

Human Capital Management



Overview

Of all ESG topics, interest in HCM seems to have grown most rapidly.

Social Utility – how should we involve employees in governance?

- HCM appears to span the political spectrum in a way that other “big” ESG topics such as climate change do not.

Financial Utility – what labor information should be disclosed?

- Current reporting frameworks provide very little HCM information, despite increasing labor costs and “human capital” focused firms.
- Particularly for these firms, additional labor-related information likely fits within our understanding of “materiality.”

Growth in CEO and Average Worker Pay, 1965-2017

CEO pay rose by almost 2000% from 1965 to 2017, while pay for the average worker grew by only 33% during the same period.

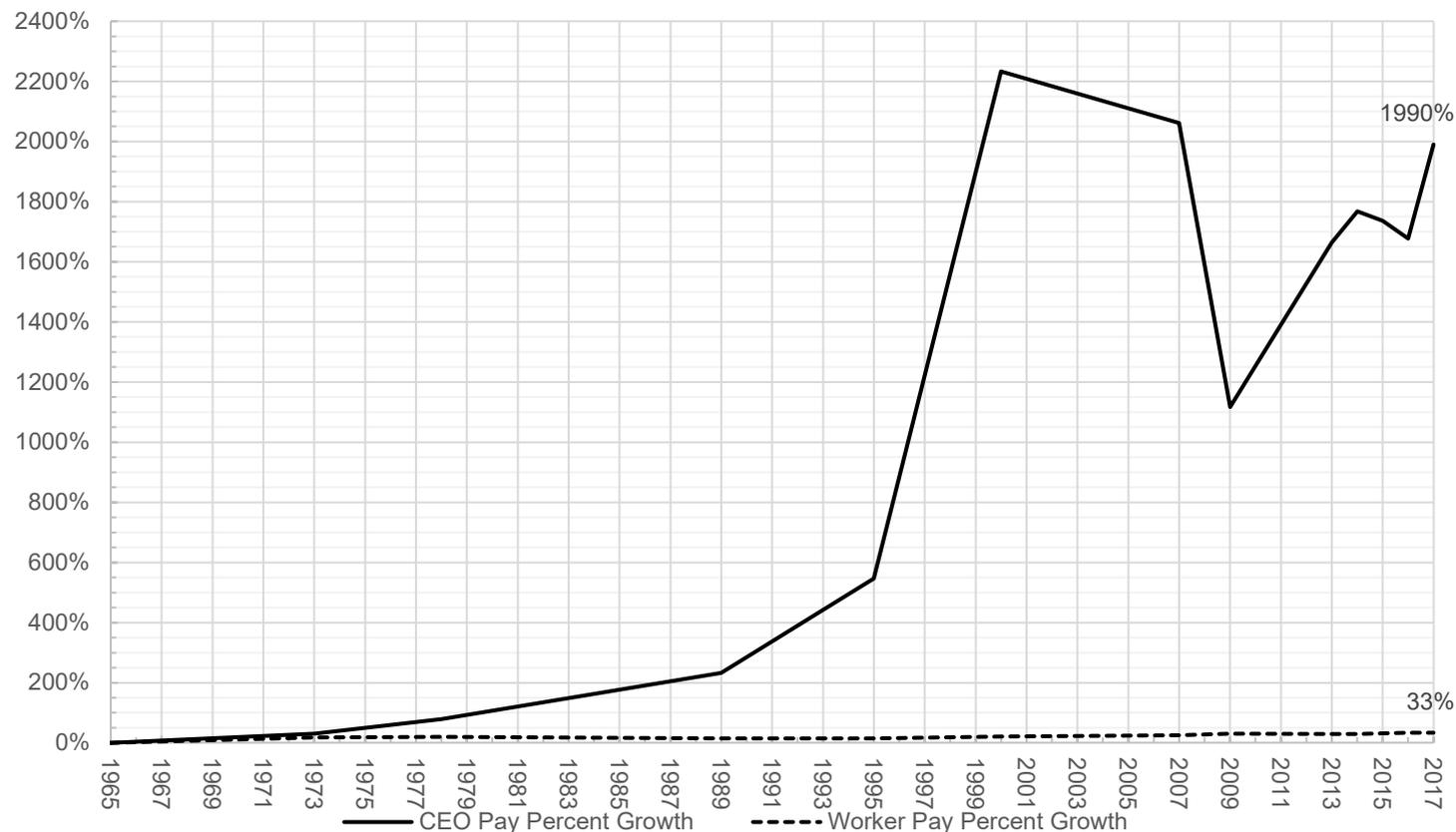


Exhibit 2, HBS Research Note. TJX.

“Our most important asset”

From a cost perspective, labor has become increasingly important, while more traditional measure of investment (e.g., CAPEX) have remained constant

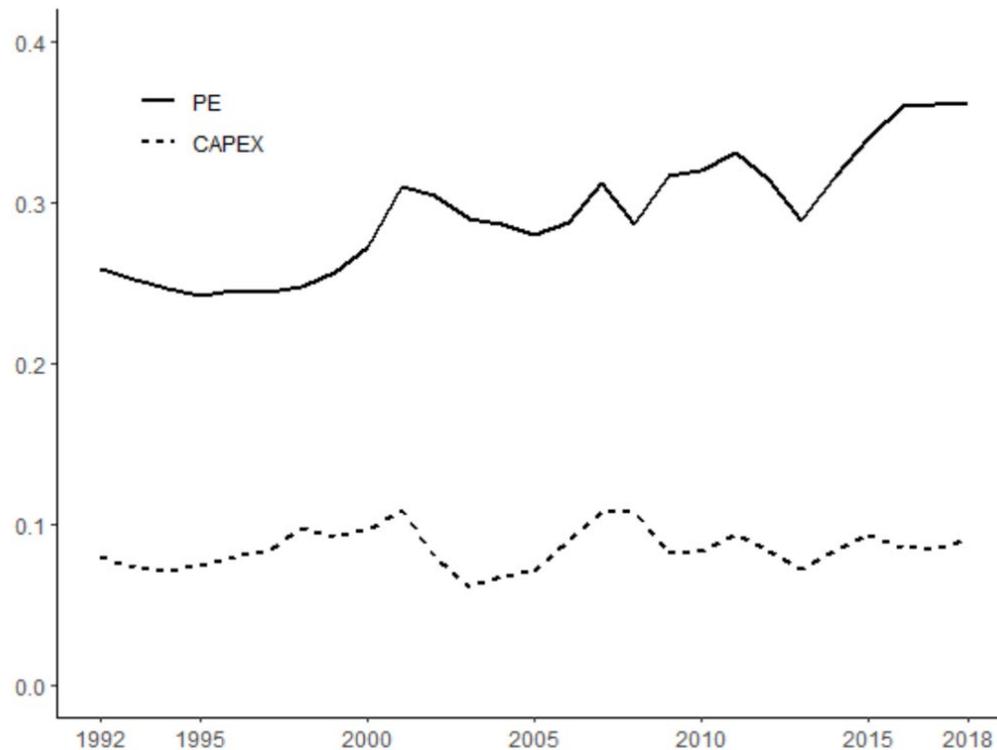


Fig. 1, Regier & Rouen, 2021.

Accounting for Labor

None of the financial statements, nor the notes to the financial statements, are required to provide total labor costs.

- **Income Statement.** On the income statement, labor costs are bundled into several different expenses rather than presented separately.
- **Balance Sheet.** Employees are not assets as per GAAP, so they are not reported on the asset side of the balance sheet. And labor costs are only reflected as liabilities when they have yet to be paid.
- **Statement of Cash Flows.** As with the income statement, labor costs are bundled into different accounts rather than presented separately.

Barely 15% of U.S. firms disclose something as basic as compensation or labor costs.

Accounting for Investment

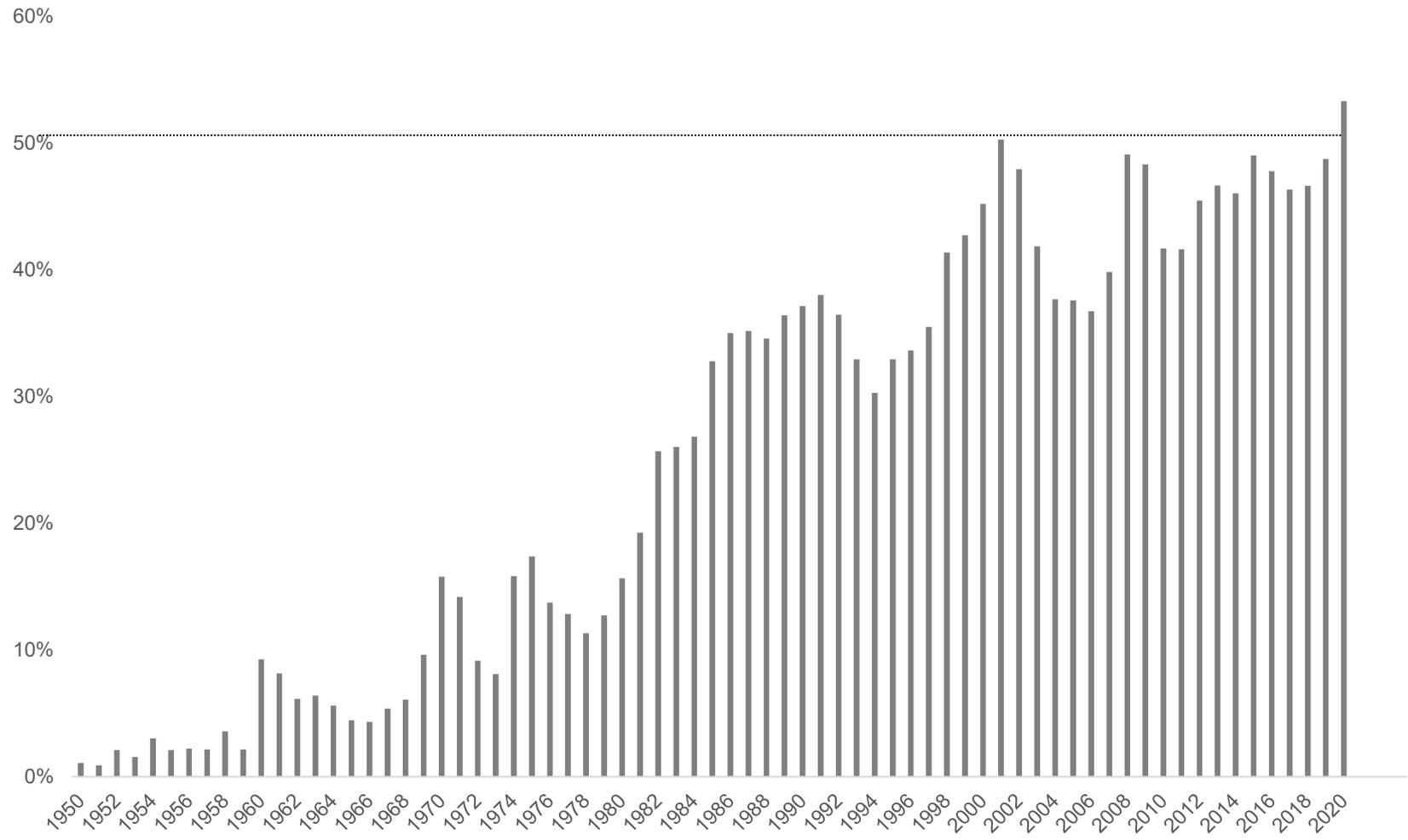
Accounting rules are inconsistent across different investments.

	Capital Expenditures	Acquisition	Research & Development	Labor
Income Statement Effect	<ul style="list-style-type: none"> • Decreases net income through depreciation and impairment • No immediate effect on net income 	<ul style="list-style-type: none"> • Decreases net income through depreciation and impairment • Profit or loss reported at sale 	<ul style="list-style-type: none"> • Immediate decrease to net income 	<ul style="list-style-type: none"> • Immediate decrease to net income
Balance Sheet Effect	<ul style="list-style-type: none"> • CAPEX is capitalized, putting those assets on the balance sheet • Value declines through depreciation 	<ul style="list-style-type: none"> • Target firm's assets and liabilities included on balance sheet • Purchase price above book value recorded mostly as goodwill 	<ul style="list-style-type: none"> • Decreases total assets (e.g., decrease in cash without a corresponding increase in assets) • Very little R&D is capitalized 	<ul style="list-style-type: none"> • Decreases total assets (e.g., decrease in cash without a corresponding increase in assets)
Note Disclosure	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • Yes 	<ul style="list-style-type: none"> • No



Percent of U.S. Public Issuers Reporting a Net Loss

The number of firms reporting net losses has increased significantly over the past 60 years. Market capitalization of these “loss firms” ranged from 5-17% over the period from 1998 to 2020.



Operating Margins

It is difficult to estimate margins for firms with operating losses.

Consider a traditional company such as Costco

	2021	2020	2019	2018	2017
Total revenue	195,929	166,761	152,703	141,576	129,025
Operating income	6,708	5,435	4,737	4,480	4,111
Operating margin	3.42%	3.26%	3.10%	3.16%	3.19%

Versus a net loss company such as Uber

	2020	2019	2018	2017	2016
Total revenue	11,139	13,000	10,433	7,932	3,845
Operating income (loss)	-4,863	-8,596	-3,033	-4,080	-3,023
Operating margin	-43.66%	-66.12%	-29.07%	-51.44%	-78.62%

PE disclosure, Example

Consolidated statements of Infineon (German semiconductor bluechip):

€ in millions	2015	2014
Revenue	5,795	4,320
Cost of goods sold	(3,715)	(2,673)
Gross profit	2,080	1,647
Research and development expenses → R&D	(717)	(550)
Selling, general and administrative expenses → SG&A	(778)	(496)
Other operating income	28	26
Other operating expenses	(58)	(102)
Operating income	555	525
Financial income	10	10
Financial expenses	(49)	(19)
Gain from investments accounted for using the equity met	4	3
Income from continuing operations before income taxes	520	519
Income tax	102	(31)
Income from continuing operations	622	488
Income from discontinued operations, net of income taxes	12	47
Net income	634	535

Notes: Personnel expenses comprised the following in the 2015 and 2014 fiscal years:

€ in millions	2015	2014
Wages and salaries	1,670	1,273
Social insurance levies, pensions and similar oblig:	269	217
Total (continuing and discontinued operations)	1,939	1,490

Personnel expenditures/expenses

Total assets	8,741	6,438
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Current SEC Guidance

SEC guidance, passed by a 3-2 vote by the Trump-administration SEC, reflects a principles-based disclosure approach.

- Disclosure of “any human capital measures of objectives that the company focuses on in managing the business.”
- Human capital is not defined.
- Firms determine what is material.
- The only mandated quantitative disclosure is the number of employees (if material to the business as a whole).

However, the democratic commissioners dissented on this guidance, and are likely to pass updated guidance this year.

The SEC's guidance has been criticized for allowing “fluffy” and “empty” disclosures.

“Caring for each other through valuing diversity, embracing inclusion, celebrating success, encouraging new thinking, supporting each other through change, and winning as a team is a key element of our plan to drive long-term business success. ...

At Ford, we believe that creating a Culture of Belonging for all our employees is foundational to our success and morally the right thing to do. ...

Nothing is more important than the health, safety, and well-being of our people, and we work hard to achieve world-class levels of safety year-over-year, through the application of policies and best practices. We maintain a robust safety culture to reduce workplace injuries ...”



Current Labor Disclosures

Voluntary HCM disclosures have been criticized as inconsistent, incomparable and unreliable.

- These disclosures primarily focus on metrics (e.g., workforce by country, % women in supervisory roles).
- Different companies disclose different metrics.
- Even similar metrics may be calculated inconsistently across different companies.
- These metrics may or may not be audited (or may be subject to limited assurance if audited).
- It is unclear how these metrics affect valuation.

Non-GAAP Labor Disclosures

Reviewing the disclosures for four European issuers yielded 70 different metrics. All four reported only one metric in common.

- **Reported by All Four Issuers:** % women managers.
- **Reported by Three Issuers:** # employees in # countries, Average number of hours of training/employee, % women in company, # new hires in prior year, % women new hires.
- **Reported by Two Issuers:** % employees in R&D, Absenteeism rate, % permanent contracts, Average rate of employees leaving at their own initiative, Average tenure, % generation/age breakdown of workforce, % workers w/ disabilities in France, Lost time incident rate, % union/works council employees, Retention rate, Employee engagement index, # employees worldwide.