

## **Standardization of Disclosure Practices for Human Resource Accounting**

**\*Dr Renu Bhargava**

### **Abstract**

The premise adopted for current research is that success of **human resource accounting** (HRA) rests on standardization of disclosure practices for HRA. The objectives of the paper have been broadly classified as first, the description of accounting practices advocated by different scholars. Secondly and more importantly the feasibility of standardizing relevant disclosure practices for calculating human resource value for the purpose of HRA. The author has made an attempt to present such practices which can be included by companies desirous of adopting HRA in the Indian context. Analysis is presented with the help of secondary data, collected through annual reports of selected companies and research carried out in this field. Author has suggested that in the face of the influence of international financial reporting standards (IFRS) in global accounting platform HRA is the basis to encourage alternative measurement and reporting standards for Indian industry. This paper also evaluates the scope of HRA and links the benefits of its practices in making human resource related decisions. Secondary research has been utilized to describe the HRA methods and fall out of each towards its adoption. Author has made an attempt to build a case for HRA and narrated the perceived challenges which have deterred the Indian Accounting System to adopt HRA.

### **Keywords**

Human Resource Accounting, Human Resource Disclosure Practices, Human Asset, International Accounting, International Financial Reporting Standards.

### **Introduction and Background**

Flamholtz., has done considerable work in the area of HRA and defines it as accounting for people as organizational resource. According to him it involves measuring the costs incurred by business firms and other organizations to recruit, select, hire, train and develop human assets and it also involves measuring the economic value of people to the organization. The American Accounting Association has also defined human resource accounting as the process of identifying and measuring data about human resource and communicating this information to interested parties. With a view to provide information about effective human resource management, an accounting platform has been suggested by several scholars popularly known as human resource accounting (HRA). Human Resource is increasingly being considered as an asset and the success of an organization rests to a large extent on the skill and performance of the employees. Currently, financial accounting treats human resource costs as current expenses that reduce the net income of the company and reduce profit, as opposed to investments which provide future benefits to the company and are reported as assets on the company's balance sheet. Human Resource Accounting (HRA) in its process identifies and measures data about human resource and communicates this information to the interested parties. HRA is expected to facilitate management in taking managerial decision relating to aspects such as selection, lay-off, transfers, training, and promotion and employee productivity. Hence, the overall valuation is important for decision making in order to achieve the organizational objectives and improve output. The main advantage emerging from HRA is determination of the value of the economic activity and performing analysis with hard numbers as opposed to traditional softer approaches. Such cost-benefit analyses helps to determine the utilization of resources for various interventions. Attempts to measure the performance of human resource and relate it to return on investment are not new. Though many scholars have made a case for HRA and suggested various methods for calculation, a standardized and validated model of performance based on accounting, in the Indian context is not available. Despite the emergence of service sector with dominant role of human resource, the accounting for such resource began gaining popularity only recently in India, with some companies adopting to show case the valuation of its human resource. HRA principles prescribe that in addition to the measures used for accounting, the process of measurement has relevance in decision-making involving the human resource of an organizations.

Estimation and projection of the worth of the human capital, requires using relevant methods to quantify the value of knowledge, motivation, skill, and contribution of the human elements along with that of organizational processes. A number of approaches emerged and these may broadly be classified into two types:

1. HR Cost Accounting (HRCA) and
2. HR Value Accounting (HRVA).

HRCA may be defined as the measurement and reporting of the costs incurred to acquire and develop people as organizational resources. It deals with accounting for investments made by an organization to the acquisition and development of human resource as well as the replacement cost of the people presently employed. Some methods used for HRCA are: Historical cost method which was first developed by William C Pyle. This method suggests that the cost of acquisition like selection, hiring and training of employees are capitalized and written off over the expected useful life of the employees. In case, the personnel leave the organization before the anticipated period of service, then the unamortized portion of costs remain in the company's books as written off against the profit and loss account for that year. If the period of service exceeds the anticipated time, then amortization of costs is rescheduled. Replacement cost method on the other hand suggests that the human resources are valued at their replacement cost wherein the monetary implications of replacing existing personnel are represented. Replacement costs could be positional which is replacing personnel for particular positions or personal which is replacing specific talent or ability of particular persons. The replacement cost method of HR accounting values an employee in terms of the amount it would cost the company to replace him. This method holds that the economic worth of a worker is equal to the estimated cost of recruiting, hiring and training a replacement, or of finding an employee with a similar set of skills and talents.

Competitive bidding method which is also known as opportunity cost method, suggests competitive bidding for scarce employees in an organization such as opportunity cost of employees linked to scarcity. The approach proposes the capitalizing of additional earning potential of human resource within the company. This method assigns value to an employee based on what each department would be willing to pay him. This method envisions a fictitious situation in which a company suddenly finds labor and talent scarce and individual divisions or departments within the company must bid on existing employees. The Standard cost method calculates standard recurring costs of hiring, training and developing per grade of employees annually. The standard cost for all personnel of the company is the value of human resource. According to the standard cost method, the economic value of an employee is the total of these expenditures, and the annual economic value of the entire workforce is equal to the total amount of money spent on recruiting, hiring, training and developing all employees during the year.

2. Methods based on Economic value or HR Value Accounting (HRVA).

The economic value model of human resource accounting involves estimating the total inflow of cash that will be produced by an employee over the course of his service to the company. Estimating the total cost of hiring, training, developing and paying an employee and deducting this from the estimate of the cash he will generate for the company, provides his net worth according to the economic value method of HR accounting.

### **Objectives**

The objectives of the paper have been broadly classified as first, the description of different accounting practices advocated by scholars. Secondly and more importantly the feasibility of standardizing relevant disclosure practices for calculating human resource value for the purpose of HRA.

### **Research Design and Scope**

Secondary research has been utilized to describe the HRA methods and fall out of each towards its adoption. Author has deduced inference regarding standardized disclosure practices for HRA through research of annual reports of selected companies and previous research carried out in this field.

### **Literature Review**

Suitable work to determine the cost and value of human beings was started by behavioral scientists across the globe since 1960. Some experts in this field were (Shultz 1960, William Pyle 1967, Flamholtz 1973, Kenneth Sinclair 1978 and DrRoa1983), who contributed appropriate methodology and correct methods for finding out the value of the employee to the organization. **Flamholtz (1985)** describes the HRA paradigm in terms of the "psycho-technical systems" (PTS) approach to organizational measurement. According to the PTS approach, the two functions of measurement are: 1) process functions in the process of measurement and 2) numerical information from the numbers themselves, thus one role of HRA is to provide numerical measures, an even more important role is the

measurement process itself. **Davidove& Schroeder (1992)** indicate that although many business leaders still view training as an overhead expense, with thorough ROI evaluations, training departments can convince business to view them as partners in creating the assets crucial to organizational success. Johanson and Mabon(l 998) indicate that expressing human resource interventions in financial terms and or cost benefit terms is more effective than using soft accounting information such as data on job satisfaction. **Flamholtz (1999)** noted that the concept of human resource value is derived from general economic value theory as all resources people possess value because they are capable of rendering future service. An individual's value to an organization can be defined as the present value of the future services the individual is expected to provide, for the period of time the individual is expected to remain in the organization. **Dobija (1998)** proposes an alternate model for capitalization, where the rate of capitalization is determined through the natural and the social conditions of the environment. Utilizing a compound interest approach, this method takes into account the three factors for valuing the human capital which include the capitalized value of cost of living, the capitalized value of the cost of professional education, and the value gained through experience. **Cascio (1998)** proposed a method for measuring human capital based on indicators of human capital of innovation, employee attitudes and the inventory of knowledgeable employees. According to him, innovation can be measured by comparing gross profit margins from new products to the profit margins from old products. Similarly employee attitudes predicting customer satisfaction and retention are an important indicator of human capital and therefore need to be measured, as well as measures of tenure, turnover, experience and learning. **Melling (2001)** suggest that, if properly implemented, the human capital planning and budgeting process will become a key driver of strategy as strategic human capital planning and budgeting ensures that the best resources are mobilized for each internal process. **Flamholtz, Bullen and Hua (2003)** utilized the HRA measure of expected realizable value, and found that employees' participation in a management development program increased the value of the individuals to the firm. Moore notes that there are link between the process of acquiring an employee (a human capital asset) and that of acquiring a fixed capital asset. However while most companies acknowledge the contributions of its employees, they do not think of the acquisition or disposal of human capital assets in the same way or with the same thoughtful planning or strategic thinking as they do fixed capital assets. In addition to external financial reporting, HRA may be useful as a managerial tool to aid in making managerial decisions that will benefit the long-run strategic goals and profitability of the company (Bullen, 2007, p. 89). However even if human assets are not reported on the face of external financial statements, HRA can play a crucial role in internal managerial decision making, and HRA measures can be used to show that investments in a company's human resources may result in long-term profit for the company (Bullen, 2007, p. 89).

### **Analysis and Presentation of Findings**

Conventionally, financial assets are accounted in the books of accounts as per the general principles of accounting, and these do not account for the human asset. In the Indian context validated model of performance based on accounting is not available. In order to estimate and project the worth of the human capital, it is necessary that some method of quantifying the worth of the knowledge, motivation, skill, and contribution of the human elements as well as that of organizational processes, like recruitment, selection, training and the like are used to build and support human contribution. HRA suggests models for this process of quantification and measurement of Human Resources. The role of human resource in the process of managerial planning and control cannot be overemphasized and hence HRA is relevant from the perspective of having reliable information about the human resource for decision making. HRA when utilized in ideal perspective must yield valuation of human resources, recording the valuation in the book of accounts and disclosure of the information in the financial statements of the business. The Institute of chartered accountants of India has not issued an accounting standard for the measurement and reporting of cost and value of human resources of an organization. So far as the statutory requirement is concerned, the Indian company Act 1956 does not furnish any significant information about human resources in the balance sheet or final account of the companies (ONGC Annual Report 2012-13). Following characteristics of HRA have been identified by companies:

- HRA is a system of accounting in which identification of human resources is made.
- Investment made in human resources is recorded.
- Measurement of costs and values are made.
- Changes occurring in human resources over a period of time are also recorded.

- Communicates information through financial statements to interested parties.

Thus HRA represents both a paradigm of viewing human resource decisions, and the set of measures for quantifying the effects of human resource management strategies upon the cost and value of people as organizational resources Davidove& Schroeder (1992). In the Indian context, despite the benefits stated by companies for HRA, its application in different industries has not been encouraging. Some of the companies which are reporting human assets valuation include: 1. Bharat heavy Electrical Ltd (BHEL). 2. Steel Authority of India Ltd (SAIL). 3. Oil and Natural Gas Commissioning (ONGC). 4. Oil India Ltd 5. Project and Equipment corporation of India (PEC). 6. Engineers India limited 7. Mineral and Metal trading Corporation of India.(MMTC). 8. Electrical India Ltd. 9. Hindustan Shipyard Ltd. 10. Cement corporation of India. (CCI). 11. Infosys Ltd. 12. Tata Engineering and Locomotive Company 13. Southern Petrochemicals Industries Corporation Ltd SPIC). 14. Associated Cement Company Ltd ACC). 15. National Thermal Power Corporation Ltd (NTPC). Lev and Schwartz is the most popular model adopted by some Indian companies with modification. Companies like SAIL adopted Flamholtz's replacement cost model. Such companies have enumerated following benefit of employing HRA practices:

- Improves managerial decision making.
- Helpful in interpretation of return on capital Employed.
- Helps in increasing employee productivity
- Identifies human resources as a valuable asset.
- HRA critical for service industries which utilize human assets extensively.

Going forward, the aspect of adopting relevant disclosure practices in the Indian Context has been suggested by the author. The disclosure practices are relevant in the scheme of HRA, since the value of human resource is based on information related to below mentioned criteria:

1. Employee Information
2. Employee Costs
3. Ratios for assessing Human Resource

Above mentioned criteria are expected to include variables, and the presence/absence of such variables is to be classified within the organizations context indicating the score for each. Absence of disclosure of certain variables results in nil score. Classification and disclosure of such standardized criteria can be used to evolve an index for calculating the value of human resource on a basis which becomes a standardized accounting practice for HRA. Such index may be called the Human Resource Accounting Index (HRAI). This index would indicate the value of human resource once the total score obtained by a company with respect to all the accounting criteria for HRA are compared with respect to the maximum score obtainable.

Presented below is a sample model for HRAI:

1. Employee Information such as classification of employees based on their age, profiles, competency, skills, total employees, etc. becomes imperative. Selection of standardized elements for inclusion need to be categorized to evolve realistic ratios for measuring human resource value. A sample for representing Employee Information is presented below:

|    | Employee Information                      | Year     | Year     | Year     | Year     | Year     | Total     |
|----|---|----------|----------|----------|----------|----------|-----------|
|    |   | 1        | 2        | 3        | 4        | 5        |           |
| 1  | Number of employees                       | 0        | 0        | 0        | 0        | 0        | <b>0</b>  |
| 2  | Job classification of work                | 1        | 1        | 1        | 1        | 1        | 5         |
| 3  | Qualifications                            | 1        | 1        | 1        | 1        | 1        | 5         |
| 4  | Grade                                     | 0        | 0        | 0        | 0        | 0        | <b>0</b>  |
| 5  | Awards to employees for their performance | 0        | 0        | 0        | 0        | 0        | <b>0</b>  |
| 6  | Employee benefit programs                 | 1        | 1        | 1        | 1        | 1        | 5         |
| 7  | Employee development programs             | 1        | 1        | 1        | 1        | 1        | 5         |
| 8  | Age distribution                          | 1        | 1        | 1        | 1        | 1        | 5         |
| 9  | Pay scale distribution                    | 0        | 0        | 0        | 0        | 0        | <b>0</b>  |
| 10 | Region-wise distribution                  | 1        | 1        | 1        | 1        | 1        | 5         |
|    | <b>Total</b>                              | <b>6</b> | <b>6</b> | <b>6</b> | <b>6</b> | <b>6</b> | <b>30</b> |

2. Employee Costs aggregate the total costs towards maintaining human resource and the criteria which can be included have been presented below. It must be borne in mind that these criteria are not standardized but have been presented with the ideation that standardization is essential to bring about HRA on a common platform so that current redundancy in the system of HRA can be prevented.

|   | Employee Cost               | Year     | Year     | Year     | Year     | Year     | Total     |
|---|-----------------------------|----------|----------|----------|----------|----------|-----------|
|   |                             | 1        | 2        | 3        | 4        | 5        |           |
| 1 | Salary Costs                | 1        | 1        | 1        | 1        | 1        | 5         |
| 2 | Training Cost               | 1        | 1        | 1        | 1        | 1        | 5         |
| 3 | Benefit/perquisites Cost    | 1        | 1        | 1        | 1        | 1        | 5         |
| 4 | Employer contribution costs | 1        | 1        | 1        | 1        | 1        | 5         |
|   | <b>Total</b>                | <b>4</b> | <b>4</b> | <b>4</b> | <b>4</b> | <b>4</b> | <b>20</b> |

3. Ratios for assessing Human Resource: Value of human resource can be calculated using different indices such as productivity per employee, value per employee, turnover per employee, Profit before tax, average sales per employee, average profit per employee and the like. Such ratios facilitate the assessment of employee value while calculating human resource contribution for the purpose of HRA. A sample is provided below and it is not mean to state again the relevance of standardization for accounting purpose.

|   | Employee Information        | Year     | Year     | Year     | Year     | Year     | Total     |
|---|-----------------------------|----------|----------|----------|----------|----------|-----------|
|   |                             | 1        | 2        | 3        | 4        | 5        |           |
| 1 | Per employee production     | 1        | 1        | 1        | 1        | 1        | 5         |
| 2 | Value per employee          | 0        | 0        | 0        | 0        | 0        | 0         |
| 3 | turnover per employee       | 0        | 0        | 0        | 0        | 0        | 0         |
| 4 | Profit before tax           | 1        | 1        | 1        | 1        | 1        | 5         |
| 5 | average sales per employee  | 0        | 0        | 0        | 0        | 0        | 0         |
| 6 | average profit per employee | 1        | 1        | 1        | 1        | 1        | 5         |
|   | <b>Total</b>                | <b>3</b> | <b>3</b> | <b>3</b> | <b>3</b> | <b>3</b> | <b>15</b> |

Besides estimating the value of human resource, the aim of every business is to increase its assets which in turn propel business prospects. The assets of the companies comprise of fixed, variable and intangible assets. When value of human resource is compared over successive years with respect to other assets, a percentage share of human resource value in total assets emerges. This value can be used to forecast the health of human resource contribution in the asset value of the organization.

**Recommendations**

While evaluating the scope of HRA, any link that may be established with emerging benefits, needs to be considered keeping in mind the significance of the information for the investors and other external users of the financial statements. Value based measures of HRA find more acceptance with companies, however these depend heavily on the measurement of individual or group contribution of valuation. Measurement of contribution, especially at the managerial levels, becomes difficult. Therefore the author has recommended that it is imperative for any system of HRA to be specific with regard to the purpose for which the information is to be used. This particularly applies in the Indian context where the Indian Companies Act, 1956, also does not offer clarity for disclosure of HR values in the financial statements of the companies. In the event of progression towards inclusion of HRA in the mainstream of accounting, it will be imperative to standardize relevant disclosure practices for calculating human resource value. Added research in this direction would be an impetus towards propelling strong links of HRA with formal accounting practices.

**Conclusion**

It is heartening to note that some companies in India have reported HRA in their annual reports, though none have mentioned the purpose for which HRA information is being used by them. However, the information may be significant for the investors and other external users of the financial statements. Limitations in the implementation of HRA emerge predominantly on account of non-standardization of disclosure variables for measuring human resource and no specific guidelines for finding cost and value of human resources. Value based measures of HRA find more acceptance with Flamholtz approach, however this approach depends heavily on the measurement of an individual or a group’s contribution of valuation. Measurement of contribution, especially at the managerial levels, is difficult. Feasibility of standardizing relevant disclosure practices for calculating human resource value for the purpose of HRA is a critical factor in the success of HRA as an accounting system. To meet the mentioned objectives it is relevant to portray the accounting practices of the companies under consideration. This has been suggested as the primary step in progression towards HRA. The author suggests that companies that are in the process of initiating HRA, will be benefited by adopting practices of existing organizations.

## **References**

1. Baker & McKenzie (2010). Australian Master Human Resources guide. CCH Australia Limited. Macquarie University. Graduate School of Management: 51
2. Brummet, R.L., Flamholtz, E.G. & Pyle, W.C. (1968b, March). Accounting for human resources. Michigan Business Review, 20-25.
3. Brummet, R.L., Flamholtz, E.G. & Pyle, W.C. (1969, August). Human Resource Accounting: A tool to increase managerial effectiveness. Management Accounting, 12-15.
4. Bullen L, Clayton State, University, Kel-Ann Eyler Journal of International Business and Cultural Studies, "Human resource accounting and international developments: implications for measurement of human capital. Maria, Wesleyan College p. 4
5. Cascio, W.F. (1998). The future world of work : Implications for human resources costing and accounting. Journal of Human Resource Costing and Accounting, 3 (2), 9-19.
6. Dobija, M.(1998). How to place human resources into the balance sheet. Journal of Journal of International Business and Cultural Studies Human Resource Accounting, Page 14 Human Resource Costing and Accounting, 3 (1), 83-92.
7. Davidove, E. A., & Schroeder, P. A. (1992, August). Demonstrating ROI of training. Training and Development, 46, 8, 70
8. Eric G. Flamholtz (1999: third edition) "Human Resource Accounting: Advances in concepts, methods & applications". Kulwer Academic Publishers
9. Flamholtz, E. (1985), Human Resource Accounting, Jossey-Bass Publishers, San Francisco, CA. Flamholtz, E. (1999), Human Resource Accounting
10. Flamholtz, E.G., Bullen, M.L., & Hua, W. (2002). Human Resource Accounting: A historical perspective and future implications. Management Decision, 40 (10), 947-54.
11. Flamholtz, E. G , Kannan-Narasimhan, R., & Bullen, M.L.(2004). Human Resource Accounting today: Contributions, controversies and conclusions. Journal of Human Resource Costing & Accounting, 8 (2), 23-37.
12. Grojer, J.E. and Johanson, U. (1991), Human Resource Costing and Accounting, Joint Industrial Safety Council, Stockholm. Grove, H.T., Mock, J. and Ehrenreich, K. (1977), "A review of HRA measurement systems from a measurement theory perspective".
13. Johanson, U. & Mabon, H. (1998). The personnel economics institute after ten years : What has been achieved and where we are we going?" Journal of Human Resource Costing and Accounting, 3 (2), 65-76.
14. Melling G.L.(2001). Skills-based human capital budgeting: A strategic initiative, not a financial exercise. Cost Management, 15 (3), 30.