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## **The Need for Inclusion of Human Resources Accounting in the Balance Sheet**

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### **Abstract**

*For many years, the concern of management was neither for technical values, human values nor the welfare of employees. The workers were considered little more than machines and were considered less worthy of attention because the machines were more expensive to replace hence a total neglect of human resources assets on the balance sheet of organizations. Today, increased attention is being focused on the keeping of an up-to-date inventory of current manpower stock in terms of skill, sex etc. for effective human resources planning, control and management. Besides, human resource accounting helps the human resource Manager/Director to place appropriate values on our physical resources so as to maximize utilization of human assets. This paper has attempted to bring the views of different researchers on the concept of human resource accounting into focus and the practicability of this concept, peruse the objectives of human resource accounting, different valuation methods from various literature emphasizing the need to show human asset in the balance sheet and finally sensitizing professional accountants to an in-depth look at the balance sheet and for professional bodies to bring up Accounting Standards to back up adequate treatment of human assets in the balance sheet.*

## **Introduction**

The origin of Human Resource Accounting could be traced to the work of Rensis Likert, a social psychologist who first used the term "Human Assets" in the late 1950s, which was subsequently replaced by the term "Resources" by later scholars. The crux of his work was the intuitive expression of the human resource in accounting terms. This ideal by Likert came at a time of an increasing awareness in behavioural problems of accounting system in particular and changes in social values in general (Akinsoyinu, 1992).

Human resources experts had for some time been uncomfortable in the presentation of organizational financial statements which invariably excluded the most important and most precious asset - the human resource (Walker, 1995). An attempt made for the incorporation of human resources in the financial statements was first reported in the study carried out by Schwan in 1970. From the study a pioneering effort of accounting for human asset carried out by R.G Barry Corporation in her financial statements was revealed (see Table1). Beginning in 1968, this firm established an investment accounting system to provide human resource accounting for its managers. This system was later extended to office and factory personnel. The system accounts for genuine employer cost that should provide regular returns on investment and which, for human reason should not be wasted through underemployment (Davis, 1995).

A similar effort in disclosing human resource information in the financial statements at the New Jersey Bell was also reported. Another attempt was made by Peter Drucker on the work done by Michael Schiff. In his study, Schiff proposed a company's financial statement that will list people as "asset" i.e., show sales and marketing forces as investments as they indeed are (Walker, 1995).

## **Importance of human resource and human resource accounting in the life of an organisation**

Central to the growth, viability and survival of any organization be it private or public, manufacturing or non-manufacturing, is the

effective acquisition, utilization and maintenance of the organisation's human resources. The human resource is so critical to organizational "survival such that it has, judging by today's complex business environment, been acclaimed as the most important resource available to any organization.

No matter how efficient and sophisticated your machines, tools and equipment are, and no matter how vast your financial and material resources may be, somebody who is the human element will have to put them to use.

Walker, in his Grolier Business Library "Human Resource Planning" in 1995 opined that "though your balance sheet is a model of what balance sheet should be, typed and ruled with great precision in a type that all can see, though the grouping of the assets is commendable and clear, and the details which are given are more clear than usually appear, though investments have been valued at the sale price of the day, and the auditors' certificate shows everything okay, one asset is omitted That asset is the value of the men and women who run the show". Organizations are social systems and they are made up of structures, technology and the environment. The common denominator among the three is 'people' (Wilson, 1966).

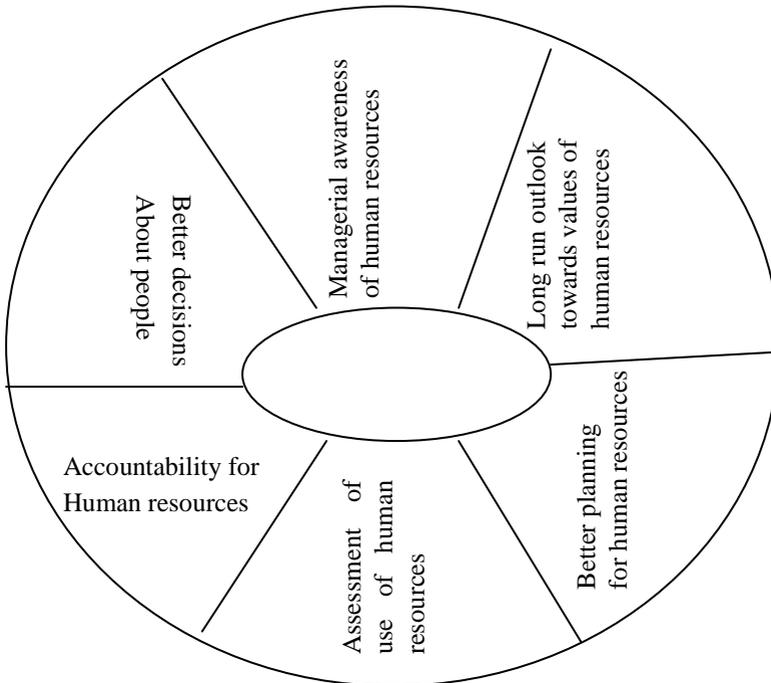
### **Objectives of human resource accounting (BRA)**

Hicks and Gullet in their research work gave four different objectives of BRA which are:

- Measure the monetary worth of an individual to an organization and treat it as an asset to be amortized over time.
- Estimate the effect of managerial actions on employees' morale, productivity and turnover.
- Provide the basis for computing a return on investment in employees just as with physical assets.

- Furnish potential investors with a more comprehensive and realistic picture of the organisation's financial strength. (Hicks and Gullet, 1987)

Walker in his work presented a diagrammatic view of HRA as below. In this way, it is expected to encourage better planning for human resources and better decisions whenever they involve people. Lastly, HRA is an excellent way to encourage managers to take a long-run outlook towards the value of people, rather than a short-run, quick-profit outlook that ignores human resources.



Source: James W. Walker (1995), Grolier Business Library

### **Valuation of human resources**

Pioneers in adoption of Human Resources Accounting were the R. G. Barry Corporation of Columbus, Ohio. The 1967 Annual Report

described its inauguration as "just the first step in the development of sophisticated measurement and accounting procedure that will enable us to rep or accurate estimates of the human assets of the organisation".

Cost were accumulated in individual subsidiary accounts for each manager under seven mail heads, namely, recruiting, acquisition, formal training and familiarization, informal training and familiarization, investment building, experience and development. Cost were amortised over expected working lives of individuals or shorter, and unamortised cost written off, for example, an individual leaving the company, his experience becoming obsolete, or his health impaired, on recommendations of operating managers from their quarterly review of their staff balances.( Baker, 1976). This method employed was described as the **Historic Cost Approach**.

The method of valuation apparently poses a major problem in Human Resource Accounting (HRA). Various methods have been proposed over the years.

**Table 1: Human Asset Accounting in Practice – the Accounts of R.G. Barry Corporation Balance Sheet as At December 31, 1972**

Assets	Conventional with Human Resource \$	Conventional Only \$
Total Current Assets	16,408,620	16,408,620
Net Property, Plant & Equipment	3,371,943	3,371,943
Excess of Purchase Price over Net Assets Acquired	1,288,454	1,288,454
Deferred Financing Costs	183,152	183,152
Net Investments in Human Resources	1,779,950	-
Other Assets	232,264	232,264
	<u>23,264,383</u>	<u>21,484,433</u>
 <b>Liabilities and Stockholder's Equity</b>		
Total Current Liabilities	3,218,204	3,218,204
Long Term Debt, Excluding Current Installments	7,285,000	7,285,000
Deferred Compensation	116,533	116,533
Deferred Federal Income Tax Based upon Full Tax Deduction for Human Resource Cost	889,975	-

Stockholders' Equity:		
Capital Stock	1,818,780	1,818,780
Additional Capital (Excess of par value)	5,047,480	5,047,480
Retained Earnings:		
Financial	3,998,436	3,998,436
Human Resources	<u>889,975</u>	<u>-</u>
	<u>23,264,383</u>	<u>21,484,433</u>

**Statement of Income**

Net Sales	39,162,301	39,162,301
Cost of Sales	<u>25,667,737</u>	<u>25,667,737</u>
Gross Profit	13,494,564	13,494,564
Selling, General & Admin Expenses	10,190,773	10,190,773
Operating Income	3,303,791	3,303,791
Indirect Expenses	<u>549,225</u>	<u>549,225</u>
Income Before Federal Income Taxes	2,754,566	2,754,566
Net Increase in Human Resource Investment	<u>218,686</u>	<u>- NIL</u>
Adjusted Income Before Federal Inc. Tax	<u>2,973,252</u>	<u>2,754,566</u>
Federal Income Taxes	<u>1,414,343</u>	<u>1,305,000</u>
<b>Net Income</b>	<u>1,558,909</u>	<u>1,449,566</u>

**Historical Cost Method** as described by Gogo is an attempt to comply with the basic concepts of conventional accounting. Here human resource is valued at the unexpired cost of recruiting, selecting, acquiring, familiarization and development of the different grades of employees within an organisation. (Gogo, 1987). Craft and Birnberg in their 1980 work categorized this method under Outlay-Based Approach. They explained that most of the initial work in HRA was directed towards determining organisational investments in people, focusing on cash outlays invested in developing human assets. They described the historical cost method as the capitalisation of the out-of-pocket expenditure, which the firm uses in securing and developing its human resources(e.g. recruiting, selection, training etc) for each individual.

**The advantages** of this approach as explained by Baker include:

- Its relative objectivity

- Its facilitation of comparison on levels of human resource investment on a basis consistent with accounting treatment of other assets.
- Its matching, to an extent of benefits with expenses iii particular time periods.

***The disadvantage*** on the other hand is majorly the invalidity of a stable currency.

This is aggravated by the much greater degree of subjectivity in the detection and write-off of expenditure, and the absence of independent valuation check in that the asset is not saleable as such (Baker,1976).

**Replacement cost approach** involves the estimated cost of replacing the entire existing human resources in an organisation. Renis Likert suggested that the valuation should be based on assumption that a similar organisation is to be formed from scratch, and how much cost in terms of human resources would be required for this purpose?(Gogo,1987).

Eric Flamholtz has pointed out that it is easier in practice to estimate replacement cost than market value and the former should therefore be adopted as surrogate measure of the latter.

This replacement cost method has been simply put by Walker as "people are worth what they cost to replace on the open market". As a better approach to historical cost where people may be worth more or less than was actually paid out, the replacement cost concept asks, if all employees were gone tomorrow what would it cost to replace them at their present level of competence?(Walker, (995).

However the disadvantages of this approach seemingly outweigh its benefits. The greater ease of establishing the measure does indicate the greater feasibility of the method, but it is far from validating it as a close approximation to market value or demonstrating usefulness. The principal decisional context in which such data would be relevant would be that dismissal and replacement of staff. Here the decision makers are already aware of the nature of the costs, there seems some

room for doubt, firstly, whether the data will be or sufficient precision to be very influential in the decision and secondly, whether such decisions are so frequent as to build in to the accounting system the regular production of such data on all employees(Baker,1976)

Akinsoyinu posits that the replacement of people can be a very complex organizational operation rather than a simple market transaction. He explained that it is not the cost of buying "A" in order to replace "B" since "A" or "B" can be bought but the cost of employing the services of "A" rather than "B". The concept of replacement cost can be applied in the following cases.

- ❖ If slavery exists
- ❖ Where a man or woman can be replaced by a machine not aided by human beings; such machine fulfils the exact role played by the human and such machine has a price. (Akinsoyimu, 1992).

**Present value method** proposed by Baruch Lev and Aba Schwartz is an economic' valuation for the probability of death. They sought to enhance the objectivity of their measure by using very widely based statistics e.g mortality tables (Baker 1976). This method is explained more clearly by Gogo. He described it as discussing on the estimated future earning streams or net contribution of Human resources to an organization at a discounted value. It therefore encourages guess dark of the estimated period an employee would remain in the organization. (Gogo, 1987)

Walker further explains that this method calls for an examination of variables, which determines the value of people and the interrelationship among these. "Value" here he said may be defined as the present value of future services provided either by given individual or any of the organization as a whole. An individual value may be directly measured by considering both conditional and realizable economic value to be provided over the years, or it may be measured more simply by using surrogate measure, such as the present value of future compensation to be paid to an individual.

Craft and Bimberg refer to this method as an inflow oriented approach explaining that a portion of the present value of earnings is allocated to human resources in the proportion of this resources' relative contribution to the firm's expected wage streams are discounted to obtain a measure of the present human resource value. This is based on the premise that an individual's wage accurately reflects his value to the organization (Craft and Bimberg, 1980).

Walker gave a technique on how it can be arrived at. This is the measurement of "unrealized goodwill". The total market value of firm (or goodwill on the balance sheet) represents the value of various intangible assets including the potential future value of its people. After the economic value patents, trademarks, customer relationships, and other items are removed, the remainder would indicate the total value of human resources (Walker, 1995).

James Heikman and Curtins and Jones rejected earnings capitalization as an indicator of human asset value on grounds inter alia, of the low correlation between man's salary and his value (Baker, 1976).

**Opportunity cost method** is based on a conceptual economic approach, which is the value of an employee, in this case, in his best alternative. That is, valuation of human resources should be based on the worth of labour in terms of the value an employer is prepared to pay in an alternative company or industry. Gogo and Saka in their different researches describe this method as involving this usage of an employee in carrying out a task at the expense of another equally important task somewhere else (Saka,1997).

**Competitive Bidding Method** also called value to the undertaking by Baker Heikman and Jones proposed that where an undertaking had several divisions seeking the same employee, he should be allocated to the highest bidder and the bid price incorporated in that division's investment base. In other words, managers may be encouraged to bid for personnel that are readily available such that the highest bidder will eventually engage the services of that employee and the price will be capitalized as investment (Baker, 1976).

This approach seems to have merits but the circumstances in which it would be operative are relatively rare. The success of this valuation however depends on the information, judgment and impartiality of the bidder divisions. It should also be noted that employees that can be easily hired cannot be "bided for" because of the ease of employing them.

They therefore do not have any investment value in the company's balance sheet. This could yield to a negative effect on the employees who have no value placed on them.

Other disadvantages of this approach include the difficulty in determining the bidding and how to determine the time limit for the "bid."

**Contract labour methods** is another valuation method which presupposes an Employment Agreement between the firm and each or a group of employees in the firm over a specific period of time; and on the remuneration over this period which is, nevertheless revised at the expiration of each agreement term. All expired values, after every year's service is written off to the profit and loss account and reduces from the capitalized figure in the balance sheet.

All attempts at the hook-keeping procedure for this valuation method would be as follows:

If the contract slim agreed for employing labour X is ₦20,000 per annum and the agreed period is five years; the total contract value to be capitalized would be ₦20,000 x 5, that is ₦100,000

DR: Human Resources Account

CR: Contractual Human Resources Account

With the capitalized value of ₦100,000

**As salaries are paid on a monthly basis**

DR: Contractual Human Resource

CR: Cash or bank

With a total of ₦20,000 for the year

**At the end of the year, accrue all expired cost by**

DR: Profit and Loss

CR: Provision for expired Human Resources;

With ₦20,000

**The balance sheet would therefore appear as follows:**

<b>Liabilities</b>	<b>₦</b>	<b>Assets</b>	<b>₦</b>
Contractual Human Resources	80,000	Human Resources	N 100,000
		<u>Less: Provision for Expired Human Asset</u>	<u>20,000</u>
	<u>80,000</u>		<u>80,000</u>

("Accounting for Human Resources", Gogo, 1987)

**Capitalization of employees' salary method** acts in opposition to the traditional treatment of the salary and wages of employees, which is, to write it off against the income statement as an expense used in earning the income.

The rationale behind capitalization of employees' salaries and wages is to make salaries and wages a capital expenditure, which is in turn subjected to a predetermined depreciation.

The limitations of this valuation method include:

- There exists a loose connection between a man's value and his salary.
- Determining an acceptable rate or percentage of salary to be capitalized is disputable.

- There exists no model to serve as a basis for calculating the depreciation value of a person.

### **Limitation of human resource accounting**

It is generally accepted that human resources are the most important to the success of every organization. However its inclusion in the balance sheet has been strongly denounced in certain quarters. These people are usually regarded as non-advocates of HRA. Also certain people, who even consider the feasibility on-IRA, do so, however not without mentioning the limitations.

According to Craft & Bimberg, many accountants have always been concerned about capitalizing on the balance sheet excessive amounts of outlays for intangibles, because many firms have had large," amount of these "assets" turning to be worthless. They caution accountants from considering an innovation which will increase the intangible assets on the corporate balance sheets, and that BRA should be considered only for internal use rather than I'm external purposes (Craft & Bimberg, 1980).

### **Benefits of human resource accounting**

All the valuation methods above have certain disadvantages or limitations. Nevertheless, accounting for human resources can be a plus to the organization and its stakeholders.

Craft & Bimberg, despite their apprehension on Human Resource Accounting explained the benefits of HRA under three headings:

**In personnel management:** HRA could help the personnel manager make better use of the resources entrusted to him, in developing measurements of cost of hiring and training new employees which would ordinarily not come lip in conventional financial reporting system.

**In line management:** HRA could also be used to inject additional inputs e.g. personnel costs and perhaps social-psychological data into the organizational internal planning and control systems.

**By investors:** HRA could be integrated into reports designed for external use in evaluating economic condition of the firm. (Craft & Bimberg, 1980)

Gogo itemized some of the benefits of HRA to include:

- Proper integration of Return on Capital Employed (ROCE) in disclosure of the value of human resources in the long-term perspective of the business performance.
- The maintenance of detailed record relating to internal human resources will improve managerial decision-making process in Recruitment Vs Promotion, Transfer Vs Retention, Retrenchment Vs Retention,
- Identification of Human Resources as a valuable asset will prevent underuse and misuse through thoughtless and reckless transfers, demotions, lay-off and day-to-day maltreatment by supervisors and other superiors.
- Help in efficient allocation of resources in the economy
- Help in efficient use of Human Resources
- Help in proper understanding of the evil effects of avoidable labour unrest or disputes on the quality of internal human resources (Gogo, 1987).

### **Conclusion and challenges**

From review of different literatures on this topic and the personal accounting and managerial experience of the paper writer, the following conclusions have been drawn:

- It is possible to value human resources in monetary terms. Such value can be arrived at using a valuation method agreed upon by management (i.e. Management Policy).

- Management, employees, shareholders and potential investors will be interested in financial information on the human resources of the organisation.
- Accounting for human resources will encourage employees to develop themselves in terms of skill and qualification so as to attract a higher value. It will also reduce labour turnover as valuation method may differ from company to company which will likely lead to a psychological effect on employees. This is based on the assumption that human beings are rational.
- Considering the different needs of the users of financial statements, HRA can be flexed to meet these needs for both external and internal purposes.
- Human Resource Accounting will offer a quantitative base for the planning, evaluation and development of human assets of the firm, assist external users, particularly investors from the information as to the extent to which human resources of the organization have been increased or decreased during a particular period and the overall effect, provides an evidence to suggest that some degree of correlation exists between a firm's investment in human assets and its profitability, enhances the stewardship concept, and makes the financial statement more complete giving room to a more exhaustive decisions.

Further research work should be aimed at conducting an in-depth research into the appropriate valuation methods to be adopted to satisfy the need of different users, just as depreciation has many accepted methods. Finally, the Accounting Profession should find a lasting solution to Human Resource Accounting through its Accounting standards and thereafter include HRA in its curriculum.

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