Human capital on the balance sheet: Recognizing non-compete clauses

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Paper contribution

Recognizing human capital on the balance sheet in the case of highly valued employees with non-compete clauses

Claim

- Closes the “missing gap” : missing key assets that create firm value (MTB, ROA)
- Improves usefulness of financial information
- Benefits more accurate firm valuations

  By incorporating the value of human capital into financial reporting, companies in these sectors (technology, healthcare and professional services) can more accurately reflect their investments in specialized, high-value employees, highlight their competitive advantages, and demonstrate long-term viability.
- Caution: additional audit and other compliance costs, legal uncertainties, risk of managerial discretion

Useful to: Standard setters (EFRAG, IASB, SEC), investors, management

Discussion topics

1. Conceptual model

2. Valuation depends on information – recognition vs disclosure

3. Empirical analysis

1. Conceptual model

What is the relation of **capitalized human capital** with other (intangible) assets?

1. *Company-developed:* R&D capitalization in the development phase (IAS 38): includes a portion of employee-related expenses such as salaries, employee benefits, stock-based compensation of R&D staff and engineers

2. *Company-acquired:* How are acquired employees treated in PPA
   – if part of R&D projects: in-process R&D
   – otherwise part of Goodwill

2. Recognition versus disclosure

Are capital markets participants able to take into account of the value-generating capabilities of unrecognized intangible assets?

- Brownen-Trinh et al. (2025): no support for the need of capitalization of intangibles, since simple residual income valuation model with analyst earnings forecasts closely approximates market value of equity over the period 1985-2020.
- **Human capital disclosure** items may provide more **verifiable details** than capitalized human capital on the balance sheet
  - ✓**SEC:** report on a broader set of workforce-related factors, tailored to their specific industry and business model. significant departure from traditional workforce disclosures, which historically focused only on headcount and executive compensation.
  - ✓**CSRD:** disclose information about employees covering working conditions, equal treatment and opportunities, training and development, diversity, health and safety, and social dialogue to demonstrate how companies manage their workforce’s well-being and human capital impacts.

Human Capital Disclosures - Example

Example from Microsoft's Form 10-K (for the year ended June 30, 2025)

HUMAN CAPITAL RESOURCES

As of June 30, 2025, we employed approximately 228,000 people on a full-time basis, 125,000 in the U.S. and 103,000 internationally. Of the total employees, 89,000 were in operations, including product support and consulting services, datacenter operations, and manufacturing and distribution; 80,000 were in product research and development; 44,000 were in sales and marketing; and 15,000 were in general and administration. Certain employees are subject to collective bargaining agreements.

We design our programs to attract, reward, and retain top talent while fostering continuous employee development and reinforcing our organizational culture and values. Our total compensation offering is both highly differentiated and competitive within the market, and we also monitor pay equity across multiple dimensions. We have invested significantly in employee wellbeing and offer a differentiated benefits package which includes many physical, emotional, and financial wellness programs. We also provide access to continuous learning through a wide range of internal and external content, supporting professional growth across roles and disciplines. Through our employee-listening systems, we gather direct feedback from our workforce, enabling us to adapt our programs and address employee needs globally with real-time insights. Additionally, our culture prioritizes the security of both our customers and Microsoft, embedding this responsibility across all teams and functions.

Human Capital Disclosures - Example

Microsoft

- Reports **quantitative data** on its workforce
  (e.g., number of full-time employees, geographic breakdown, functional roles).

- Reports **qualitative aspects** of how it manages human capital: culture, development, compensation, inclusion, wellbeing, etc.

- It acknowledges that the disclosure is tailored to what is "**material**" for its business

- It links human-capital management to broader **business strategy** rather than just HR metrics.
  (e.g., enabling products & services, workforce composition)

Human Capital external information

- **Crowdsourced employer reviews and stock returns** (Green, Huang & Wen JFE 2019) –firms experiencing improvements in employee ratings on Glassdoor significantly outperform firms with declines, and rating changes help predict future earnings surprises and stock returns.

- Consider information to value **football players:**
  - acquired via transfer vs. transfer free acquisitions, self-developed, extensions of current contracts (mixed types make comparison difficult)
  - football analytics widely available to value individual players and teams in real time

3. Empirical analysis

1. Ratios change: ROA, LEV, MTB

   Consider effects of differences in performance: good and bad performance, resulting in different growth rates and depreciation of human capital expenses

   (young growth firms may have lower ROA* compared to reported ROA)

2. Predicting future sales, CFO (considering value of non-compete clauses)
3. Value relevance - valuation model estimation specification

$$Price_i = \beta_0 + \beta_1 NI_i + \beta_2 BVE_i + \beta_3 Loss_i + Year + \varepsilon$$

   Why not single out the human capital component in the value relevance test and adjust NI and BE accordingly? Include a loss dummy. Recognize shortcoming of Ohlson specification (missing "other info" component affects linear info dynamic)

Conclusion

- **Contribution** intangibles assets debate – recognition of human capital
- **Nice setting** New Zealand offers a nice empirical setting with respect to non-compete clauses
- **Suggested improvements**
  - Provide a better conceptual framework and theoretical underpinning of valuation
  - more rigorous empirical analysis
  - Discuss practical implementation challenges

Good luck with the paper!