, and when procurement personnel leave, change roles, or retire, their knowledge leaves with them. It can take new employees years to get to know immediate suppliers, let alone the suppliers’ suppliers and their global footprint.”

In short, companies may not be doing enough to assess their workforce and supply chain disruption risk, but the SEC has made clear that such diligence is expected.

ASSESSING SUFFICIENCY OF DISCLOSURES

In its March 25 guidance, the Division of Corporate Finance posed a number of questions to assist public companies in their assessment of the sufficiency of their disclosures, including:

- Have Covid-19-related circumstances such as remote work arrangements adversely affected your ability to maintain operations, including financial reporting systems, internal control over financial reporting and disclosure controls and procedures? If so, what changes in your controls have occurred during the current period that materially affect or are reasonably likely to materially affect your internal control over financial reporting? What challenges do you anticipate in your ability to maintain these systems and controls?

- Do you anticipate a material adverse impact of Covid-19 on your supply chain or the methods used to distribute your products or services? Do you expect the anticipated impact of Covid-19 to materially change the relationship between costs and revenues?

- Will your operations be materially impacted by any constraints or other impacts on your human capital resources and productivity?

- Are travel restrictions and border closures expected to have a material impact on your ability to operate and achieve your business goals?

A THIRST FOR OPERATIONAL DETAIL

Further, in their April 8 joint statement, SEC Chairman Jay Clayton and William Hinman reiterated Corporate Finance's March 25 guidance and emphasized that investors are "thirsting" for registrants to provide specific operational detail about the impact of the Covid-19 crisis on the business and the plans to confront the challenges of the crisis.

While acknowledging "that estimates of the type we are requesting are unavoidably based on a mix of assumptions, including assumptions regarding matters beyond the control of the company," the SEC has left little doubt that companies are required to dig deeper into the operations of their companies to assess potential risks, which, in turn, must be disclosed to the markets.

In the current environment, firms must do their best to understand the patchwork of state and federal regulations (i.e., which employees may return to the workplace, which plants must remain closed or open, which spacing restrictions are in place) and their impact on workforce and supply chain disruption.

The sufficiency of public companies' forthcoming disclosures will be judged by their depth, as well as their accuracy. Companies should avoid relying on anecdotal evidence and instead fully explore supply chain in order to meet the standards the SEC has emphasized. Would-be plaintiffs will be relying on these standards as well.

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