BUSINESS, HUMAN RIGHTS AND THE ENVIRONMENT

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When is short-termism a problem? We don’t really know!

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About the author: Professor George S. Georgiev is an associate professor of law at Emory University School of Law. His scholarship examines topics at the intersection of corporate governance and securities regulation, including questions about the design and performance of the SEC disclosure regime, corporate sustainability, and executive compensation. His research has been published in a variety of law journals and it has also been featured in a number of media outlets, including the New York Times, Los Angeles Times, Financial Times, BBC, and Bloomberg.

This blog post is based on oral remarks offered by Professor George S. Georgiev as part of a discussion group entitled “First Things First: Is Short-Termism the Problem?,” convened on July 29, 2021 as part of the 2021 Southeastern Association of Law Schools annual conference at the Omni Amelia Island Resort.

Short-termism is often blamed for the excesses of capitalism in 21st-century market economies both in the United States and in Europe. In a nutshell, the argument is that corporate initiatives aimed at maximizing the stock price and delivering immediate returns to shareholders lead to suboptimal decisionmaking, hurting shareholders in the long run and imposing significant societal externalities. In the words of Ernst & Young’s 2020 “Study on Directors’ Duties and Sustainable Corporate Governance” prepared for the European Commission, “the social norm of shareholder primacy and short-term pressures from the financial markets” cause directors and executives to “maximise shareholder value and distribute earnings through dividends and buybacks, at the same time sacrificing investments (in R&D, CapEx, employee development, etc.) that are much needed for a transition to sustainable value creation.” The argument that short-termism is a corporate governance problem is as controversial as it is intuitive.

In this short piece, I want to focus on a small but important slice of the short-termism debate: the impact of corporate decisionmaking on a firm’s employees. And the question here is: Does our corporate governance regime predispose firm management to take short-term decisions that hurt employees at the expense of shareholders? And if so, when and how? Based in part on a recent article, *The Human Capital Management Movement in U.S. Corporate Law*, my answer is that we don’t know—but that we should.

It is useful to first take a step back. Even though corporations cannot exist without workers, workers are not part of the formal or informal governance structures established by U.S. corporate law. Commentators and policymakers have bemoaned this state of affairs for decades to little avail. Since the mid-2010s, however, a concept related to workers, human capital management (HCM), has become an increasingly prominent part of U.S. corporate governance. HCM is premised on the notion that workers can be viewed as “assets” and ought to be managed just as carefully as firms manage physical and capital assets. In practice, HCM is an expansive concept that has been used to refer to workforce training, compensation and retention issues, gender pay equity, diversity and inclusion, health and safety, matters related to corporate culture, employees' ability to participate in stock purchase programs, and various other matters.

The speed with which HCM has emerged in the United States and the depth and breadth of its reach have been surprising. While broadly fitting within the rubric of environmental, social, and governance (ESG) factors, HCM has quickly surpassed more traditional ESG topics in terms of prominence and uptake. Boards of directors have started to focus on HCM as part of their monitoring and oversight responsibilities, including by amending committee charters to cover HCM matters, identifying HCM as a desirable qualification for director nominees, and incorporating HCM metrics into executive compensation plans. Investors are now actively engaging with management and boards on questions pertaining to HCM. In August 2020, the U.S. Securities and Exchange Commission (SEC) adopted a new rule requiring HCM disclosure by public companies; an expansion of these rules is widely expected in early 2022. A variety of private standard-setting organizations have already developed detailed HCM reporting standards, which firms have started to adopt. Taken together, these developments represent a powerful and heretofore unprecedented push to incorporate worker-related concerns in U.S. corporate governance—a phenomenon I describe as an "HCM movement."

Despite recent progress, systematic information about the impact of management decisions on employees is lacking. My research on human capital management suggests the need to consider certain changes to applicable SEC regulations and financial accounting rules under U.S. GAAP, so that they more accurately reflect *firms' investment in human capital*. These proposals are discussed in Part IV.D (pp. 727-733) of my article on human capital management. As a first and fairly straightforward step, firms should be required to break down *workforce training expenses* and *employee compensation expenses* as separate items. These represent the most significant human-capital-related expenses incurred by firms, but, in both instances, they are lumped together with other expenses on the income statement, which obscures relevant information and—problematically—makes human capital spending an attractive target during cost-cutting rounds.

Under current U.S. accounting rules, workforce training expenses are part of SG&A, a general category that covers overhead items ranging from marketing expenses to professional services to office supplies. As a catch-all category, SG&A often contains expenses arising from inefficiencies. Understandably, investors view high SG&A amounts and yearly increases in SG&A amounts as a negative signal about the firm's current operations and future prospects; conversely, lower SG&A amounts, or yearly reductions in SG&A amounts, are viewed as a positive signal.

Information about employee compensation expenses presents similar problems. Apart from the median worker pay figure required for the calculation of the CEO pay ratio, neither the accounting rules nor the SEC disclosure rules provide a way for investors to gauge with any specificity what a firm pays its workers. Yet, this information is relevant when investors analyze a firm on its own terms, over time, or in relation to industry peers. Currently, even the total amount spent on worker salaries is not disclosed; it is, instead, lumped into other aggregate figures (COGS for the direct labor costs used to produce a good, and SG&A for all other labor costs).

This is one area of divergence between U.S. GAAP and IFRS. Under IAS 19, firms that follow IFRS are required to disclose the amounts paid in wages, salaries, and social security contributions, among other information. Nevertheless, even information under IFRS is not presented with a sufficient degree of granularity. In the case of large multinational conglomerates, where it matters the most, the information is also distorted by the application of the materiality standard.

The Ernst & Young report focused on changing directors' fiduciary duties in the EU—a significant and controversial step. But, as this short piece shows, there is another category of reforms—improving disclosure and accounting systems, both in the EU and in the

U.S.—that is essential to understanding the problem of short-termism. Without adequate information, it is not possible to diagnose whether corporate decision-making is short-termism or harming important corporate constituencies.

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