Human resource accounting – An accountant's dilemma

T. Raju □ **M. Ashok Kumar** □ **Sangeetha Mohandas T** □

An accountant always views an asset (including human asset) as something with a value on the Balance Sheet but as yet, HR value does not appear as 'asset'. Applying accounting oriented formula to human resources needs to be explored very seriously.

The debate on the significance, validity and reliability of including human resource in the asset column of the balance sheet of a commercial organization is not new. While one school of thought argues for quantification of the human resource as an asset, the other group dismisses the very thought of assessing the all-pervading intangible asset as it is beyond valuation and, in fact, invaluable. Nevertheless, attempts have been made by various researchers to quantify the human resource by an array of permutations and combinations. Some have put forward certain calculations such as SPE (Sales Per Employee), RR (Recovery Rate), Utilization percentage, PpH (Profit Per Head) and CpP (Compensation Per Profit) while some others have advocated CIV (Calculated Intangible Value) method and MVA (Market Value added) approach equating HR with Intellectual Capital. But the predicament of the accountant still lingers, as there is no full-proof formula to quantify the omnipresent human resource without which no organization can come into existence.

Adam Smith, in his classic work "Wealth of Nation", classified the factors of production into Land, Labor and Capital. The modern management stalwarts reclassified them as 4 Ms (Men, Material, Machinery and Money). The terms 'Labor' and 'Men' have now been christened 'Human Resource'. Popularly known as HR, the Human Resource is not just the number of pairs of hands engaged in any organization. HR is above the simple number game. Human Resource may be thought of as the total knowledge, skills, creative abilities, talents and aptitudes of an organization's workforce. It is the sum total of inherent abilities, acquired knowledge and skills of the employees.

HR In The Balance Sheet

Irrespective of the glossy and laudable vision and mission statements, the ulterior motive of any commercial venture is profit. Ultimately it is the profit making business that survives in any environment. To monitor the success, failure or performance of any business the interested parties, specifically the shareholders, always look up at the profit/loss statement and the Balance Sheet, more so on the asset column. In a conventional Balance Sheet money is accounted as it is while the Machinery and Materials are either depreciated or appreciated. But it is an irony that the HR that created wealth utilizing the Money, Machinery and Material does not find a place in the asset column.

HR Accounting

Attempts to account the HR are not new. It was Rensis Likert (Bowers, 1973) who initiated research into HR accounting in the sixties. He stressed the importance of long-term planning of human resource's qualitative variables that result in greater benefits in the long run. The resource theory (Conner, 1991) considers that the competitive position of an organization depends on its specific assets, which

□ Faculty Members, Human Resource Area, SNR School of Management Studies and Research, Coimbatore.

is the Human Resource. This explains why some firms are more productive than others under almost similar conditions. It is the human resource that makes all the difference (Archel, 1995).

According to American Accounting Association (1970) HR accounting is the human resource identification and measuring process and also its communication to the interested parties.

Any resource will have two sides i.e. its assets value and the cost of procurement; HR is not an exception. But curiously enough in the case of HR, only the procurement/maintenance cost is accounted in the balance sheet and not the asset value.

The cost of HR encompasses the following:

- ☐ **Cost of Recruiting:** This starts from the time of searching for human resources. It includes the publicity, mailing, rejected applicants and contracted applicants.
- ☐ **Cost of Selection:** It corresponds to the selected personnel. The components are derived from the candidate's interview (traveling, lodging/boarding, organisation of exams and selective tests).
- ☐ **Cost of Contracting:** This begins from the selection of personnel. It includes the cost of formulating the contract, travel and other incidental expenses.
- ☐ **Cost of placing:** It is a variety of administrative costs, necessitated by situating the new employees in their job.
- ☐ **Cost of training:** A greater part of this cost is the salary of the trainee who is unproductive. It hold good for the supervisor's or the trainers lost time while coaching the employee to do the job correctly. Costs also originate from a decrease in the productivity of the rest of the workers whose jobs are adversely affected by the deficiencies of the new employees.
- ☐ **Cost of Orientation:** This cost generally includes adapting the new person to the organization as a whole and to a specific job. The cost of familiarizing the new employee with the personnel policy, products and services of the organization and the organizations in general is hardly estimable.
- ☐ **Cost of Promotion:** It originates every time an employee changes his job in the same category or another due to promotion.
- ☐ **Cost of Improvement:** This cost is for maintaining and improving the real potential of every employee.
- ☐ **Cost of Substitution:** This includes the exit costs of the leaving employee and recruiting and training of the replacement.
- ☐ **Opportunity Cost:** It is the estimate of an asset value that is the target of an alternative use.
- ☐ **Exit Cost:** This cost covers the lost efficiency prior to separation, job vacancy cost during the new search and termination pay.

In addition to the above, the cost of HR includes the following also:

- ☐ Rewards: Cash-like and non-Cash-like
- ☐ Facilities: Tools, Fixtures/Fittings and accessories at work essential for the welfare of the employees.
- ☐ Health and Safety: Specific policies (Statutory and Voluntary) implementation systems.
- ☐ Consultation and communication overheads
- ☐ Pensions and contributions to social security payments
- ☐ Severance Costs: Retirement, Redundancy and Dismissal.

Should HR be Accounted in the Asset Column ?

To set the things in the right perspective, one school of thought emphasizes the need for incorporating the asset value of HR in the balance sheet. Ripoll and Labatut (1994) identified two reasons for including the HR in accounting:

1. People are a valuable resource as long as they perform services that can be quantified.
2. The value of a person as a resource depends on how people are employed which is influenced by the management style.

Contrary to the demand of inclusion of HR in the asset column in the balance sheet, the other school of thought right away dismisses the very idea on the contention that quantification of HR is beyond imagination as there cannot be any business without HR. It could be argued that when HR is the 'Creator' of all resources, who dares to quantify the 'Creator'? HR is not only the foundation of the edifice of business, it is the very 'Soul and Body' and 'Blood and Flesh' of the business. When one tries to quantify the HR on par with other resources it amounts to degradation of the HR. Above all, quantifying the HR to fit into the rig morale of balance sheet is a Herculean task since HR as an intangible asset changes its value according to the working environment of the business and the management policies.

An Accountant’s view of HR

Notwithstanding the influence of the strategic and personnel managers, the accountant's view takes precedence in primary decision-making within a business. The HR managers' argument for employee development and the contribution of HR to organization performance unfortunately represents a softer principled view that is only secondary to the accountant's view.

An accountant always views an asset as something with a value on the balance sheet. The costs of HR always feature in the Profi/Loss statement but the HR value does not find a place as an asset. The exceptions could be a publicly quoted football team where the players are the real assets or a performing troupe where the performers are the only assets. The crux of the problem lies in searching for and applying accounting-like formulae to people.

Accountant's Dilemma

When no established formula is available, the accountant is in a fix to evaluate the asset value of HR. Some workers suggest that the following data could be used for inclusion in the balance sheet.

- **FTEs:** Full Time Equivalent staff, (the formulae may aggregate part time, short-term and long-term contract staff).
- **Headcount (H):** Total FTEs at month end.
- **Revenues (R):** Total operating income in i.e. total sales.
- **Expenses (E):** Operating expenditure excluding tax, interest etc.
- **Profit:** R Less E
- **Cash-like Rewards (C):** Emoluments i.e. salaries, wages, overtime, bonuses and commissions.
- **Benefits (B):** Other rewards that may or may not be taxed as 'benefit in kind' such as cars, pension, company loans etc.

Staffing Performance Indicators (Carme et al., 1999)

Internal

I. **Sales Per Employee:** It indicates general employee productivity. Compare SPE this year over last year and with SPEs of rival organizations (benchmarking). Their turnover may be smaller but they may have a better SPE.

SPE = R/H

H may increase if the business expands.

II **Recovery Rate:** Aggregate compensation and benefits then divide by revenue. RR compares staffing costs with revenues delivered. A decreasing RR is desirable.

RR = C+ B/R

Unraveling influences on RR can be difficult. The impact on additional Investment should show through in RR later - revenue increases whilst staffing costs fall.

III. **Utilization Percentage:** It can be applied e.g. to a consultancy company or school whose main business is allocating or selling the time of its staff. We assume that an increase in U% is desirable.

U% = R/C + B

R (revenue) can be substituted by another measurable output e.g. Wagons delivered, dustbins emptied, examination results (points). Calculation must include staff costs of the whole business unit-Direct and support staff.

External

IV. **Profit Per Head:** Like RoCE, shareholders and business analysts may use profit per head or profit before-tax-per head to focus on employee related costs and returns.

PpH = P/H

A firm's PpH rating may highlight under-achievement and profit potential when compared to industry competitors. Corporate predators may be attracted. A publicly funded organization such as a college may see it's funding reduced if its funding authorities use the ratio as a control measure.

V. **Compensation Per Rupee Profit:** This evaluates profit against cost/ employee rather that headcount. Interpretation can be difficult. CpP can swing with profits e.g. where there are close links between profits and staff compensation (profit related bonuses). CpP is negative where a firm is making a loss. CpP may indicate that better management could improve cost-effectiveness or controls.

CpP = C + B/P

Getting VfM from Personnel/HRM sevices

We can evaluate the productivity/ contribution (value for money?) of those delivering personnel/HRM services to the business. Organization size, location, corporate culture etc however makes external comparisons more difficult.

VI. **Personnel Services Expenses** (PSE): It is the total operating expenses of the personnel/4RM section (personnel salaries, cost of facilities/equipment, training and development budgets, research/project expenditure, communications activities etc.)

VII. **Personnel Services Headcount** (PSH): It is total FTE for the personnel/ HR section in the calculation period.

VIII. **Personnel Services Cost %** (PSC): Divide PSE by total operating expenses (E) to identify trends and to influence budgeting processes.

PSC = PSE/E

For each operating unit, split the PSE element into its constituent budgets. Identify the proportion that, say, central personnel services are consuming compared to decentralized personnel sections. An operating unit may have a worsening PSC whereas another's may be steady yet have increased training and reduced recruitment costs. The former may be investing in training people who then leave for another job.

Intellectual Capital

Of late HR is equated to Intellectual Capital (IC). "Intellectual Capital of a firm is its possession of the knowledge, applied extensively, organizational technology, customer relationships and professional skills that position it with a competitive edge in the market. It is the intellectual material - knowledge, information, intellectual property and experience - that can be put to use to create a corporate legacy." Most researchers in their definition of Intellectual Capital include factors like technology, leadership, ongoing employee training, brand names and trademarks and even speed of response to client service calls. If we have a look at a contemporary balance sheet we would invariably find an entry under the subheading of goodwill Trademark and Brand emphasized unusual but real assets such as trademarks. By contrast Intellectual Capital looks beyond to more ineffable assets such as the ability of an individual to learn and adapt.

Whatever definition is used, it is apparent that the value of IC in the world's book is immense. According to Morgan Stanley's World Index, the average value of companies in the world's stock exchanges is two times book value and this can be ascribed as the Intellectual Capital the companies posses.

Intellectual Capital is made up of:

"Human capital... the firm's collective capability to extract the best solutions people.. .

Structural capital. . . the firm's organizational capabilities to meet market requirements, and...

Customer capital... the organization's relationship or network of associates satisfaction with and loyalty to the company."

Assessment of Intellectual Capital

Human capital measures include items such as innovation, employee attitudes, turnover, experience, competencies and learning. Structural measures are the technical "bundle" (trade secrets and proprietary knowledge), the marketing forte encompasses (copyrights, corporate name and logo, warranties, advertising, package etc) and the skills and knowledge bundle (databases, manuals, quality standards, security systems, business licenses, etc.). Rational capital would involve firm's dealings with and level of satisfaction of customers, collaborators and suppliers.

The measurement of IC can be broadly classified in two categories:

- Indirect Measures
- Direct Measures

The direct measures ascribe the money value to the constituents of intangible assets calculation whereas the indirect measure ascribes intellectual capital to the performance of the company.

Calculated Intangible Value Method (CIV)

The method (CIV) for measuring IC is based on the return on assets concept (ROA) based on the average pre-tax earnings of a company for three to five years. This average is then divided by the average tangible assets of the company over the same period. The resulting ROA is compared with the company's industry average to calculate the difference. This excess ROA is then multiplied by the company's average tangible assets to calculate an average annual excess earning. Dividing this by the cost of capital of the company yields the IC.

IC = (ROA of Co. - ROA of Industry)* (Avg. assets of Co./ Cost of Capital of Co.)

As clear from above, the subtracted component is proportional to the asset leverage of the company and is the expected IC. The excess that the company gets over the value is the intellectual capital of the company.

Market Value Added (MVA) Approach

The buyer, not the seller, defines value. A company therefore is worth what market says.

Price Per share * Total number of shares outstanding = Market Value

The simplest, measure of intellectual capital is the difference between the market value of the company and its book value. This value is known as the market value added of the company.

Market value of the Company - Net Worth = Market value Added = IC Net Worth = Equity + Reserves

The assumption here is that everything left in the market value after the accounting of fixed assets must be intangible assets.

Conclusion

In management studies, Human Resource Accounting (HRA) may be considered as a controversial subject. It is opined that, the advocates of HRA have perhaps too much focused their field of research on accounting problems, particularly on those related to the allocation of human capital costs in the balance sheet. Even though there is a growing tendency, particularly in large organizations to pay more attention in co-coordinating human and information resources management and development activities and in assessing productivity of the related costs, it is quite difficult, specifically the human resources costs, to introduce market related or joint responsibility control mechanism.

Reference

- American Accounting Association, A Statement of basic accounting theory, Evanston II, AAA Revised Edition, 1970, P .35
- Archel, P. Actives intangibles: analysis de lacunas partidas polemicas. Revista Tecnica del instituto de censoves jurados de cuentas de espara, 7, 1995.
- Bowers, David G. A review of Rensis Likert's improving the accuracy of P/L reports and estimating the change in dollar value of the human organisation. Michiaan Business Review, 25. March 1973.
- Carme, B. C., Gutierrez, S.M., Antonio, S.L., Joseph, V.C and Carlos G.M. Human Resource Accounting, International Advances in Economic Research 5(3): 386-394, 1999.
- Conner K. A historical comparison of resource based theory and five schools of thought within industrial organisation economics, Journal of Management17(1): 121-154, 1991.
- Ripoll, V and Labatut, G. La contabilidal de gestion of los costes de recursor humanos: Implicaciones constales of fiscals de su activation. Technica Contable, Jan 1994.