How Public Company Boards Can Mitigate Supply Chain Risk

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Directors must understand the major supply chain risks and the effect they have on the company.

Over the past several years, breakdowns in the supply chain have resulted in significantly higher risks to more companies than in the past. In the National Association of Corporate Directors' *2023 Governance Outlook: Projections on Emerging Board Matters*, company directors ranked "disruptions in the global supply chain" as the fourth most important trend (out of a list of nearly 20) likely to affect their company over the next year. Because these disruptions can affect a company's income statement and balance sheet as well as customer retention and operational effectiveness, boards need to be more aware of supply chain risks and provide more oversight in this area than has traditionally been the case. Unfortunately, few board members currently provide expertise in supply chain management and the associated risk mitigation.

Risk management is a key responsibility of public company boards and is part of good governance. In *Be Board Ready: The Secrets to Landing a Board Seat and Being a Great Director*, Betsy Atkins states that "enterprise risk management has landed squarely in the sights of institutional investors. As a result, boards must enhance their oversight of risk management." While many public company boards have risk committees that focus on important areas such as cybersecurity risk, currency fluctuation risk and climate change risk, it is time for supply chain risk to be added to their purview.

Here are some of the most prominent supply chain risks, along with the impact they can have on a company.

Supplier concentration risk. Sourcing materials or services from only one supplier presents several risks that need to be considered. What if a supplier factory has a fire or flood? What if essential systems are shut down by a cybersecurity attack, preventing them from supplying their customers? What if the supplier has financial challenges, falls behind in technology or becomes uncompetitive? While single sourcing is sometimes unavoidable, a thorough review to ensure this is the case is a good practice.

Geopolitical risk. Even if there are multiple suppliers for critical materials and services, it is also important to understand how dependent a company is on materials and services provided by any one country. The risks resulting from country concentration are multifaceted. One country may impose trade restrictions (tariffs and import limits) on parts from another nation. Or a country may face instability or infrastructure disruption because of a natural disaster, impacting the ability to obtain materials or services from suppliers located there. In the extreme, a country may be invaded, as we saw when the attack on Ukraine threatened the supply of neon gas for lasers used in making semiconductor chips.

Extended supply chain risk. While obtaining parts and supplies from another continent may allow the company to benefit from lower costs, local expertise and raw materials, extended supply chains also present risks. In 2021, a grounded container ship blocked the Suez Canal, delaying dozens of other ships. In that same year, at times, up to 100 container ships were waiting off the Southern California coast to offload their cargo, creating weeks of delays. Companies dependent on this cargo faced the prospect of delaying shipments to customers (thus delaying revenue) and idling assembly lines.

Lead time and availability risk. The company’s supply chain and inventory

strategy determine its susceptibility to sudden supply chain disruption. When material lead times extend unexpectedly, there can be a significant impact on customers and on company financials. During the COVID supply-and-demand imbalance, lead times went from weeks to months to over a year. Automobile factories paused production owing to lack of parts, homeowners waited months for appliances, and supermarket shelves were stripped of toilet paper. It is not only global pandemics that cause unplanned delays, so companies should assess their vulnerability.

Navigating the Risks

How can boards help companies navigate these supply chain risks? In *Be Board Ready*, Atkins explains that “the board’s primary roles related to enterprise risk management are ensuring that the company’s strategy is still relevant, examining the real risks the company faces and determining what risk oversight mechanisms are most effective.” Boards can apply this approach to these challenges by asking how the company is assessing and addressing existing supply chain risks and scanning for new risks.

Potential investors and acquirers often look at customer concentration when considering the purchase of a company, and boards should, too. In addition, boards should also understand which suppliers the company spends the most money with and how large a percentage of total spend they make up, along with what strategies are in place to mitigate or reduce any supplier concentration considered to be too high. This can take the form of supplier agreements, inventory agreements, increased on-hand inventory or dual sourcing initiatives.

In response to the geopolitical risks and extended supply chain risks discussed above, many companies are exploring combinations of onshore, nearshore and offshore sources. Offshore generally refers to another continent, often Asia. Sourcing from a low-cost, nearby country, such as manufacturing in Mexico for customers in the United States, qualifies as nearshoring. Onshoring is manufacturing and selling the product in the same country. There are advantages and disadvantages to all these options, and different risks to accompany them. Board members should consider that a combination of these options may be the optimal supply chain strategy. The board should ask the questions that will enable it to understand the company’s strategy on this topic, how decisions on the geographic allocation of supply chain spend are determined and the major risks associated with that strategy. It may be helpful for the COO or a supply chain executive to present the company’s approach to this topic to the board so

that it can evaluate and provide guidance as needed.

The board will also want to have a high-level understanding of what disaster recovery and continuity of supply plans exist for the company's factories and at key suppliers' facilities. Directors should assess whether the company has looked farther down its supply chain to ascertain how dependent its suppliers are on materials and services from individual sub-suppliers in certain countries. If a domestic supplier cannot obtain materials it needs to make products your company needs, the supplier's location poses no advantage.

Not all supply chain risks can effectively and efficiently be eliminated. In some cases, the best that can be achieved is that they are mitigated and managed. The board's focus should be to ensure that the company has:

- Developed a robust process for identifying supply chain risks.
- Objectively evaluated the magnitude and likelihood of occurrence of these risks.
- Created documented plans for addressing those risks to the best extent possible.
- Implemented and audited those plans.
- Reviewed the risks and risk mitigation activities on a regular basis.

We don't live in a static world. New risks arise while previously identified ones may increase or decrease in terms of severity and/or likelihood. Therefore, boards should ask how frequently the company reviews the list of risks it considers.

It is important to note that one size does not fit all – the personnel, resources, tools, time and effort that are appropriate for a multibillion-dollar corporation will not be the same as what is needed for a small company, and the needs will vary by industry as well. Regardless of the company size, understanding these supply chain risks and the strategies to mitigate them is the best way to prepare for them and fulfill the board's responsibility for good governance.

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