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House Financial Services Committee

Re: Testimony before the House Financial Services Committee Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets related to "E, S, G and W: Examining Private Sector Disclosure of Workforce Management, Investment, and Diversity Data"

Thank you, Chairwoman Waters, ranking member McHenry and the esteemed members of the subcommittee for inviting me to speak today. It is an honor to be here. My name is Shiva Rajgopal and I am the Kester and Byrnes Professor of Accounting and Auditing at Columbia Business School.

My testimony touches on the "E" and "W" part of our hearing today. I express support for the SEC's proposed rules with mixed feelings about scope 3 emissions disclosures. I also highlight the need for mandatory disclosure related to compensation, workforce tenure and turnover for publicly listed U.S. companies.

Proposed SEC climate rules and scope 3 emissions

Let us start with the SEC's proposed climate rules related to E. The SEC has asked public listed firms to disclose the impact of climate-related risks on the firm's business model, its financial statements and governance process to manage such risk. Turning to quantitative disclosures, the SEC has asked firms to disclose scope 1 and 2 greenhouse gas (GHG) emissions and scope 3 emissions, if material, or if the firm has set a GHG emissions reduction target that includes Scope 3 emissions. Scope 1 covers direct emissions from owned or controlled sources. Scope 2 refers to indirect emissions from the generation of purchased electricity consumed by the reporting company. Scope 3 includes all other indirect emissions that occur in a company's value chain especially from consumption of the product by customers.

I support the SEC's attempt to mandate rigorous, comparable, consistent data on GHG emissions across companies. My perspective is informed by a research project where my colleagues and I tried to assess whether the net-zero pledges of 57 odd oil and gas firms are credible. It took us close to six months to code what these companies were doing. The underlying data is scattered across press releases, websites, 10-Ks and sustainability reports. There is tremendous variation in the path followed to a net zero promise, the GHG scope category the promise covered, the reporting framework followed and the verifiability, if any, of the promised path to net zero. Companies routinely follow multiple NGO (non-governmental organization) sponsored frameworks such as those proposed by the TCFD (The Task Force on Climate related Financial Disclosures), GRI (Global Reporting Initiative), CDP (Carbon Disclosure Project) and the SASB's (Sustainability Accounting Standards Board). On top of that, the four ESG rating agencies, ISS (Institutional Shareholder Services), Sustainalytics, Bloomberg and MSCI provide environmental ratings that do not converge and are all over the map. Without rigor, consistency, comparability, and verifiability of climate risk disclosures, these companies cannot be held accountable for the promises they make in terms of carbon reduction. This concern is even more pressing for investors of ESG funds that claim to hold stocks that are climate friendly.

It is useful to point out that the disclosure framework suggested by the SEC is agnostic with respect to investor preferences about GHG emissions. Comparable and consistent GHG disclosures can also inform an investor who wants to bet on high GHG emitters. If an investor wants to buy stocks with higher GHG emissions, so be it.

However, I have mixed feelings about the SEC's requirement to disclose scope 3 disclosures. Although the SEC only asks for scope 3 emissions if material to a firm, I can think of cases where the costs of gathering material scope 3 data can be quite high. Consider the scope 3 emissions related to say a public listed pizza company that sells prepared pizzas to a retail distributor. The retail distributor uses delivery services to get the pizza to the customers' homes. Asking the publicly listed pizza company to calculate scope 3 emissions related to those deliveries can be potentially burdensome.

Another issue is the significant double counting of emissions if one adds up all the emissions across companies. If Chevron sells jet fuel to Delta Airlines for use in a plane made by Boeing, these emissions are scope 3 for Chevron and Boeing, and scope 1 for Delta. These emissions are effectively counted three times, which is problematic for any decent accounting system. Every scope 2 or scope 3 emission is someone else's scope-1 emission.[1] Having said that, if a firm has promised a scope 3 reduction to investors, we need disclosures to check whether that promise is being met.

The need for mandatory disclosure on labor costs and turnover

Let me devote my remaining time to the W aspect of the hearing today. In a typical high school economics class, we teach students that a typical company creates shareholder value by combining materials, labor, capacity using physical or intangible investments and managerial talent. However, an investor struggles to place even a range of values to the components of such a model for an American public company. This is because the standard income statement of a U.S. company lists expenses that a company incurs by function such as cost of goods sold, research and development, selling, general and administrative expenses (SG&A) but not by the value drivers of a business such as materials, labor and capacity costs needed to produce this year's product or services.[2]

Having laid out the limitations of the reporting model in general, let us concentrate on the topic at hand: labor, which I define broadly to include all compensation costs paid by firms. Labor costs are tangled up in every functional line item on the income statement where labor is employed, leaving pieces to a puzzle scattered throughout the income statement without thorough disclosure. For instance, compensation paid to scientists and engineers is tallied in the research and development number, or R&D. A significant portion of selling, general and administrative (SG&A) expenses is tied to compensation paid to hourly workers in stores and distribution centers, compensation for salespeople and to administrative labor such as accountants, lawyers and support staff. Very few U.S.

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[1] https://www.project-syndicate.org/commentary/carbon-offsets-types-of-corporate-emissions-by-geoffrey-heal-2021-11

[2] https://www.forbes.com/sites/shivaramrajgopal/2020/01/24/why-the-public-reporting-model-is-broken-and-how-to-fix-it/?sh=33f6b97f5b09

firms gather the puzzle pieces together for the investor to provide a cohesive, total picture of labor costs, stripped away from function.[3]

To be sure, the SEC has made some progress on this issue by mandating qualitative disclosures of human capital. However, a review of current voluntary disclosures of human capital metrics spans a wide array of non-comparable, often qualitative, information: For example, Tyson Foods has a new goal on employee retention, Visa has announced a target of increasing number of employees from underrepresented minorities at the vice president level and higher, Wells Fargo has disclosed adjusted pay gaps between women and men and between people of color and their white peers, Broadcom and Qualcomm talk about employee retention relative to their industry benchmarks, and Jacobs Engineering and Tyson Foods want to bring down reportable incidents to the OSHA. A glaring omission from this conversation is the most basic human capital metric: "compensation costs." As of now, approximately 15% of U.S. public firms disclose their compensation costs in their financial statements.[4]

How can an investor use information about labor costs to ascertain the financial sustainability of a business? Physical and tangible assets are now less important compared to human capital, especially in a rapidly digitizing corporate America. As an example, consider the business models of so-called network businesses such as Facebook or Uber.[5] The basic idea of such models is to keep building platforms, mostly in the form of labor costs embedded in software or brand building costs, till the business hits the so-called tipping point where the network is seen as large enough to become a dominant platform. Once that tipping point is hit, incremental revenue, net of variable costs, is supposed to contribute to the bottom line in an exponential manner. How is an investor supposed to track a company's progress towards the tipping point if the investor does not know the investment portion of labor employed to build the platform relative to the variable cost of labor associated with selling the product?

Another immediately useful application of reliable labor data would be to compute whether the gains made by shareholders reflect the gains made by employees. That is, if labor and shareholders truly operate as a partnership, we would expect percentage increases in shareholder value to mirror percentage increases in the value the company adds to its labor. My co-author and I have tried to test whether American companies reflect such a partnership using very coarse compensation data.[6] Precise self-reported compensation cost data by companies would greatly improve our ability to identify which companies follow such a partnership model and hence contribute meaningfully to the measurement of stakeholder value added, which is an important aspect of our hearing today.

This discussion is also related to the larger anxieties about the future of labor in our economy. There are legitimate concerns that automation and AI (artificial intelligence) will systematically replace

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[3] https://www.forbes.com/sites/shivaramrajgopal/2021/05/17/labor-costs-are-the-most-pressing-human-capital-disclosure-the-sec-should-consider-mandating/?sh=4e165d615192

[4] https://www.forbes.com/sites/shivaramrajgopal/2021/05/17/labor-costs-are-the-most-pressing-human-capital-disclosure-the-sec-should-consider-mandating/?sh=4e165d615192

[5] https://www.forbes.com/sites/shivaramrajgopal/2021/04/12/what-would-a-new-financial-reporting-model-for-network-businesses-look-like/?sh=2227a6862af3

[6] O'Byrne S and S. Rajgopal. 2022. Employee value added: A new measure of gain-sharing between labor and capital. Journal of Applied Corporate Finance 34(2): 30-44. Available at https://onlinelibrary.wiley.com/doi/abs/10.1111/jacf.12503

labor as manufacturing has been outsourced from the U.S. to overseas destinations and our service companies become increasingly dependent on "gig" workers or contractors. Indeed, branded hotels appear to carry a large portion of the workforce who work their hotel ecosystem in off-balance sheet entities.[7] How does an investor assess the impact of these forces on the company's financial sustainability unless that investor can observe the firm's labor costs, including that related to compensation paid to contractors and its employees on its payroll?

The pressing concern on many investors' minds these days is to assess and understand how the company attracts and retains human capital which I define as the knowledge, skills, competencies, and attributes of the workforce, that enable the firm to earn higher operating returns and stock-based returns. Essential information that an investor needs to assess the quality of a company's human capital is the average number of years a worker spends with the firm and the level of employee turnover. My research suggests that employee turnover is robustly associated with the effectiveness of corporate culture in a firm.[8]

Guided by such research and observations, my co-author, Colleen Honigsberg of Stanford Law School, and I have filed a petition with the SEC detailing a suggested grid on what such mandatory labor disclosures might look like.[9] In particular, we ask for quantitative data related to salary, bonus, pension, stock awards, option awards, non-equity incentive compensation, pension and deferred compensation, health care, training and other costs. We suggest that these expenses be disclosed separately for full time employees, part time employees and contingent workers. We also ask for quantitative data related to mean tenure, employee turnover and number of workers for these three categories of labor.

We believe that such disclosure will enable investors assess the financial sustainability of companies better and hence improve the efficiency of stock prices and allocation of capital to public enterprises. We also believe that the cost of compiling such data is unlikely to be significant given that such data is already likely prepared by firms to send tax statements to their workforce.

Thanks again for listening to my testimony. I look forward to answering your questions.

Yours sincerely

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Shiva Rajgopal

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[7] https://www.forbes.com/sites/shivaramrajgopal/2022/03/20/asset-lite-companies-rely-on-labor-based-arbitrage-heres-the-investor-and-esg-case-for-disclosing-their-labor-practices/?sh=34693fdf5f09

[8] Graham, J., J. Grennan, C. Harvey and S. Rajgopal. Corporate culture: Evidence from the field, Journal of Financial Economics 146(2): 552-593. Available at https://www.sciencedirect.com/science/article/pii/S0304405X22001684

[9] https://www.sec.gov/rules/petitions/2022/petn4-787.pdf