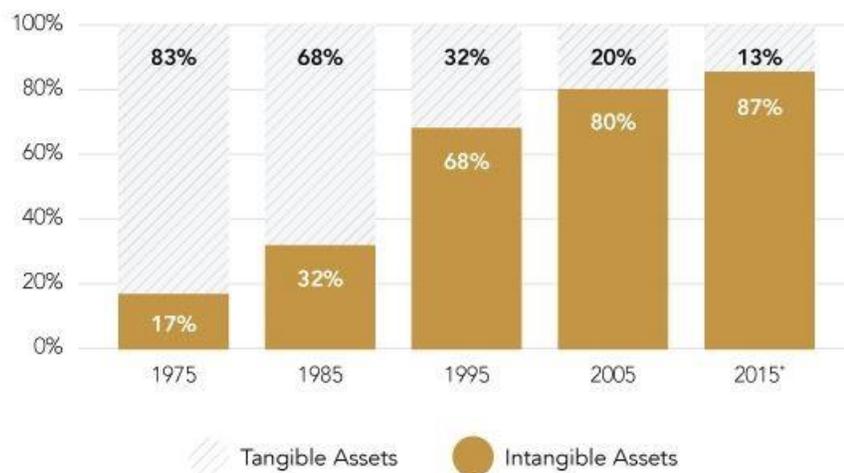


## Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management Disclosure

### Findings:

- Today's companies are increasingly dependent on their workforces as a source of value creation. Indeed, for many of the most dynamic companies, human capital is their primary source of value. As the US transitions from being an economy based almost entirely on industrial production to one that is becoming increasingly based on technology and services, it becomes more and more relevant for our corporate disclosure system to evolve to include disclosure regarding intangible assets, such as intellectual property and human capital. Human capital is increasingly conceptualized as an investable asset.<sup>1</sup> Modernizing the Commission's framework for corporate reporting generally should reflect these facts, subject to the standard of materiality.
- More specifically, as depicted in Figure 1, a 2015 study of the components of S&P market value data found that the implied intangible asset value of the S&P 500 grew to an average 84% by 2015 from the 1970s, when it was less than 20%.<sup>2</sup> The shift is ongoing, and reflects a growth in the importance of intangibles, such as human capital, of four percentage points over ten years. Figure 1

### COMPONENTS of S&P 500 MARKET VALUE



SOURCE: OCEAN TOMO, LLC

<sup>1</sup> This does not imply that human capital can or should be simply reported as an asset on balance sheets for financial reporting purposes. Generally accepted accounting principles (**GAAP**) reflect a number of important values, including objectivity and prudence, aka conservatism. But trade-offs in GAAP make it all the more important for disclosure frameworks to reflect value-relevant information available for disclosure that are not currently reflected in financial statements, as discussed more below.

<sup>2</sup> <http://www.oceantomo.com/2015/03/04/2015-intangible-asset-market-value-study/>.

- For that reason, last year, the Human Capital Management Coalition – including a number of large institutional investors -- petitioned the Commission for a rulemaking to require human capital disclosures from public companies.<sup>3</sup>
- In contrast to the financial markets’ view of human capital as a source of value, the Securities and Exchange Commission’s historical approach to the workforce has been to view human capital as a cost. The Commission’s disclosure frameworks – both quantitative and qualitative – have not kept pace with the shift towards human capital management (**HCM**) as a primary source of value. Valuation of firms with few hard assets based on public SEC-mandated disclosure alone is increasingly difficult. Currently available information is not consistent, verified, or comparable across companies.<sup>4</sup> Differences in HCM make existing disclosure requirements, such as the 10-K requirement to disclose the number of employees, difficult for investors to interpret or use. Yet HCM metrics such as those outlined below are a routine part of financial due diligence, such as in M&A transactions, including for basic valuation models.
- Institutional and retail investors have a pronounced interest in clear and comparable information about how firms approach HCM. This interest is reflected in ongoing projects by the Sustainability Accounting Standards Board (**SASB**),<sup>5</sup> as well as sustained streams of academic research in fields ranging from finance and law to labor economics and management. Research has found that high quality HCM practices correlate with lower employee turnover, higher productivity, and better corporate financial performance,<sup>6</sup> producing a considerable and sustained alpha over time.<sup>7</sup> The value-relevance of HCM metrics is consistently demonstrated in financial research. A meta-review was conducted in 2015 by Harvard researchers of 92 studies that measured performance using metrics of value to investors, such as total shareholder return, return on assets, return on capital, profitability and Tobin’s Q. The review found positive relationships in a majority of studies between financial performance, however measured, and disclosed training programs or HR policies on such topics as employee participation and pay for performance.<sup>6</sup>
- Yet current accounting standards on their own may obscure workforce investment by reflecting it only as an expense not distinguished from other inputs. Investing in research and development, by contrast, is often identified by its separate line item in the income statement, and acquired in-process R&D can be reflected on the balance sheet. While these distinctions may be grounded in rational if competing goals of the financial accounting system, qualitative disclosures about HCM do not currently reflect these distinctions in accounting treatment in a clear way, potentially skewing investor understanding of sources of value. Some but not all companies use disparate ad hoc supplemental disclosures that vary in substance and form within industries, and even for the same firm over time,<sup>7</sup> which can add further misunderstandings to how HCM and value are related.

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<sup>3</sup> <https://www.sec.gov/rules/petitions/2017/petn4-711.pdf>.

<sup>4</sup> Marleen A. O’Connor, Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge-Based Economy, 1 U. Pa. J. of Lab. and Emp’t L. 527 (1998).

<sup>5</sup> E.g., <https://www.sasb.org/standards-overview/materiality-map/>. See also Embankment Project for Inclusive Capitalism (**EPIC**), Report for 2018, <https://epic-value.com> (report on HCM published an alliance of investors, including Allstate, Allianz, and CalPERS, asset managers, including Barings, BlackRock, and State Street, and issuers, including Aetna, Dow/DuPont and Pepsico). <sup>6</sup> Mark Huselid, The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance, 18 Academy of Management J. 635 (1995). For more recent research, see articles and surveys cited above and below, as well as Dan Ariely, et al., Man’s Search for Meaning: The Case of Legos, 67 J. Econ. Beh. & Org. 671 (2008); Liad Bareket-Bojmel, It’s Not All About the Jacksons: Testing Different Types of Short-Term Bonuses in the Field, J. Mgt. 1-21 (2014). <sup>7</sup> Alex Edmans, Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, 101 J. of Financial Economics 621 (2011).

<sup>6</sup> Aaron Bernstein and Larry Beeferman, The Materiality of Human Capital to Corporate Financial Performance, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School, Apr. 2015. See <https://tinyurl.com/y7a84mdb>.

<sup>7</sup> The need for comparability over time for the same firm was noted by Chairman Clayton in an IAC call. <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619>.

- Lawmakers have called for improvements in HCM disclosures, and we note the comments of Chairman Clayton to the House Appropriations Subcommittee on Financial Services and General Government last April on the same topic, including that he “**would like to see more disclosure from public companies on how they think about human capital.**”<sup>8</sup>

## Recommendations

Given these substantial shifts in how value is created, the Committee recommends the Commission recognize the significance of HCM and incorporate it as a part of the Commission’s Disclosure Effectiveness Review and the Commission’s approach to modernizing corporate reporting and disclosure. We encourage the Commission to learn more from investors, issuers and the academic community through its customary processes, such as roundtables, concept releases, and proposed rules for public comment, including information about what kinds of HCM disclosures are already required under other regulatory regimes,<sup>9</sup> with a view to minimizing marginal costs of compliance while achieving the benefits of improved disclosure.

There are a wide range of potentially material HCM disclosures and ways to integrate that information into current reporting. At the most basic, issuers could be required to comply with a principles-based disclosure requirement asking them to detail their HCM policies and strategies for competitive advantage and comment on their progress in meeting their corporate objectives. This would essentially augment existing principles based requirements with explicit discussions of HCM.

Companies use many metrics to evaluate the success of their HCM strategies and investments. Development of specific metrics should depend on the outcome of standard regulatory processes, and should be adopted only after due consideration for how they might have unintended consequences, such as “managing to the metric.” Any requirements should be crafted so as to reflect the varied circumstances of different businesses, and to eschew simple “one-size-fits-all” approaches that obscure more than they add. For example, workplace safety metrics may be crucial for mining companies, but immaterial for software companies.

Nonetheless, the fact that board and managers routinely rely on a number of similar metrics suggests that they can add value for investors, at least within a given sector, similar to the “view from management” approach to MD&A disclosure. We offer a few examples here of disclosure that – based on research findings in the studies cited above -- could be considered. They could be considered in rule-making or as part of routine disclosure reviews by Commission staff. At a minimum, application of existing SEC guidance on non-GAAP accounting, including efforts to prevent issuers from providing inconsistent or otherwise misleading HCM disclosures over time, could be specifically applied to HCM metrics.

More specifically, the following specific disclosures are worth consideration as a way of augmenting existing requirements or the principles-based requirement outlined above:

- Item 101 of Regulation S-K currently calls simply for disclosure of the number of people employed as part of the narrative business description.
  - This existing requirement could be expanded to break down the numbers of:
    - full-time,
    - part-time, and
    - contingent workers,

which have distinct implications for the cost and value of a company’s workforce.

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<sup>8</sup> See <https://appropriations.house.gov/calendararchive/eventsingle.aspx?EventID=395258>.

<sup>9</sup> For example, all private employers with 100 or greater employees must provide an EEO-1 report by law, reporting on race/ethnicity and gender diversity within their workforces. See <https://www.eeoc.gov/employers/eo1survey/about.cfm>.

- Using these subcategories of employees, the background section could include company selected but standardized human capital related key performance indicators (**KPIs**), such as:
  - the stability of the workforce, including voluntary and involuntary **turnover** and **internal hire** and **promotion** rates;
  - the **safety** of the workforce, including frequency, severity and lost-time due to injuries, illnesses and fatalities, and percent of first-tier suppliers that were audited for safety and health compliance;
  - average hours of **training** per employee per year,<sup>10</sup>
  - race/ethnicity and gender **diversity data**,<sup>13</sup> and
  - standardized survey measures of employee **satisfaction**.
- Finally, the background section could also be augmented with a summary of material elements of material **company policies** and goals regarding career development, safety and health compliance, subcontracting and outsourcing.
- Another current element of Item 101 is a statement of the **competitive conditions** in the issuer’s area of business.
  - Because labor is an increasingly important supply factor for most firms, this element could be reasonably interpreted to include the productivity and competitive advantages of the issuer’s employee population, relative to competitors and available pools of labor.
  - As a result, during any SEC comment process, companies could be encouraged to summarize data on the education, experience, and training of its workforce.
  - Existing requirements to disclose competitive conditions could also include measures of worker **productivity**, either developed by the company, or preferably based on recognized and broader approaches already adapted in specific sectors or regions.
- In addition, the proxy statement, Form DEF 14A, incorporates significant information about executive compensation. The Commission has long viewed the **details** of compensation practices to be part of the internal business of management, not subject to public disclosure. We do not here seek to revisit this judgment.
  - However, we recommend that the Commission adjust its approach to help investors understand the human capital within a firm and how it is being incentivized and managed.
  - Specifically, existing executive compensation disclosure could be augmented, for example, to include useful summaries of material information about broader workforce compensation and incentive structures, such as:
    - How performance, risk, compliance, and long-term sustainability are considered in setting pay and making promotion decisions more generally, and

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<sup>10</sup> As noted by one literature survey, “dozens of studies in multiple industries and countries concluding that well-run employee training programs correlate directly to financial outcomes.” Aaron Bernstein and Larry Beeferman, Corporate Disclosures of Human Capital metrics (Oct. 2017) at 15. <sup>13</sup> See note 8 above.

- Through what organizational structures, such as:
- Does the head of HR report directly to the board's compensation committee, risk committee or audit committee?
- Do formal management committees have responsibility for measuring and valuing the effects of turnover, layoffs, outsourcing and offshoring decisions, and are these decisions within the scope of board review?
- While narrative business descriptions could easily adapt to include many HCM metrics, some data may be best suited for a table or more structured format, particularly as the Commission moves increasingly towards the use of structured data.
- To this end, and because human capital disclosures are likely to interact with accounting principles applicable to human capital and intangibles more broadly, we encourage the Commission to work with the Financial Accounting Standards Board to consider the evolving role of HCM in value creation and update Generally Accepted Accounting Principles accordingly.
- Finally, we note that without effective enforcement, the value of new guidance to investors and the markets is significantly diminished.

We hope that as part of its ongoing disclosure review, the Commission will undertake a robust examination of the role HCM plays in value creation today and incorporate that analysis into the wide range of tasks the Commission performs on behalf of investors and the US capital markets.