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Labor cost voluntary disclosures and firm equity values: Is human capital information value-relevant?

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Abstract

This study examines the market value relevance of labor cost voluntary disclosures using a valuation model relating firm market values to book values of equity and to disclosed human capital information, such as labor costs, net pension liabilities (NPLs), and estimated average and marginal labor productivity and efficiency indicators. Results indicate that labor cost disclosing companies command higher equity market values in general, and that labor productivity and efficiency measures appear to be undervalued. Both findings suggest that there might be market opportunities for firms with valuable human capital to differentiate themselves from their industry peers, which might encourage further human capital disclosure in the future. More refined measures of human capital assets and investments are needed to assess firms' human resource management decisions and performance impacts in the capital markets more adequately.

Keywords: Voluntary disclosure; Market valuation; Labor productivity; Managerial efficiency; Human capital

1. Introduction

There has been a growing and continuing debate in the accountancy profession about the need to have transparent, concise, and comparable financial information disclosures regarding human capital-related accounting issues, such as executive and employee stock-based compensation and pension, and post-retirement benefits data.[2] Given its voluntary disclosure, human resource

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[2] FASB news release 03/12/03 at www.fasb.org/news/ highlights the increasing importance of employee stock options and pensions in its future work projects agenda. SFAS No. 87 (issued 12/85) describes the standards in place for employer's accounting for pensions while SFAS No. 123 presents the standards for accounting for stock-based compensation (issued 10/95).

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information in North America is currently non-standardized, scattered throughout firms' annual reports, and thus difficult to synthesize. Labor costs represent an important component of human capital valuation at both the firm and market levels (e.g., Becker, 1993; Rosett, 2001). With increased business complexities, accounting profits might not give an accurate picture of a company's financial health and growth prospects (e.g., Sherman, Young, & Collingwood, 2003) and disaggregated information (such as labor costs and employee compensation) might be warranted in the future if it can be shown that incremental information value is gained by disclosing such detailed human resource information.[3]

Accounting research in intangible assets valuation and measurement, including human capital-related disclosures such as executive compensation and pension arrangements, has increased in the past few years (e.g., Amir, 1996; Ballester, Livnat, & Sinha, 2002, Collett, 2002; Landry & Callimaci, 2003). Among the reasons for the increased interest in human capital-related information are the pressing requests from investors, financial analysts, and other accounting information users to adequately account for the potentially expense increasing employee stock-based compensation and the funded status of the pension funds since they both would affect current and future firm performance, growth prospects, and ultimately, the way the firm's net earnings are distributed among different stakeholders. A second reason is that human and organizational capital seems to be taking an increasing importance in the new knowledge-based economy. Most companies across different industries, particularly industries that rely on human capital assets to generate earnings (such as the computer software and the financial services industries) are expected to compete on those knowledge grounds. Therefore, more adequate information disclosure about the efficiency and effectiveness of human resource management (e.g., Flamholtz, 1971) and human capital investments within the firms could be a potentially valuable piece of information in the future. Thus, the current study extends prior related literature by offering an alternative and complementary approach to measuring and assessing human capital investments and performance effects on firm valuation that relies not only on aggregate labor costs disclosures but also on derived firm-level marginal productivity, and efficiency measures following a labor economics approach (e.g., Becker, 1993). To the best of our knowledge, no study in the prior literature has followed such an approach.

The primary objective of this study is to examine the association between firm equity (market) values and human capital proxies, such as disclosed labor costs and estimated labor productivity and efficiency indicators. Therefore, we focus in the current study on the market valuation aspects of human capital-related accounting information rather than the determinants (or incentives) for voluntarily disclosing such information (e.g., labor costs), which has been fairly well documented in prior studies (e.g., Ballester et al., 2002; Deegan & Hallam, 1991).

Unlike many European countries, North American companies disclose labor costs[4] information publicly in their financial statements on a voluntary basis. Less than 10% of publicly listed firms on the U.S. exchanges consistently disclose labor and related costs as a separate item in their financial reports (Ballester et al., 2002). The information on labor costs is usually implicitly incorporated into other financial statement items such as "cost of goods sold" and "general and administrative expenses" and ultimately enters the net income calculation. By including labor costs disclosures and other productivity measures (computed and estimated from both labor costs

[3] See, for example Venkatachalam (1996) for evidence on the value relevance of disaggregated off-balance sheet hedging instruments by U.S. banks.

[4] "Labor and related expenses" is an accounting variable covering salaries, wages, pension costs, profit sharing, and incentive compensation as well as payroll taxes and other employee benefits (Compustat).