Human Resource Accounting: An Overview

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Human resource accounting is the process of identifying and reporting investments made in the human resources of an organization that are presently unaccounted for in the conventional accounting practices. It is an extension of standard accounting principles. Measuring the value of human resources can assist organizations in accurately documenting their assets.

Human resources are considered as important assets and are different from the physical assets. Physical assets do not have feelings and emotions, whereas human assets are subjected to various types of feelings and emotions. In the same way, unlike physical assets human assets never gets depreciated.

Therefore, the valuations of human resources along with other assets are also required in order to find out the total cost of an organization. In 1960s, Rensis Likert along with other social researchers made an attempt to define the concept of human resource accounting (HRA).

According to Rensis Likert, the objectives of HRA are to:

1. Provide cost value information about acquisition, development, allocation and maintenance of human resources so as to achieve organisational goals in an effective manner.

2. Enable management of the organisation to effectively monitor the use of human resources.

3. Ascertain whether human assets are conserved, appreciated or depreciated during a given period of time.

4. Assist in the development of effective management practices by classifying the financial consequences of various practices followed by the organisation.

Objectives of Human Resource Accounting are as follows:

- To facilitate effective and efficient management within an organisation for human resources.
- To provide information of changes in the structure of manpower to the management.
- To provide basis to the future investors in making better decisions about investment in human resources.
- To provide qualitative information on human resources. (HR)
- To measure the costs incurred on human resources by firms.
- To evaluate the return on investment on human capital.
- To communicate the organisation and the public at large about the worth of human resources of an organisation.
- To know whether the human resources have been properly utilised and allocated.
- To help the persons interested in the human resources are giving a return equivalent to their worth or not..

Methods of valuation of Human Resource management

1. **Historical Cost Approach**

This approach was developed by William C. Pyle (and assisted by R. Lee Brummet & Eric G. Flamholtz) and R.G. Barry corporation, a leisure footwear manufacturer based on Columbus, Ohio (USA) in 1967. In this approach, actual cost incurred on recruiting, hiring, training and development the human resources of the organisation are capitalised and amortised over the expected useful life of the human resources. Thus a proper recording of the expenditure made on hiring, selecting, training and developing the employees is maintained and a proportion of it is written off to the income of the next few years during which human resources will provide service. If the human assets are liquidated prematurely the whole of the amount not written off is charged to the income of the year in which such liquidation takes place. If the useful life is recongnised to be longer than originally expected, revisions are effected in the amortisation schedule. The historical cost of human resources is very similar to the book value of the other physical assets. When an employee is recruited by a firm, he is employed with the obvious expectation that the returns from him will far exceed the cost involved in selecting, developing and training in the same manner as the value of fixed assets is increased by making additions to them. Such additional costs incurred in training and developing is also capitalised and are amortised over the remaining life.

This method is simple to understand and easy to work out. It meets the traditional accounting concept of matching cost with revenue. But it suffers from the following limitations:

- It takes into account a part of the employees acquisition costs and thus ignores the aggregate value of their potential services.
- It is difficult to estimate the number of years over which the capitalised expenditure is to be amortised.
- It is difficult to determine the rate of amortisation. Should it be increasing, constant or decreasing one?
- The economic value of human resources increases over time as the people gain experience. But in this approach, the capital cost decreases through amortisation.

2.**Replecement Cost Approach**: This approach was first suggested by Rensis Likert, and was developed by Eric G. Flamholtz on the basis of concept of replacement cost. Human resources of an organisation are to be valued on the assumption that a new similar organisation has to be created from scratch and what would be the cost to the firm if the existing resources were required to be replaced with other persons of equivalent talents and experience. It takes into consideration all cost involved in recruiting, hiring, training and developing the replacement to the present level of proficiency and familiarity with the organisation.

This approach is more realistic as it incorporates the current value of company's human resources in its financial statements prepared at the end of the year. It is more representative and logical. Limitations:

- This method is at variance with the conventional accounting practice of valuing assets.
- There may be no similar replacement for a similar certain existing asset. It is really difficult to find identical replacement of the existing human resource in actual practice.
- The determination of a replacement value is affected by the subjective considerations to a marked extent and therefore, the value is likely to differ from man to man.

3. Asset Multiplier Method:

This method is based on the assumption that there is no direct relationship between cost incurred on an employee and his value for the organisation. This is because the value of an employee depends on factors like motivation, working conditions and their attitude toward work and organisation. In this method, all employees working in an organisation are broadly classified into four categories; viz., top management, middle management, supervisory management and operative and clerical staff.

The salary bill of each category is multiplied with appropriate multiplier to ascertain the total value of each category for the organisation at a given point of time. Here, multiplier is an instrument that relates the personal worth of employees with the total asset values of the organisation.

As per principle, the value of human asset should match with the value of goodwill. Inconsistency in the value of human assets in comparison to goodwill is indicative of inaccuracy in multiplier that should be adjusted accordingly.

4. Oppurtunity Cost:

This method was first advocated by Hc Kiman and Jones for a company with several divisional heads bidding for the services of various people they need among themselves and then include the bid price in the investment cost. Opportunity cost is the value of an asset when there is an alternative use of it. There is no opportunity cost for those employees that are not scarce and also those at the top will not be available for auction. As such, only scarce people should comprise the value of human resources.This method can work for some of the people at shop floor and middle order management. Moreover, the authors of this approach believe that a bidding process such as this is a promising approach towards more optional allocation or personnel and a quantitative base for planning, evaluating and developing human assets of the firm. Limitations:

- It has specifically excluded from its preview the employees scarce or not being 'bid' by the other departments. This is likely to result in lowering the morale and productivity of the employees who are not covered by the competitive process.
- The total valuation of human resources on the competitive bid price may be misleading or inaccurate. It may be due to the reason that a person may be an expert for one department and not so for the other department. He may be valuable person for the department in which he is working and thus command a high value but may have a lower price in the bid by the other department.

- Under this method, valuation on the basis of opportunity cost is restricted to alternative use within the organisation. In real life such alternative use may not be identifiable on account of the constraints in an organisational environment.

5. Economic Value Method:

Under this method, human asset is valued on the basis of the contribution they are likely to make to the organisation till their retirement from the jobs. The payments made to them in the form of pay, allowances, benefits, etc., are estimated and then discounted appropriately to arrive at the present economic value of the individuals. This model can be expressed in the following formula:

Vr =TΣE (t)/r-r(i+r)

Where,

Vr = the human capital value of an individual r years old.

E(t) = the individual's annual earn.

ings up-to retirement, represented by the earnings profile. r = discount rate i.e., cost of capital.

T = retirement age.

The drawback of this method is that the under or over-fixation of salary may affect equating the total earnings to the human capital.

B. Non-Monetary Methods:

Taking note of the changes in the effectiveness of individuals, groups and the organisation from time to time, the behavioural scientists have developed some non-monetary methods in HRA.

1. Expected Realisable Value Method:

Under this method, the elements of expected realisable value of employee are measured through behavioural measures. For example, the productivity of an employee can be measured by using objective indices and managerial assessment. Psychometric tests and subjective evaluations can be used to measure the promotability and transferability of employees. Similarly, attitude surveys can be used to measure employee satisfaction, motivation, etc.

2. Discounted Net Present Value of Future Earnings:

This method is propounded by Rensis Likert. The method is based on three variables— casual, intermediate and output. According to Likert, the effectiveness of human capital/resources can be measured by using these three variables. Casual variables such as leadership style and behavior affect intermediate variables such as morale, motivation, commitment to work, etc., which, in turn, affect output variables such as production, sales, profit, etc.

Advantages

1. It throws light on the strengths and weaknesses of the existing workforce in an organisation. This in turn, helps management in recruitment planning, whether to hire people or not. It thus provides useful information about the value of human capital which is essential to managers for taking the right decisions e.g. choice between,

- Direct recruitment and promotion
- Transfer and retention and
- Retrenchment and retention.

2. Management can evaluate the effectiveness of its policies relating to human resources. For instance, high costs of training may indicate the need for changes in policy for reducing labour turnover.

Management can also judge as to whether there is adequate return on investment in human resources. HRA provides feedback to manager on his own performance.

3. It helps potential investors judge a company better on the strength of the human assets utilised therein.

If two companies offer the same rate of return on capital employed, information on human resources can help investors decide which company to be picked up as an investment. The present law does not require the value of the human asset to be shown in the balance sheet.

4. It helps management in taking appropriate decisions regarding the use of human assets in an organisation that is whether to hire new recruits or promote people internally, transfer people to new locations or hire people locally, incur additional training costs or hire consultants keeping the impact on the long-run profitability in mind.

5. The return on investment (ROI) can realistically be calculated only when investment on human resources is also taken into account.

The return on investment may be good because there is an investment on human beings. On the other hand, a low investment may be the reason of low investment on human asset. So ROI can give accurate results only when expenditure on employees is treated as an asset.

6. HRA may help to improve the motivation and morale of employees by creating a feeling that the organisation cares for them.

HRA will also help in improving the efficiency of employees. The employees come to know of the cost incurred on them and the returns given by them in the form of output etc.

7. It can be seen whether the business has made proper investments in human resources in terms of money or not. If the investment is excessive then efforts should be made to control it.

8. HRA will give the cost of developing human resources in the business. This will enable the management to ascertain the cost of labour turnover also.

Limitations

1. Not easy to value human assets:

There are no guidelines differentiating the “cost” and “value” of **human resources**. The existing valuation system suffers from many drawbacks. After valuing human resources in a specific way, many of them may leave the organisation.

Human life itself is uncertain and hence valuing the asset under such “foggy” conditions is not proper. Like physical assets, human assets cannot be owned, retained and utilised at the sweet will and pleasure of an organisation.

Hence, treating them as “asset” in the strict sense of the term would not be appropriate. The so called “asset” – after getting enriched within a company – may simply disappear, causing irreparable loss to the company.

2. Results in Dehumanising Human Resources:

There is a possibility that HRA may lead to dehumanising and manipulation employees. For example, a person having a lower value may feel discouraged and this, in itself, may affect his competence in work.

3. No Evidence:

The much needed empirical evidence is yet to be found to support the hypothesis that HRA as a managerial tool facilitates better and effective management of human resources.

4. HR is full of measurement problems:

There is no agreement among the accountants and financial professionals regarding the measurement process. In what form and manner should their value be included in the financial statements?

To compound the problems further, there is the question of deciding the recovery rates. If a valuation has to be placed on human resources, how should it be amortised?

Should the rate of amortisation be decreasing, constant or increasing? Should it be the same or different for different categories of personnel?

5. Employees and Unions may not like the idea:

There is constant fear of opposition from trade unions. Placing a value on employees would prompt them to seek rewards compensation based on such valuation.

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