

Human Resource Accounting

Financial accounting has developed various tools that largely measure activities and their results in such areas as profit, costs, production, etc. These tools also measure the value of various physical assets (land, building, machinery, etc.) as well as of various intangible assets (goodwill, patent, brand, etc.). However, financial accounting does not measure the value of human resources which can be 4 to 20 times of value of physical and financial assets of an organisation. In order to bridge this gap, behavioural scientists have made attempts to measure the value of human assets. An early attempt was made by Likert and Bowers.⁵

This attempt was further extended by others to give some concrete shape which has generated human resource/asset accounting. Flamholtz, who has done considerable work in the area of human resource accounting, has defined it as follows :

"Human resource accounting is accounting for people as an organisational resource. It involves measuring the costs incurred by business firms and other organisations to recruit, select, hire, train, and develop human assets. It also involves measuring the economic value of people to the organisation."⁶

American Accounting Association has defined human resource accounting as follows:

"Human resource accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties."⁷

⁵Rensis Likert and David G. Bowers, "Organisation Theory and Human Resources Accounting," *Psychologist*, Vol. 24, 1969, pp. 582-592.

⁶Eric G. Flamholtz, *Human Resource Accounting*, Elcino, Cliff.: Dickenson Publishing, 1974.

⁷American Accounting Association, *Terms and Concepts in Accounting*, New York, 1980.

Thus, human resource accounting is primarily involved in measuring the various aspects related to human assets. Its basic purpose is to facilitate the effective management of human resources by providing information to acquire, develop, retain, utilise, and evaluate human resources. The more specific objectives of human resource accounting are as follows:

1. To provide cost-value data for managerial decisions regarding acquiring, developing, allocating and maintaining human resources so as to attain cost-effective organisational objectives.
2. To provide information to monitor the effectiveness of human resource utilisation.
3. To provide information for determining the status of human asset whether it is conserved properly; it is appreciating or depleting.
4. To assist in the development of effective human resource management practices by classifying the financial consequences of these practices.

VALUATION OF HUMAN ASSETS

Valuation of human assets is the most important aspect of human resource accounting. A recent trend in today's corporate world is to measure the value of intangible assets of the companies such as goodwill (valuation of goodwill is quite old), brands, patents, and now human assets. Consultants in HRM emphasise the need for valuation of human assets. For example, Brian Friedman, human capital consultant with Arthur Anderson, views that "if you treat human resources as your most valuable assets, measure these assets and find out return on those assets."⁸ Before we go through the mechanism of valuation of human assets, let us see the types of various human assets.

Types of Human Assets

Human assets are in intangible form and are within the inside of human resources. Therefore, there may be different ways in which these can be classified. For example, Sumantra Ghoshal has classified these into three categories—intellectual capital, social capital, and emotional capital.⁹ Besides, there is recent emphasis on spiritual capital. Let us briefly discuss these to identify how these contribute to individual effectiveness.

⁸Brian Friedman, "People Power". Interview with *The Economic Times*, April 7, 2000, p. 2 (Supplement).

⁹Sumantra Ghoshal. "Competing on Human Capital". *The Economic Times*, June 11, 1999, p. 1 (Supplement).

Intellectual Capital. The first element of the human capital is intellectual capital which can be defined at individual level as well as at organisational level. At the level of individual, it refers to his knowledge, skills and expertise. It may be in the form of specialised knowledge, tacit knowledge and skills, cognitive complexity and learning capacity. At the organisational level, intellectual capital consists of both the stock of knowledge, skills and expertise that members of the organisation collectively possess, and the knowledge and expertise that may be embedded in or owned by the organisation including patents, information technology based knowledge systems, or specialised processes of work. Ghoshal observes that "in the recent past, much management attention has been paid to this issue of intellectual capital, and rightly so. Knowledge rather than money is increasingly becoming the key competitive differentiator—certainly in service industries like consulting, investment banking, IT services, and so on, but also in manufacturing-based businesses like pharmaceuticals, consumer electronics, and electrical machinery."¹⁰

Social Capital. Social capital is the second element of human capital. It is derived from the network of relationships, both internally and externally. From organisation's point of view, social capital relates to the structure, quality, and flexibility of the human networks which can be created through cohorts, joint training in which people get to know each other, job rotation through different departments and functions, long-term employment and internal culture. The other aspect of social capital is external—built on the relationships with external forces like customers, suppliers, government agencies, etc. However, building external relationships and working on these does not involve taking undue advantages for furthering the interest of the organisation. It is used in the context of trustworthiness.

Emotional Capital. Emotional capital involves self-confidence, ambition, courage, risk-taking ability and resilience. It is reflected in what is described as a 'can do' spirit. Individuals need self-confidence based on self-esteem, courage, and resilience to convert their knowledge and relationships into effective actions. Organisations require high internal energy and an environment of pride, trust, and openness to create a bias for speed and action in rapidly changing environment. In today's context, more companies are involved in developing emotional quotient (EQ) as the individuals in an organisation depend more on

¹⁰Ibid, p. 1.

their emotional capital for effectiveness than their intelligence and technical skills. Emotional capital helps in controlling such emotions as anger, hatred, frustration, confusion, sadness, etc., which affect the job performance adversely. Further, it helps in reducing stress, a major problem of the modern organisations.

Spiritual Capital. Spiritual capital is the recent development in the practice of human resource management. First, it was intelligent quotient (IQ) followed by emotional quotient (EQ), and now has come spiritual quotient (SQ). Ullhas Pagey, Director (HR & OD), Aptech Limited, views that "whereas with a high IQ, you may get hired; with a high EQ, you get promoted. But this is a short-term perspective and long-term growth is linked to SQ."¹¹ Spiritual capital is assuming increasing importance throughout the world. Spiritual capital is multi-directional and includes values, ego, and approach to work. Most growing organisations are of the opinion that people can be made to learn; their skills can be developed; but when it comes to values, ego, and approach to work, these cannot be changed. Therefore, it is desirable to hire those whose values, ego, and approach to work match those of the organisation.

All these forms of human capital are not isolated rather these are interrelated. Therefore, while measuring human capital, all these must be taken together. Human resource accounting makes attempt to measure this capital.

Methods of Valuation of Human Assets

There are a number of methods suggested for the valuation of human assets. Many of these methods are based on the valuation of physical and financial assets while others take into account human consideration. Major methods of valuation of human assets are historical cost, replacement cost, standard cost, present value of future earnings, and expected realisable value.

Historical Cost. Historical cost is based on actual cost incurred on human resources. Such a cost may be of two types—acquisition cost and learning cost. Acquisition cost is the expense incurred on recruitment, selection, and placement. While calculating the cost of recruitment and selection, entire cost is taken into consideration including those who are not selected. Learning cost

¹¹Ullhas Pagey, "Handle With Care," *The Economic Times*, August 14, 2000, p. 7.

involves expenses incurred on training and development. This method is very simple in its application but it does not reflect the true value of human assets. For example, an experienced employee may not require much training and, therefore, his value may appear to be low though his real value is much more than what is suggested by historical cost method.

Replacement Cost. As against historical cost method which takes into account the actual cost incurred on employees, replacement cost takes into account the notional cost that may be required to acquire a new employee to replace the present one. In calculating the replacement cost, different types of expenses are taken into account which may be in the form of acquisition and learning cost. Replacement cost is generally much higher than the historical cost. For example, Friedman has estimated that the replacement cost of an executive in middle management level is about 1.5 to 2 times the current salary paid in that position.¹² Replacement cost is much better indicator of value of human assets though it may present certain operational problems. For example, true replacement of a person may not be found easily with whose cost the valuation is done.

Standard Cost. Instead of using historical or replacement cost, many companies use standard cost for the valuation of human assets just as it is used for physical and financial assets. For using standard cost, employees of an organisation are categorised into different groups based on their hierarchical positions. Standard cost is fixed for each category of employees and their value is calculated. This method is simple but does not take into account differences in employees put in the same group. In many cases, these differences may be quite vital.

Present Value of Future Earnings. In this method, the future earnings of various groups of employees are estimated up to the age of their retirement and are discounted at a predetermined rate to obtain the present value of such earnings. This method is similar to the present value of future earnings used in the case of financial assets. However, this method does not give correct value of human assets as it does not measure their contributions to achieving organisational effectiveness.

Expected Realisable Value. The above methods discussed so far are based on cost consideration. Therefore, these methods may provide information for record purpose but do not reflect the true value of human assets. As against these methods, expected realisable value is based on the assumption, and this is true also, that there is no direct relationship between cost incurred on an individual and his value to the organisation at a particular point of time. An individual's value to the organisation can be defined as the present worth of the set of future services that he is expected to provide during the period he remains in the organisation. Flamholtz has given the variables affecting an individual's

¹²Friedman, *op. cit.*, p. 2.

expected realisable value (ERV) individual conditional value and his likelihood of remaining in the organisation. The latter is a function of the individual's ability and activation level, while the later is a function of such variables as job satisfaction, commitment, motivation, and other factors as shown in Figure 6.1.1.

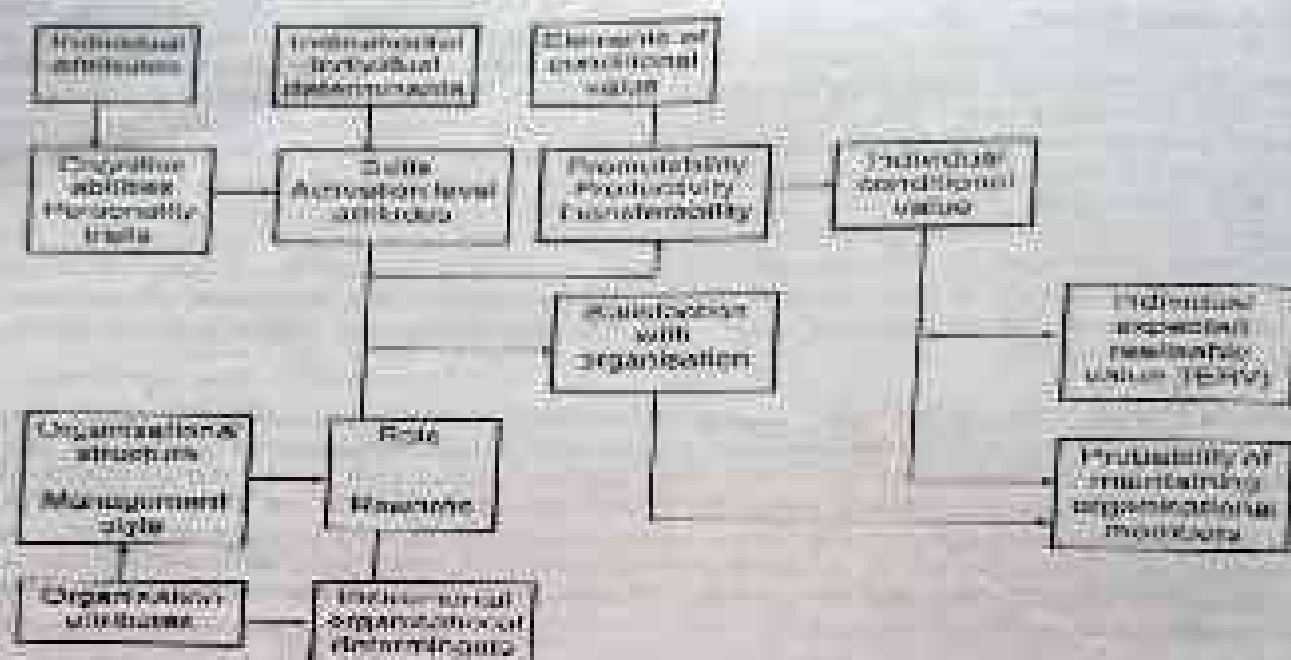


EXHIBIT 6.1 Model of the determinants of an individual's value to an organisation

Advantages of Human Resource Accounting

Many organisations, particularly in the USA, are following the human resource accounting approach. In our country, too, there is a need for establishing systems which can generate monetary and non-monetary information about human beings in the organisations, particularly about managerial talents whose dearth is felt by business organisations. This is due to the fact that human resource accounting offers following advantages:

1. It helps in giving valuable information to the management for efficient planning and managing human resources.
2. It helps in measurement of standard cost of recruiting, selecting, hiring and training people and organisation can select a person with highest expected realisable value.

3. Human resource accounting can change the attitude of managers completely, thereby, they would try to maximise the expected value of human resources and effective use of human resources in the organisation.
4. It also provides necessary data to devise suitable promotion policy, congenial work environment and job satisfaction to the people.

Problems in Human Resource Accounting

There are certain operational problems in human resource accounting because it attempts to measure intangibles. Therefore, subjective factors may play crucial role. Thus, the major operational problems involved in human resource accounting are of the following types:

1. There is no well-set standard accounting practice for measuring the value of human resources. In the case of financial accounting, there are certain specified standards which every organisation follows. However, in the case of human resource accounting, there are no such standards. Therefore, various organisations that adopt human asset valuation, use their own models. With the result, value of human assets of two organisations may not be comparable.
2. The valuation of human assets is based on the assumption that the employees may remain with the organisation for certain specified period. However, this assumption may not hold true in today's context because of increased human resource mobility.
3. There is a possibility that human resource accounting may lead to the dehumanisation in the organisation if the valuation is not done correctly or results of the valuation are not utilised properly.
4. There is also a possibility that trade unions may oppose the use of human resource accounting. They may want parity of wages/salaries and value of employees.

However, many of these problems are of operational nature or of attitudinal nature. These may be overcome by developing suitable organisational climate and culture.

HUMAN RESOURCE ACCOUNTING IN INDIA

Human resource accounting in India has not become popular in the way in which it should be. Most companies show employee costs, measured in terms of amount of wages/salaries and of various perquisites which can be expressed

in monetary terms, in their annual reports. Besides these, they also show the number of employees category-wise. So far as valuation of human resources is concerned, only stray attempts have been made. For example, Infosys Technologies valued its human resources in 1995-96 which was Rs. 184 crore, much more than its physical assets of Rs. 84 crore and profit of Rs. 93 crore. Similarly, Balrampur Chini Mills valued its human resources at Rs. 10.43 crore while BPL Limited valued its human resources at Rs. 125.44 crore. Value of human resources in knowledge-based sector like information technology, consultancy, electronic media is quite high. The reasons for low importance given to human resource accounting in India are as follows:

1. In India, high importance to human resource management has been accorded only recently; earlier it was considered as fiddle. In such a situation, companies have accorded higher importance to more pressing needs of HRM rather than going for human resource accounting.
2. Many organisations do not realise the importance of human resource accounting. They hold the view that human resources are precious to them whether their value is measured or not. Therefore, the need for human resource accounting is not that important in managing human resources effectively.
3. There are certain operational problems in human resource accounting, particularly in valuation of human resources. In the case of physical and financial resources, there are generally accepted accounting principles (GAAP). In the case of valuation of intangible assets like goodwill, brands, patents, etc., there are consultants available. However, in the case of human resources, no such facility is available. With the result, companies show reluctance to human resource accounting.
4. Reporting of results arrived at in financial accounting is compulsory as per the legal requirements while there is no compulsion to report the results of human resource accounting. This makes companies reluctant to opt for human resource accounting.

The presence of above reasons and consequent scenario of human resource accounting should not be taken to mean that human resource accounting does not exist in India. It is followed by various companies in different forms. For example, when a knowledge-based company like IT or BPO company is

acquired, much premium is paid for the quality of its human resources. The basis of paying such a premium is valuation of human assets. It may be mentioned that many companies in IT and BPO sector have changed hands in India.