Accounting for the Human Capital-the Most Significant but Deprived Area

Pranav Mishra[1],
Gulab Singh[2]

Institute of Business Management
GLA University Mathura 281406 U.P.

As per the economic principles there are three basic factors of production namely land, labor and capital. Under the present accounting framework both land and capital is appropriately accounted for, however labor has been deprived of the appropriate accounting treatment which it qualifies for. Though there have been some attempts to prescribe the accounting of the human resource starting with the path breaking work of Flamholtz and Pyle and followed by many but none were successful in suggesting a solid conceptual framework in dealing with the issue. This paper is an honest attempt to fill the gap in an age where the role of Human capital and Intellectual capital is growing day by day.

Keywords Human capital, Intellectual capital, factors of production, accounting framework, economic principles

Introduction

Human Capital is the most significant resource that any organization can possess. Without a competent human resource at its disposal no organization can reap the benefits from other inanimate resources under its ownership. A business can employ the latest technology but it will be useless unless the firm has persons possessing the intellect to comprehend the complex intricacies of the technology and be able to implement the same. In an economy that has transformed from a primary sector through secondary and finally to a tertiary sector the role of human capital cannot be overemphasized. Thus it is expected that in the future the share of the service sector which is dominated by intensive use of Human capital to any economy's GDP is going to increase on a much greater pace than ever.

However, the issue of accounting for the human resource and recognizing it in the books of accounts seems to have not been adequately addressed till now. Though attempts of accounting for the most significant resource of an organization started long back in 1967 with the work of Flamholtz and Pyle, no significant development has been done in this field. This study aims at revisiting the issue with altogether new approach.

According to Ganta and Geddam (2014), human resource accounting is the process of assigning, budgeting, and reporting the cost of human resources incurred in an organization, including wages and salaries and training expenses. For determining the efficiency of management the usual practice is to analyze the balance sheet of the organization and thus accounting for human resource becomes significant for portraying the correct picture to both the internal as well as external users of the accounting information.

In order to account for the human capital, the authors have borrowed the basic theme from Flamholtz's work and tried to propose accounting treatment for human asset in the books of accounts. As per the present practice amount of compensation that is paid to an employee is treated as an expense to be charged to the current year's profit & loss account. We differ on this point and propose an alternative to this approach. The mindset of the management is that expenses are meant to be reduced. This acts a de-motivating factor for the Human capital at work. On the contrary valuing the same as an asset will go a long way in motivating the human resource and increasing its efficiency in the future.

Objectives of Human Resource Accounting

Human resource accounting will enable the management to take informed decisions with respect to enhancing the value of the existing human resource base and thus increasing the efficiency of the business in the long run. Other significant objectives of HRA are enunciated as under-

1. Helps in asset control, i.e., determine whether the human capital is conserved, depleted or appreciated.
2. To facilitate the determination of the appropriate timing for initiating any training and development program for employees.
3. To provide the interested users in the firm to know whether their investment in human resource is producing a return equivalent to their worth or not.
4. To help in the human resource management.

Literature Review

The concept of valuating the human capital was first felt by Flamholtz and Pyle(1967) at the R. G. Barry Corporation. They proposed that the amount that an employer incurs on recruiting, acquisition, training etc. up to the point he is ready to work with the organization should be capitalized in the books of accounts and be written off over the period he serves the organization.

Hekimian and Jones(1967) substantiated the above concept by saying that, only scarce people should comprise the value of human capital. Employees not considered scarce are not included in the human resource base of a firm. The present authors believe that every individual is unique in one way or the other and hence dropping some part of human resource from valuation doesn't seems to be well justified.

Lev and Schwartz (1971) opined that the value of human capital at the disposal of any organization is the present value of future earnings from employment. The method however ignores the cost that the organization incurs in placing the employee to the role for which he is hired. Further what discount factor should be used to discount the future earnings was not clarified.

Finally Likert and Flamholtz (1985) later proposed another model to account for the human resource of the organization. Referred to as the replacement cost approach it values human capital by calculating how much it would cost to replace the existing human resource with other person of equivalent experience and talent. As it is not necessary that the firm would be able to hire an exact substitute to fill the post of an ex-employee the model is somewhat unrealistic. Further it can be taken as the value of the outgoing employee who will not serve the organization anymore and not the new hire.

Proposed Accounting Treatment

We believe that when an organization hires an employee it invests in the form of advertising, recruiting, acquisition, training and familiarization both formal as well as informal and experience and development (Flamholtz) as well as commit itself to provide compensation (both monetary and non-monetary) in future as long as the employee serves the firm, in other words remain as an asset for the company. Thus both cost incurred for hiring as well as the total compensation payable must be capitalized in the books of accounts. As the benefits from these present and future cash outlays will be received in the future years, therefore these should be written –off from the books equally over the service period of the employee. Hiring an employee is a peculiar transaction where the firm makes investment in human capital on one hand and incurs a liability to pay the employee his compensation in the future.

Our accounting treatment is based on the following assumptions-

1. The total value of compensation payable to an employee is almost equal to the benefits that the firm can derive from his service.
2. Benefits received from an employee are invisible. They are however manifested through other indicators like increased sales, reduced cost etc.
3. Non-monetary compensation payable to an employee in the form of perks is easily convertible in monetary terms.
4. Compensation for an employee is determined assuming that he would serve the organization for the entire tenure as per the employment contract.

We propose that for proper valuation of human resource the organization must capitalize all cost incurred in hiring and placing the employee to the role for which s/he is hired along with the future compensation (monetary and non-monetary) as an investment. Further the firm needs to create a provision for the compensation payable to the employee in future. The proposed accounting treatment is as under-

<u>On Hiring</u>

Human Capital A/c……………….Dr (Investment part)
To Provision for Compensation A/c (Liability part)

<u>On payment of salary</u>

Provision for Compensation A/c…………………Dr
To Cash A/c

<u>On payment of non-monetary salary</u>

Provision for Compensation A/c……………………Dr
To Asset A/c

Provision for Compensation A/c……………………Dr
To Share capital A/c (When shares are paid as compensation)

<u>At year end</u>

Profit & Loss A/c………………………………………Dr (Amount to be written-off)
To Human Capital A/c

Employee Training and Development

During the tenure of service employees undergo training and development programs which are entirely sponsored by the employer. These are meant to enhance the skill sets and competencies of the organization's human resource. These also make the employees updated with the latest happenings in their concerned field. Such efforts by the organization are expected to increase the value of its human capital. Thus as per the proposed model the authors opine that such expenses must also be capitalized in books and written off over the remaining part of the service life of the trained employees.

On Employee's Training & Development

Human Capital A/c………………………………Dr
To Cash

Special cases

Often the employee does not serve the organization the entire tenure as per the employment letter due to various modes of employee separation like dismissal, retrenchment, lay-off etc. In such a situation there would be a diminution in the value of Human Capital standing in the books of the organization. At the same time the organization is no longer required to carry the provision for compensation in its books of accounts.

On Employee Separation

Provision for Compensation A/c……………………….Dr
To Human Capital A/c

However these special cases mentioned above may entail some expenditure to be incurred on the part of the organization in the form of exit interviews, legal charges, and retrenchment compensation. These expenditures must however be charged to the Profit & Loss account as by incurring those expenses the organization would not reap any Human capital related benefits.

For expenses incurred during employee separation

Specific expense A/c…………………………Dr
To Cash A/c

At year end

Profit & Loss A/c……………………………Dr
To Specific expense A/c

Pension and Provident Fund

Certain organizations pay out pensions and provident fund to their ex-employees after their retirement. Such a payment is made after the employee has served the organization for a considerable time period. However by making such payments the organization cannot derive any human capital related benefits. Hence such costs must be charged to the Profit & Loss account.

Conclusion

In developing the above explained model we have merged two of the earlier models. We feel that future earnings from employment should not be converted into their present values as none other item of the Balance Sheet is shown at its present value. We feel that the above model if implemented will go a long way in properly accounting for the most valuable resource of any organization which is its Human capital as it is based on the fundamental concept of Matching principle of accounting.

References

D. C. Bose(2006) Fundamentals of Financial Management,1st Ed. Prentice Hall of India Private Limited, New Delhi pp 508-512

E.G. Flamholtz (1999) Human Resource Accounting: Advances in Concepts, Methods and Applications,3rd. Ed. Kluwer Academic Publishers, New York,

Likert, R & Flamholtz, E.G.(1985) Human Resource Accounting, Inflation Accounting, Social Responsibility Accounting and Environment Accounting *in* Financial Accounting by S.J. Gabriel and A. Marcus; Tata McGraw Hiils; New Delhi Ed. 2010 pp 876

Flamholtz. E.G, Bullen M. L. & Hua W., (2002) "Human resource accounting: a historical perspective and future implications", *Management Decision*, Vol. 40 (10), pp.947 – 954

Ganta, V. C.& Geddam, M.(2014) Human Resource Accounting, *International Journal of Academic Research*, Vol. 1 54-61.

Hekimian, J. S., & Jones, C. H. (1967).” Put people on your balance sheet”,.*Harvard Business Review*, *45*(1), 105-113

Lev, B., & Schwartz, A. (1971). On the use of the economic concept of human capital in financial statements. *Accounting Review*, 103-112.