

Human Resource Accounting—A Conceptual View

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Abstract—*The success or failure of any organization is largely dependent on human resources—the most important component of any organization. Investors in the global capital market give priority to this important component. Needless to say, effective and rational use of human resources is of utmost importance in taking vital managerial decisions. Although money and materials are accounted, but accounting for human resources is very often neglected. Pronouncing qualitatively by dignitaries is the manifestation of the importance of human resources but excepting a few cases, quantitative information with regard to their contribution or value is not recorded in books of accounts. Human resource accounting is an information system which considers human resources invested in business as assets and places their monetary value recorded in books of accounts. This accounting system provides valuable information relating to human resources to all interested parties—both internal and external. Unfortunately, though the importance of human resources to the prosperity of an organization cannot be denied in corporate pronouncements but it does not find due attention in the traditional accounting practices prevalent in India mainly on the ground of inappropriately or insufficiency of their quantification. In a developing country like India with abundant human resources paying inadequate attention and keeping their contribution outside the financial status of an organization evidence the lack of transparency in books of accounts.*

In the light of the above, this paper is concerned with rationale of human resource accounting and directs our attention to the failures of traditional accounting system. A modest attempt has been made to classify the costs associated with the human resources and to discuss the different methods of human resource accounting. The conceptual view also highlights the problems associated in implementation of human resource accounting and lastly conclusion along with recommendation to overcome the same has been given

Keywords: *Human resource accounting, financial status, traditional accounting system.*

1. INTRODUCTION

The world economy is going through the stage of rapid changes. To adopt these changes in a smooth manner, the role of human resources cannot be denied as organizational strategies fail to work without appropriate support of human resources. Recently human resource development has drawn the attention of both academicians as well as practicing managers all over the world. However, the recognition of importance of this resource in organization as one of the productive resources has been accepted by all for taking resourceful managerial decisions. But unfortunately, failure of

accountants to incorporate information of human resources is a serious obstacle for impressive management. Human resource accounting develops useful management information system in which investment on human resources is given special attention.

2. FAILURE OF TRADITIONAL ACCOUNTING SYSTEM

Traditional accounting system does not always exhibit true financial picture of an organization as excepting a few cases this system does not quantify data relating to human resources—the most important asset in an organization. Scientific management gives stress on the quantitative aspect of asset with a view to making most effective use of all assets and for taking managerial decision. The main drawbacks or failures of traditional accounting system relating to human resources are as follows:

- i. Like other resources management requires information about the total investments in human resources for the purpose of planning and control. But traditional accounting system fails to supply such information.
- ii. Expenses incurred on acquisition, training and development of human resources provide the organization long-term benefits. Hence, such expenses from accounting point of view should be treated as capital expenditure and as such assets. But traditional accounting system shows these expenses on the debit side of profit & loss account and hence wrongly treated as revenue expenditure.
- iii. Traditional financial accounting does not recognize talent, capability etc. of human resources. As a consequence, high labour turnover, frustration among the working-men etc. are observed.

3. OBJECTIVE AND METHODOLOGY

In the light of the deficiencies in the traditional accounting system cited above, the objective of this paper is to present conceptual view of human resource accounting through several phases. The study being conceptual, a simple methodology has been adopted and the opinion expressed in this paper reflects the author's own opinion and the opinion of some reputed authors to some extent. This paper highlights the

rationale of human resource accounting and recommends few measures to overcome the shortcomings of traditional accounting system.

4. RATIONALE OF HUMAN RESOURCES ACCOUNTING

The prosperity of an organization largely depends on human resources. Any large amount spent on selection, placement, recruitment, training and development of human resources to get benefit for a long-period of time is actually capital expenditure in nature and should be treated as asset which goes against the traditional accounting practice in which these are treated as revenue expenditures and accordingly treated in profit & loss account. The rationale behind introduction of human resource accounting lies in the fact that human resources should be treated as physical assets and should be shown on the asset side of the balance sheet. Failing to exhibit such assets on the balance sheet in the traditional accounting system indicates lack of reliability of the financial picture. Recognition of human resource as asset removes the obstacles of traditional financial accounting practice and reflects the actual financial status of an organization. Alfred Marshall once told that “the most valuable of all capital is that invested in human beings”. Human resource accounting deserves the following benefits:

- i. Any change in the investment in human resources effecting the earning capacity and growth of a business cultivates the concept of human resource accounting in which assets status is accorded to human resources and accordingly brought into account like other assets.
- ii. Any cost incurred in connection with acquisition, training and placement of human resources for productive purposes should be capitalized. Human resource accounting first justifies this truth.
- iii. Expansion of building, plant & machinery etc. obviously leads to enhancement in human resources. Hence, information in the form of human resource accounting is necessary.
- iv. Additional information in the form of human resource accounting inspires the shareholders and creditors to make long-term investment with confidence.
- v. Cordial relationship among the employees in an organization is possible only when management realizes the importance of contribution made by the employees and workers in an organization.
- vi. Human resource accounting can be used as a tool in detecting the spirit of labour turnover, return on investment and utilization of potential capacity of an organization.

5. HUMAN RESOURCE COSTS – ITS CLASSIFICATION

The human resource costs can broadly be classified into three groups i.e. acquisition costs, development costs and periodical wages and salaries.

a. Acquisition Costs – Acquisition costs are incurred by an organization upto the time of “reporting for duty” by the candidates selected. Acquisition costs include costs for advertising, application processing, screening, conducting tests and interviews, honorarium to the members of the recruitment board, a portion of administrative expenses etc.

b. Development Costs – Development costs are incurred by an organization from the time the selected candidates report for duty to the stage of placing them on the specific jobs. Usually, these costs include salary of both the trainees and the trainers, cost of study materials, consultancy fees, a portion of administrative expenses, etc.

c. Periodical Wages and Salaries – Periodical wages and salaries are incurred by an organization periodically for the selected candidates report for duty and start attending the work assigned to them. Usually, these include salaries of employees, employer’s contribution to insurance fund and provident fund, cost of non-monetary facilities, etc.

6. A CRITICAL EVALUATION OF HUMAN RESOURCE COSTS

A critical analysis of different human resource costs indicates that all the aforesaid costs do not possess the features of assets. The costs or expenses from which future benefits can be derived are capitalized and hence assets. With this objective in mind, the following inferences can be deduced:

Periodical wages and salaries do not possess the ability to yield future benefits; hence should not be asserted. This type of payment is made not with the intention of extracting work from employees in future but is made as a reward for the past service or work.

On the other hand, acquisition and development costs possess all the requisite features of assets. These costs are basically non-recurring in nature and the organization derives benefits from these costs for a long-period of time in future. The capitalized amount can be placed on asset side of a balance sheet and is amortized over a period of time.

In order to find out employee-wise acquisition and development costs, this type of costs consists of both common and specific. Costs incurred for the purpose of recruiting and/or training an employee termed as specific acquisition and/or development costs; and the costs incurred to recruit and/or train more than one may be termed as common acquisition and/or development costs. Common costs are to be apportioned among the number of employees on some sound and suitable basis. This analysis can easily be made with the help of simple mathematical model which is as follows: Let C_H be total human resource cost of an organization and C_{H1} , C_{H2} , C_{H3} C_{Hn} be the cost values of employees 1, 2, 3, n.

So,

$$C_H = C_{H1} + C_{H2} + C_{H3} + \dots C_{Hn} \dots \text{ (i)}$$

. Hn

$$\dots C_H = \sum C_H \dots \text{ (ii)}$$

H=Hi

7. METHODS/MODELS OF HUMAN RESOURCE ACCOUNTING

Measuring human resource costs and human resource accounting is not an easy task. To consider the rapid changes in the global economy smoothly, the role of human resources is crucial as organizational strategies have a tendency not to work without the proper support of human resources, especially in terms of issues relating to its implantation. Several human resource accounting models have been developed to estimate the monetary value of human resources as assets. The important models are discussed here in brief:

i. Historical Cost Method – Under this method developed by Brummet, Flamholtz and Pyle the actual expenditure incurred on advertising, selecting, recruiting and training the labour force are capitalized and are written off over the period for which the employee remains in the organization. The unexpired costs are considered to be the investment in human resources. If the employee expires before the expiry of the expected service period, the remaining net human asset value relating to the expired employee is charged off against the current earnings.

ii. Replacement Cost Method – This approach suggested by Rensis Likert values human resources at their present replacement cost instead of the cost of acquisition (i.e. historical cost) on the assumption that if the entire human resources are to be replaced, what would be the cost of such replacement to the organization?

iii. Competitive Bidding Method / Opportunity Cost Approach –The value of the assets under this method is the value for its alternative use foregone. A human asset may have a value only when it is a scarce resource, i.e. when its employment in one division denies to another division, the amount payable by the division or department against the highest bid will be taken as opportunity cost of that particular human resource.

iv. Standard Cost Approach – This approach suggests calculating standard cost for recruitment, training and development of different categories of labour and applying the cost so calculated for all those employees in an organization and aggregating it as the investment in human resources for the organization.

v. Present Value of Future Earnings Method – In this method the total future earnings of the entire labour force upto the date of retirement is grossed up and discounted at the rate of cost of capital for the organization. This represents the value of human resource. The important models for such calculation

are: a) Flamholtz's model; b) Lev and Schwartz's model; and c) Jaggi and Lau's model.

As per Flamholtz's model the ultimate measure of an individual's value in an organization is the expected realizable value i.e. the present worth of the future services expected to be provided during the period employee is expected to remain in an organization.

Present value method estimates the contribution made by the employees to the future growth of the organization.

As per Liew & Schwartz's model the value of human capital is the present value of the remaining future earnings.

The value may be calculated thus:

$$V_r = \frac{I_t}{(I + R)^{t-r}}$$

Where V_r = the value of individual 'r' year.

I_t = individual's annual earnings upto the age of retirement.

t = retirement age and

R = discount rate

The proposed model suggested by Jaggi and Lau requires the determination of the rank transitional matrix and the expected quantities of service for each rank of service. This model seeks to simplify the calculations of the value of human resources by taking groups of the employees as valuation base.

8. A CRITICAL EVALUATION OF METHOD/ MODELS OF HUMAN RESOURCE ACCOUNTING

A critical evaluation of the methods of human resource accounting shows that in some aspects they are found to be similar while in some other aspects they differ. For example, historical costs method suffers from the measurement of duration, magnitude and value of services, discount factors etc.; replacement cost method suffers from the objective information relating to replacement costs of employing the current huge number of employees; on the other hand, opportunity cost also suffers from the consideration of the value and volume of services, discount factors etc. Actually most of the models appear logically sound in appropriate cases, but it is not possible to apply all the models in practice for lack of sufficient data and inability to have objective measurement. Some of the measurements of models though appear theoretically acceptable, but it is difficult to provide an objective assessment of human resources. An analysis of human resource accounting models reveals that there is not even a single model which satisfies all the requirements of a model which could help in the process of human resource development. Where certain models fail to recognize the factors determining the value of human resources, in other cases certain models have computational problems. Hence, there is a need for great deal of research work with regard to application of a system of human resource accounting which

might be of considerable help in the process of human resource management and development.

9. PROBLEMS

It is not exaggeration to say that in reality human resources play a vital role in the development and progress of business organization. Excepting a few, most of the organizations in the world is still reluctant to accord the assets status to this resource which it rightly and justifiably deserves. It was perceived that most probably certain problems are associated with the design and the use of human resource accounting system. The problems are:

i. Although human capital plays an important role in any organization, disagreement with regard to its recognition and valuation as assets still exists. Human resources hardly fulfill the essential criteria of assets. As such, recognition of human resources as assets suffers.

ii. Sometimes costs do not match with revenue until and unless costs on recruitment, training and development of employees are capitalized over their effective service lives. The benefits derived from such expenses are enjoyed over a number of years beyond the year of payment. Moreover, earnings potential of an employee largely depends upon certain other factors like skill, motivation, group loyalty, effective interaction, decision making, etc, not on the expenditure incurred by the organization alone.

iii. Since human capital cannot be bought or owned by an organization theoretically, it is not possible to show it on the balance sheet.

iv. Unlike other assets labour force assets does not possess service potential extending beyond the current period. Total value of its periodic services is written off as a cost in each year. Organizations invest not only in training and development programmes but also in welfare and pension schemes and recreational facilities to create an asset and commitment to organizational objectives.

v. The costs associated with the aforesaid schemes are already dealt with in the traditional accounting system but the future benefit from better labour relations with management is not exhibited as an asset.

vi. Practically, discount rates for the purpose of calculating the present value of future earnings of employees are arbitrary.

vii. Many reputed companies in India show value of human resources both on the assets side and liabilities side of the balance sheet which actually means that their net value is zero. In addition, costs incurred on employees with regard to recruitment, training, development etc in the past result negative net value.

viii. Huge expenses incurred by companies on account of hiring, training and developing their employees are mostly

charged on the debit side of profit and loss account and as such violate the accounting principles.

ix. Accountants may admit the theoretical validity of recognizing human capital as an asset for decision making and financial reporting purpose but find difficulty in the need for objectivity in measuring the value of human capital. Objectivity versus usefulness is another problem in external reporting.

x. Information system dealing with human resources is observed by many as the most important shortcomings in current accounting information practice. Concealment of showing human resources in the annual reports creates obstacle in decision making and fails to provide better estimate of the value of the company, return on investment and efficient allocation of resources within the economy.

xi. Human resource accounting looks very attractive; but it is very subjective and difficult in practice.

xii. Human resource accounting goes with the basic assumptions of money measurement concept. But practically it is impossible to measure human resources and changes in that. Morale, motivation, dissatisfaction, etc cannot be measured or quantified. It is absolutely a theoretical idea which may look good on paper only. This might be the reason why after so many years of big talk, human resource accounting is still in infancy stage.

xiii. It is wrong to use human resource as asset for present or future purpose as we use for non-living objects like plant and machinery. Human resource does not require any adjective like asset; they are more important than the common saying of assets.

10. CONCLUSION AND RECOMMENDATION

In this paper, an attempt has been made relating to various aspects of human resource accounting. Human resources play a vital role in labour intensive industries. This information is useful both for its internal and external purposes. Certainly there are drawbacks in the models applied by corporate sectors in India; but it is worth nothing that by reporting human resource accounting, they have at least shown their interest for their employees. The result of non-disclosure of human resources cost and value information in financial statement of business houses is that financial statements do not reveal any quantitative information on human resources and the statement of affairs is wrongly reported to different authorities. The prosperity of an organization depends on the build up of quality workforce at all spheres. If this vital asset is ignored in the balance sheet, the common people and investors will be handicapped to that extent. The changed appreciable discipline of human resource accounting should get the required status in the balance sheet.

The trend to satisfy the legal compulsions through the current disclosure norm should be changed. Impact of the human

resources to the organization and the functional impact of the organization towards the resource will be ascertained and accounted. Researchers, accountants and managerial consultants should face the challenge. Positive indication is that to some extent impact of human resource development and its relationship to earning is calculated and reported.

The application and usefulness of human resource accounting depends on the future efforts, experiments and supports to be made by practicing managers, accountants, academicians, professional bodies and government. Modified version of human resource accounting to make qualitative presentation in lieu of quantitative aspects may become practical as well as popular. It may lose some of the ingredients of accounting but may acquire a new name. Let us hope human resource accounting will bring a new area in accounting and control in near future.

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