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Value relevance of human capital based disclosures: Moderating effects of labor productivity, investor sentiment, analyst coverage and audit quality



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ABSTRACT

Voluntarily disclosed employee costs in annual reports of listed firms are value relevant, according to US based studies. However, investors appear to fail to take full advantage of the signaling opportunities presented by these disclosures. This study suggests that labor productivity, audit quality, analyst coverage and high technology categorization moderate the value relevance of voluntarily disclosed employee costs in Malaysia, contributing a novel set of moderating variables to the human capital accounting and value relevance literature, and extending the extant literature to an emerging economy. The results are consistent with the findings from US based settings, after incorporating these moderating factors. Pertinent policy recommendations, based on these findings, are suggested.

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1. Introduction

The resource based view (RBV) indicates that a firm's unique resources confer competitive advantages (Kraaijenbrink, Spender, & Groen, 2010; Penrose, 1959). Talented employees are regarded as an important factor of production (Eisfeldt & Papanikolaou, 2013) and well trained, competent employees, or human capital, comprise valuable unique resources within the context of the RBV (Wright, Dunford, & Snell, 2001). Becker (1964) posits that the human capital's skill set is dependent on innate ability and education, including tertiary education.

Firms generally pay higher wages for higher educational qualifications (Acemoglu & Autor, 2012; Bills, 2003), in expectation of superior performance. Specifically, higher education is seen to boost productivity, improve long-term competitiveness in firms and promote national economic growth (Blundell, Dearden, Meghir, & Sianesi, 1999). However, the relationship between higher pay and performance is presumed, rather than empirically proven (Ng & Feldman, 2009).

Firms that invest in higher grade human capital could benefit from disclosing pertinent human capital based information in annual reports. The extant literature, based on studies in US settings, reports positive correlations between employee costs and firm valuation, suggesting that investors consider employee costs as investments (Ballester, Livnat, & Sinha, 2002; Lajili & Zeghal, 2005). However, there is also evidence that investors fail to take advantage of the signaling provided by

employee cost and headcount information (Lajili & Zeghal, 2006), indicating that investors may not fully understand the implications of human capital based disclosures and firm valuation may not reflect the full information content of employee costs and headcounts.

However, the evidence to date does not explain why human capital is value relevant and “the challenge is to understand the nuances of the human capital role in generating value through the contribution to the firms' operations” (Wyatt & Frick, 2010, p. 203). For instance, given that employees with higher educational qualifications tend to earn higher pay and higher educational qualifications may not always lead to superior job performance (Ng & Feldman, 2009), higher employee costs may potentially be related to higher firm valuation only when higher employee pay is associated with higher productivity. In addition, other factors may also moderate the observed statistical association between employee costs and market valuation, including labor intensity, use of high technology, investor sentiment and audit quality. Finally, noise may confound the results. Virtually no research to date has examined the impact of these factors on the value relevance of voluntarily disclosed employee costs.

The paucity of literature in this area could be due to the difficulty of finding settings where the moderating effect of labor productivity and other factors, on the value relevance of employee costs, could be explored empirically. Ideally, the macroeconomic environment should actively promote human capital upgrading, with the view that higher grade human capital will be absorbed into public listed companies (PLCs). The PLCs should likely pay higher employee costs to benefit from higher productivity and disclose pertinent quantitative human

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capital based information that will enable investors to make informed decisions. These quantitative disclosures would enable the testing of statistical associations with the market valuation of PLCs.²

Malaysia offers such a setting, establishing large numbers of universities and colleges, since 1996, to provide access to higher education and upgrade the nation's human capital. This upgraded human capital is projected to flow into Malaysian firms and enhance firm level productivity, which in turn is expected to lift per capita GDP and personal incomes. Some Malaysian PLCs disclose employee costs and headcounts in corporate annual reports, making available the data required for these investigations. The current paper takes advantage of this setting and data to examine a set of moderating variables pertaining to the value relevance of voluntarily disclosed human capital costs.

Unlike studies based in the US setting, this paper finds a significant negative correlation between employee costs and market values of Malaysian PLCs. However, positive significant correlations between employee costs and market values, that are consistent with the conclusions from the US based studies, are found after factoring in the moderating impact of labor productivity, high technology categorization, analyst coverage and audit quality.

2. Literature review

2.1. Human capital accounting

Human capital accounting (HCA) is defined as the process of identifying and measuring data about human capital and communicating this information to interested parties (American Accounting Association, 1973). Abeyseker and Guthrie (2004) identify three current literature streams in HCA, pertaining to measurement approaches, usefulness and disclosures of human capital based information. These are discussed below.

2.1.1. Human capital measurement models

Cost and value based models have been used to measure human capital (Flamholtz, 1999). Human capital quality is proxied by human capital based expenditures in the former (Brummet, Flamholtz, & Pyle, 1968; Caplan & Landekich, 1974) and human capital related outputs in the latter (Jaggi & Lau, 1974). Samudhram, Shanmugam, and Low's (2008) human capital valuation framework (HCVF) integrates these cost and value based models. The HCVF regards cost based measures as human capital based inputs and value based measures as outputs.

Fig. 1 presents an application of the HCVF. A firm may incur either low or high levels of labor costs (human capital inputs).³ A firm that has low levels of human capital based inputs may, theoretically, experience either low or high levels of outputs (yields).⁴ Fig. 1 presents four theoretical scenarios that arise from this reasoning. In the first, low levels of human capital based inputs lead to high yields, in the second low levels of inputs result in low yields, and in the third high input levels give rise to high yields. In the fourth scenario, high input levels result in low yields. Decision makers are likely to favor human capital based expenditures that provide high yields, namely, the first and third scenarios.

The HCVF contributes the insight that value and cost based measures should be considered simultaneously in explaining the usefulness of human capital based information, rather than as alternative or competing human capital measurement approaches.

Fig. 1 suggests two types of high yield strategies (Scenarios 1 and 3). Resource constrained small and medium scale enterprises (SMEs), would likely prefer low cost high yield strategies (Scenario 1). Although

such strategies address the resource limitations, there would likely be limited upside, since very high quality human capital, that is capable of driving meaningful firm wide transformation, innovation and efficiency, is unlikely to be available at low cost.

In contrast, resource rich firms, particularly PLCs, would likely aim for high cost, high value strategies. PLCs that invest in higher cost labor, and thereby experience labor productivity that exceeds industry averages (Scenario 3), are likely to be viewed favorably by investors. Thus, human capital based information that signals high labor cost, high yield strategies (Scenario 3) will likely be associated with higher market valuation. Since the consideration of the outputs, or yields, resulting from corresponding human capital based expenditures, influences the valuation of the expenditures (i.e. favored or not favored), human capital based outputs can be regarded as moderating factors in assessing the usefulness of human capital based expenditures. Virtually no papers have explored the moderating effect of labor productivity on value relevance of human capital based expenditures, including employee costs. The current paper addresses this gap in the literature, offering insights that value based human capital measures likely moderate the value relevance of voluntarily reported employee costs.

2.1.2. Usefulness of human capital based information

The second stream considers the usefulness of human capital based information, for internal and external users (DTI, 2003; Flamholtz, 1999; Flamholtz, Bullen, & Hua, 2002; Johanson, Eklov, Holmgren, & Martenson, 1998; Sackmann, Flamholtz, & Bullen, 1989; Verma & Dewe, 2004, 2008). Early studies were beset with issues related to using student surrogates (responses of students may not reflect that of professionals), but later studies included surveys of professionals, improving validity. Validity issues may be overcome by using historical data. The disclosure of the quantitative human capital based information required for studies based on historical data, such as employee costs and headcounts, is not mandated by current financial reporting standards.⁵ Nevertheless, this information is reported voluntarily, and some US based studies have explored the value relevance of such disclosures (Lajili & Zeghal, 2005, 2006). Only around 10% of firms listed on US exchanges have been found to consistently disclose this quantitative information (Ballester et al., 2002). As such, a common limitation of these studies is that the results may not be generalized to the overall population. Nevertheless, the premise of these studies is to examine whether human capital based information that has been voluntarily disclosed is relevant to investors. Such investigations can be based only on listed firms that have voluntarily disclosed pertinent human capital based information, and the conclusions that for firms that have chosen to disclose this information voluntarily, such information is value relevant, is not affected by the generalizability limitation.

Although voluntarily disclosed quantitative human capital based information is generally found to be useful and value relevant (Lajili & Zeghal, 2005), investors appear to fail to take full advantage of the opportunities arising from the signaling indicators provided by these disclosures (Lajili & Zeghal, 2006). It is possible that noise and moderating influences could explain why sometimes investors could be missing the signaling indications. This paper extends this research stream by considering noise and various likely moderating factors.

Moreover, the extant research is based on studies undertaken in developed economies, particularly the US. There are virtually no studies regarding voluntarily disclosed human capital based information based on the setting of emerging economies. The current study also extends the extant literature by considering the setting of an emerging economy.

² The availability of market valuation data makes PLCs the ideal units of analysis for studies that explore the value relevance of quantitative human capital based disclosures.

³ In this study, labor cost levels are defined as high when a firm's average labor costs per employee exceed industry averages, and low when these averages fall below industry averages.

⁴ In this study, labor output levels are defined as high when a firm's labor productivity, measured as average sales per employee, exceed industry averages, and low when these averages fall below industry averages.

⁵ Wyatt and Frick (2010) review various sub-provisions within the International Financial Reporting Standards (IFRSs), and find little scope for formally reporting employee costs as a line item in audited financial statements. Although, firms are not legally required to disclose employee costs as a separate line item, some firms disclose this information voluntarily. Similarly, in the US, employee cost disclosures are voluntary, not mandatory (Ballester et al., 2002; Lajili & Zeghal, 2005, 2006). Wyatt and Frick's (2010) conclusions are also applicable to Malaysia, which has adopted IFRSs.

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