

Testimony of Dr. Colleen Honigsberg
Professor of Law
Stanford Law School

Before the
Financial Services Subcommittee on Investor Protection, Entrepreneurship, and
Capital Markets
Of the
United States House of Representatives

Hearing on
E, S, G and W: Examining Private Sector Disclosure of
Workforce Management, Investment, and Diversity Data

Tuesday December 6, 2022

Thank you, Chairman Sherman and Ranking Member Huizenga, for the opportunity to testify before you today. To give you a sense for my background, I began my career as a Certified Public Accountant with PricewaterhouseCoopers. I became interested in how accounting standards are set, so I returned to school, earning a law degree from Columbia Law School and a Ph.D. in Accounting from Columbia Business School. I am now a Professor of Law at Stanford Law School, where I teach classes on securities law, corporate governance, and accounting. While at Stanford, I have served as an Economic Research Fellow at the Public Company Accounting Oversight Board, and I currently sit on the Securities and Exchange Commission's Investor Advisory Committee. My recent scholarship has focused on the incentive structure for auditors and human capital disclosure.

This past spring, I was delighted to join forces with my colleague here today, Columbia Business School Professor Shiva Rajgopal, along with other esteemed academics, including former SEC Commissioners Joe Grundfest and Robert Jackson, to create the Working Group on Human Capital Accounting Disclosure. In June, the working group [petitioned](#) the Securities and Exchange Commission to develop rules requiring public companies to disclose sufficient information for investors to assess the extent to which firms invest in their workforce.

I share the view of our Working Group that investors need additional information to examine whether and how public companies invest in their workforce. As Senator Mark Warner wrote in 2018:

Unlike significant physical investments, which are often capitalized, investments in human capital (and R&D investments) are expensed, as if increased worker capability were less useful to a company in successive quarters than a new building. At least R&D is disclosed on its own expenditure line—investors can assess company expenditures on R&D separately from other firm costs. Because human capital is included in administrative expenses, not as a stand-alone item, it is plausible that capital markets punish companies that invest in their workers as if those companies had excessive energy bills.¹

I agree. Despite the value generated by employees, U.S. accounting principles provide virtually no information on the knowledge, skills, competencies, and attributes of firms' workforces. Investors

¹ Letter from Sen. Mark Warner to Hon. Jay Clayton, Chairman, Sec. & Exch. Comm'n 3 (July 19, 2018); *see also id.* (calling for "quantitative and qualitative" disclosure requirements in this area).

typically cannot even determine total workforce costs—much less identify how much a firm invests in its employees.² I believe that increased transparency around intangible assets such as human capital will better allow shareholders to assess public companies’ investments in their people—just as our transparency around investment in tangible assets has long facilitated analysis of public companies’ investments in their physical operations.

In today’s testimony, I explain that prompt action on labor cost disclosures is necessary due to two market trends: the growth of human capital firms and the increasing prominence of net loss firms. The lack of human capital disclosure, I will show, limits investors’ ability to accurately value these firms. Finally, drawing on core accounting principles, I conclude my testimony by proposing three reforms that would allow investors to better analyze public companies’ investments in their workforce. **First**, managers should be required to disclose what portion of workforce costs should be considered an investment in the firm’s future growth. **Second**, workforce costs should be expensed for accounting purposes but disclosed, allowing investors to capitalize workforce costs in their own valuation models as appropriate. **Third**, the income statement should be disaggregated to give investors more insight into operational costs.

I. MARKET TRENDS REQUIRE PROMPT ACTION ON HUMAN-CAPITAL ACCOUNTING

Two key market trends demand prompt regulatory attention in this area. First, an increasing proportion of public companies derive much of their value from intangible assets, including human capital—yet only about 15% of those firms even disclose their labor costs.³ Second, an increasing number of public companies report a loss for accounting purposes, making analysis of firms’ operational costs—the most significant of which is likely to be labor—more important than ever to

² See Honigsberg and Rajgopal, *Wage Wars: The Battle over Human Capital Accounting*, 12 HARV. BUS. L. REV. ____ (2022).

³ Shivaram Rajgopal, *Labor Costs Are the Most Pressing Human Capital Disclosure the SEC Should Consider Mandating*, FORBES (May 17, 2021).

understanding firm value. As explained below, disclosure rules have not kept pace with either of these two trends, leaving investors in the dark with respect to key measures of firm value.

First, accounting rules have not kept pace with the emergence of the so-called human-capital firm in the 21st century, leaving investors without information necessary to accurately value the firms that they own. When the first accounting standard-setter came into existence in the 1930s,⁴ the bulk of industries were made up of firms that built, moved, and sold tangible products using tangible assets.⁵ Accordingly, America’s accounting standard-setters designed rules that made sense for those firms at that time.

We see the legacy of these rules in accounting today, as different forms of investment are treated differently. Compare the different accounting treatment for a firm’s spending on capital expenditures (i.e., physical property), research and development (“R&D”), or its people. When a firm invests in capital expenditures, that property’s value is included as an asset on the firm’s balance sheet and depreciated over time. By contrast, spending on R&D and labor are typically treated as expenses: they reduce net income in the current period, and they do not appear as assets on the balance sheet.⁶

These legacy rules do not reflect the current reality that the largest firms add value through internally developed intangible assets such as human capital. And while accounting rules have been sporadically updated over time, they have not been sufficiently reimagined to address the changes in the characteristics of today’s public companies. As evidence of the increased importance of intangible assets to the value of U.S. public companies, consider that, in 1975, intangibles represented 17% of the value of the S&P 500.⁷ By 2020, intangibles represented 90% of the S&P 500 market value.⁸ The

⁴ Stephen Zeff, *EVOLUTION OF U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)* 3.

⁵ In 1925, the largest industries in the S&P 500 were transportation (28.75%), energy (19.48%), consumer discretionary (17.08%), and industrials (10.53%). *GFD Indices - Market Capitalization*, GLOB. FIN. DATA. Honigsberg & Rajgopal, *supra* note 2.

⁶ PETER D. EASTON ET AL., *FINANCIAL ACCOUNTING FOR MBAS* (8th ed. 2021).

⁷ Intangible Asset Market Value Study, Ocean Tomo.

⁸ *Id.* This study suggests that intangibles are especially important for U.S. firms; among the other indices examined by Ocean Tomo, the S&P Europe 350 had the highest share of intangible market value at 75%.

growth of human capital firms is also apparent if we look at industry composition. Two of today’s largest industries, healthcare and information technology (industries which rely heavily on human capital), jointly account for more than 33% of the market capitalization of the S&P 500, despite the fact that they are relatively new industries.

Second, accounting rules have not been updated to reflect the fact that in 2020, for the first time, more than half of U.S. listed companies reported negative earnings.⁹ As shown in Figure 1, there has been a steady increase in the percentage of net loss firms over the past several decades. A leading explanation for the growing number of net loss companies is that many of these companies are relatively young, technology-heavy firms, and investors are betting on their future profitability.¹⁰

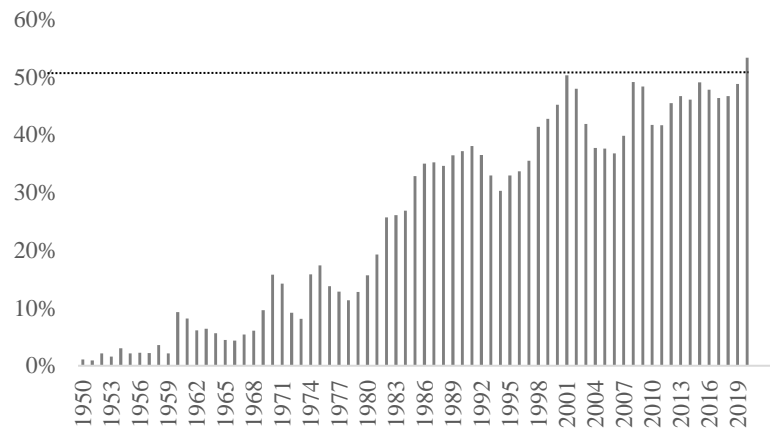


FIGURE 1. THE INCREASING PROPORTION OF LOSS-MAKING FIRMS AMONG PUBLIC COMPANIES.¹¹

Commonly used valuation techniques, such as price-to-earnings ratios, cannot be used to value these firms. Instead, investors must project future earnings—an analysis that requires reliable information about costs, margins, and scalability. Unfortunately, this information is commonly

⁹ Honigsberg & Rajgopal, *supra* note 2.

¹⁰ As noted in CEO Today Magazine, “[b]ack in the day, investing in a firm that is not making profits would be considered insane, but the status quo is changing.” Richard Rossington, *5 of the World’s Biggest Companies That Are Making Zero Profit*, CEO TODAY.

¹¹ Figure 1 includes firms traded on the New York Stock Exchange, American Stock Exchange, OTC Bulletin Board, NASDAQ-NMS Stock Market, NASDAQ OMX Boston, Midwest Exchange (Chicago), NYSE Arca, Philadelphia Exchange, and Other-OTC.

obfuscated under current accounting principles, as investors typically do not receive a sufficiently detailed breakdown of the firm's cost structure to identify contribution margins. And, of course, given the different accounting treatment for different types of investment, it is possible that these firms would be profitable if they were investing in physical equipment rather than R&D or people.

In sum, accounting rules have not kept up with two defining trends of 21st-century capital markets: the rise of the human-capital firm and the growth of lossmaking public companies. For the reasons explained below, the outdated accounting framework creates difficulties for investors.

II. VALUATION CHALLENGES UNDER TODAY'S OUTDATED DISCLOSURE RULES

The prominence of human capital firms and lossmaking firms poses challenges to valuation. To accurately value a firm, investors must distinguish whether cash outflows should be considered investments or maintenance expenses.¹² For example, the purchase of new equipment that improves the firm's operational efficiency and contributes to revenue growth is often considered an investment, as that equipment will be used going forward and will create future value. By contrast, the replacement of existing equipment to maintain current levels of revenue is often considered a maintenance expense, as that expenditure allows the firm to maintain its current productivity, but does not increase its productivity.

It is clear that sophisticated investors consider the distinction between investment and maintenance expenditures to be important. For example, skilled investors such as Warren Buffet have long incorporated this information in valuation of physical assets.¹³ Mr. Buffet and other investors can perform this analysis for physical assets because existing accounting rules require disclosures that allow

¹² The absence of disclosure breaking down costs into fixed, variable, and semivariable is a concern with accounting principles more broadly. Because labor costs are likely to be firms' largest operating cost, it is intuitive to first address the lack of disclosure in this area, but it would be beneficial to consider the opacity of cost disclosures more generally.

¹³ Letter from Warren E. Buffett, Chairman of Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. (1987). *But see* Venkat Peddireddy *Estimating Maintenance CapEx* (Sept. 2021) (distinguishing maintenance and investment capital expenditures, but describing the limitations of the current approach).

investors to estimate, albeit imperfectly, the portion of capital expenditures that can be considered investment and the portion that can be considered maintenance expense.

By contrast, current disclosures do not even allow investors to determine total workforce costs, much less to identify a firm's investment in its workforce. As the SEC recently recognized, information of this kind is "an important driver of long-term value."¹⁴ That's why our Working Group reached broad agreement that, to improve pricing accuracy, investors need the information that will allow them to distinguish the portion of labor costs that should be considered an investment and the portion should be considered a maintenance expense.

III. PROPOSED REFORMS

Our Working Group has proposed three straightforward disclosure rules in this area that would allow investors to draw that distinction. *First*, managers should be required to disclose, in the Management's Discussion & Analysis ("MD&A") section of the annual report, what portion of workforce costs should be considered an investment in the firm's future growth. *Second*, workforce costs should be treated *pari passu* with research and development costs, meaning that workforce costs should be expensed for accounting purposes but disclosed, allowing investors to capitalize workforce costs in their own valuation models as appropriate. *Finally*, the income statement should be disaggregated to give investors more insight into workforce costs.

As a first step, managers should be required to disclose in the MD&A what portion of labor costs they view as an investment and why. This would allow investors better insight into what portion of labor costs should be capitalized in their own models—and may incentivize management to consider employees as a source of value creation.

Second, managers should also be required to give investors quantitative, tabular disclosure containing information on the number of employees, their total compensation (broken down by type of

¹⁴ Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K (Aug. 26, 2020).

compensation), and turnover rates. Although management’s perspective is always helpful, the limits of quantitative disclosures are well-documented.¹⁵ Detailed, quantitative disclosure is especially necessary in this area because some labor-related expenditures are more likely to reflect investments than others. For example, employee training costs seem likely to be considered an investment. Equity compensation, too, seems more likely to be classified as an investment, given the evidence that providing employees with equity compensation significantly improves retention.¹⁶

The Working Group’s proposed “disclosure-only” approach is consistent with the treatment of R&D under current U.S. accounting rules. Although R&D is expensed, it is disclosed, allowing investors to make their own decisions regarding how R&D investments should be assessed. The result is that investors frequently, though not always, capitalize R&D.

I also note that, to be most helpful to investors, the tabular disclosure should include employee turnover rates. This information would permit investors, as appropriate, to amortize a firm’s investments in labor. For example, if a firm has investments in labor of \$100,000 and employees typically remain at the firm for five years, investors might capitalize that \$100,000 and amortize it at \$20,000 per year for five years. This is akin to how physical property is capitalized and depreciated under current accounting rules. Of course, whether to capitalize and amortize labor costs is a decision that investors can and should make—but they are only able to do so if the law gives them the pertinent information.

Finally, the income statement should be disaggregated so that investors have detailed information about specific operating costs—including labor. As noted above, investors in lossmaking firms need information on costs, margins, and scalability to estimate future profitability. Unfortunately,

¹⁵ See, e.g., Andrew A. Acito, Jeffrey J. Burks & W. Bruce Johnson, *The Materiality of Accounting Errors: Evidence from SEC Comment Letters*, 36 CONTEMP. ACCT. RES. 839, 862 (2019) (documenting differing managerial approaches to SEC inquiries about the need for disclosure of particular items). See also Shivaram Rajgopal, *Amazon Spends \$42 Billion on R&D but the 10K Discusses R&D in 300 Words*, FORBES (Mar. 8, 2021).

¹⁶ See, e.g., Bo Cowgill & Eric Zitzewitz, *Incentive Effects of Equity Compensation: Employee-Level Evidence from Google* (working paper 2015) (documenting retention effects of equity-based incentives).

this information is obfuscated under current accounting principles. Scores of costs are aggregated together under generalized headers such as “Cost of Goods Sold” or “Selling, General, & Administrative Expenses.” Rather than purely generalized categories, investors need detailed information on specific operating costs, the most important of which is labor, to predict future margins, and to determine what portion of cash outflows reflect investment that will improve firm productivity and what portion reflect maintenance expenses that merely maintain the firm’s current productivity. Without more detailed cost-level information, it is difficult, if not impossible, to reliably value these firms, or to stress-test the market’s valuations of a firm using fundamental analysis. Further, disaggregating labor costs in this manner would allow investors to better understand the job function of employees, their expected value creation, and the firm’s reliance on those employees.¹⁷

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Given the importance of workers in today’s economy, it is long past time for modernization of these rules. Specifically, public companies should be required to discuss what portion of their labor costs should be considered an investment in future firm profitability, disclose tabular information that would allow investors to assess that question for themselves, and disaggregate the income statement to show what portion of major expenses are attributable to labor costs.

Thank you again for the opportunity to testify before you today. I would be delighted to answer any questions you might have.

¹⁷ Consider Microsoft’s reporting from the early 2000s. In the Employee Stock and Savings Plan footnote, Microsoft presented pro forma disclosures showing the effect of expensing stock options on different operating expenses. The 2003 Annual Report showed that, if it were to expense stock options, operating expenses would have been nineteen percent higher in total. The allocation was not spread evenly across different expenses. Cost of revenue would have increased by only seven percent, but research and development would have increased by forty-two percent! Microsoft Corp., Annual Report (Form 10-K), Note 16 to Financial Statements.