

INSIGHT: Expect Form 10-Qs Securities Challenges Due to Covid-19

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Sidley Austin LLP attorneys predict the SEC will focus on financial reporting and disclosures of public companies to look for accounting or disclosure misconduct related to Covid-19. The commission may be most likely to open inquiries where a company's accounting judgment has a significant or unanticipated effect on its financial reporting, results in press coverage, or is the subject of a submission to the SEC's whistleblower program.

Typically, public companies drafting their periodic reports must make a number of judgments, such as those concerning how to best describe the company's outlook and risks, how to properly value assets, and whether to take an impairment (and, if so, the appropriate size).

Covid-19 has created extraordinary challenges to management making those judgments—judgments that regulators are likely to scrutinize closely once the crisis is over—for the first quarter 2020 Form 10-Q.

In anticipation of this regulatory scrutiny, public companies should take extra care while preparing their Form 10-Qs. Three areas related to financial reporting—internal controls over financial reporting, forward-looking statements and other disclosures about the effects of Covid-19, and accounting judgments—may require particular attention.

Internal Controls

With many areas under stay-at-home orders, companies have increasingly shifted to remote work arrangements for most employees. Companies should consider whether remote-work arrangements or other Covid-19 responses have adversely affected their internal control over financial reporting or disclosure controls and procedures.

To the extent that they have, companies should consider what steps they may take to mitigate the effect and confirm that their controls are functioning properly in these unusual circumstances.

Forward-Looking Statements & Other Disclosures

Public companies may face difficulties in determining how to draft forward-looking statements that specifically address Covid-19-related issues, as Securities and Exchange Commission Chairman Jay Clayton and Corporate Finance Director William Hinman recently noted in a joint statement.

Drafting these types of statements can present a number of challenges, both regarding what to discuss and what may be appropriately omitted. In particular, deciding on the appropriate level of detail or specificity and evaluating what constitutes material information for investors under current circumstances. In their recent joint statement, Clayton and Hinman stated that, in their view, historical information about the results of the quarter may be less relevant to investors than qualitative forward-looking information.



Thomas Kim
Sidley Austin LLP



Ike Adams
Sidley Austin LLP



David Petron
Sidley Austin LLP



Chris Mills
Sidley Austin LLP

Companies should also consider whether to discuss aspects of their operations that have not previously been included in their periodic reports but have now taken on more importance in light of Covid-19.

Accounting Judgments

Public companies should also carefully assess the accounting judgments reflected in their Form 10-Qs in light of Covid-19. If revenues have decreased dramatically, historic benchmarks as to what is material from a quantitative standpoint may need to be reset.

Just as the pandemic has affected seemingly every aspect of the global economy, the pandemic has the potential to affect essentially all aspects of a company's accounting involving judgments and estimates. These areas include, among others:

- valuation of tangible assets or illiquid securities held on balance sheets;
- fair value of goodwill and other intangible assets, and any related impairments;
- revenue recognition (which could be affected by changes in arrangements or courses of dealing between a company and its customers—discounts, refunds, price concessions, returns, etc.—and customers' ability to pay);
- bad debt reserves and loan loss reserves; and
- tax liability.

Anticipated Regulatory Scrutiny

We expect the staff from the Divisions of Corporation Finance and Enforcement will eventually focus on the financial reporting and disclosures of public companies to look for accounting or disclosure misconduct related to Covid-19.

For example, similar to its prior focus following major events, the SEC staff will likely try to assess whether companies have failed to appropriately impair assets held on their balance sheets, have misleadingly attributed write-downs or other adjustments to Covid-19 instead of other reasons, or have tried to use Covid-19 as an excuse to take a "big bath" to clean up their financial reporting.

The staff may also try to determine whether companies failed to appropriately disclose drivers and known trends or uncertainties associated with Covid-19 in portions of periodic reports such as management's discussion and analysis or risk factors.

Although there can be no way to forecast which companies will be the subject of the staff's scrutiny, commission staff may be most likely to open inquiries where a company's accounting judgment has a significant or unanticipated effect on its financial reporting, results in press coverage, or is the subject of a submission to the SEC's whistleblower program. (A company that believes an employee has contacted the commission regarding potential misconduct should carefully assess how to proceed in light of the statutory and regulatory protections afforded to such individuals.)

Of course, scrutiny by the SEC staff does not necessarily mean the staff will object to a company's judgments. As the Chief Accountant recently reiterated, the Office of the Chief Accountant "has consistently not objected to well-reasoned judgments that entities have made, and we will continue to apply this perspective."

Because the SEC staff generally will show deference to well-reasoned judgments, public companies should confirm that their internal controls over financial reporting are producing those types of judgment.

If the staff does inquire about a company's disclosures and financial reporting, it may review internal communications, work papers, and other materials created in the course of preparing the periodic reports.

These types of documents sometimes reveal that there were differences of opinion during internal deliberations, and the staff may closely examine judgments that were the subject to internal disagreement. Companies may find themselves in the position of needing to demonstrate that the judgment reflected in the periodic report was, in fact, appropriate, which will be viewed with the benefit of hindsight.

As a result, companies should assess whether they are appropriately documenting the rationale for their accounting and disclosure judgments in a way that will enable the company to show the staff that those judgments were reasonable and based on the best known information when they were made. This includes maintaining sufficient documentation showing how Covid-19 was relevant to write-downs, adjustments or other occurrences that the company publicly attributed to Covid-19. The inability to provide the staff with this type of information can heighten the risk that the staff may not consider the company's judgments to have been well-reasoned.

Covid-19 has created numerous challenges for public companies. Although the current environment is in many ways unprecedented, the SEC staff may still question accounting judgments made during this time and may bring enforcement actions in appropriate circumstances.

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Author Information

Thomas Kim is a partner in Sidley Austin LLP's Securities Enforcement and Regulatory practice group. Among other things, he advises public companies on a broad range of SEC disclosure and regulatory matters.

Ike Adams, a partner in Sidley Austin LLP's Securities Enforcement and Regulatory and White Collar practice groups, represents clients in investigations and enforcement actions by the SEC, DOJ, and other law enforcement authorities. He frequently handles matters involving, among other things, alleged accounting fraud, financial reporting and disclosure issues, auditor independence, and other issues arising under the federal securities laws.

David Petron is a partner in Sidley Austin LLP's Securities Enforcement and Regulatory group. His practices focuses on defending public companies, investment advisers, broker-dealers, and credit rating agencies in SEC investigations and related matters.

Chris Mills is a senior associate in Sidley Austin LLP's Securities Enforcement and Regulatory group. He regularly advises clients in connection with SEC inquiries and investigations, including those related to potential accounting and disclosure issues.

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