Accounting for Human Capital: Is the Statement of Financial Position Missing Something?

Oseni, Abubakar Idris\textsuperscript{1} and Igbinosa, Peter E.\textsuperscript{2}

Department of Accountancy, School of Business Studies, Auchi Polytechnic, Auchi, Edo State, Nigeria
osenimallamabu@yahoo.com

Abstract
Human capital has become a significant factor in the success of organizations and is often regarded as one of the most valuable assets of corporations. This paper explores the current viewpoint on whether or not human capital should be accounted for on the statement of financial position. Related literatures were reviewed conceptually in the course of this study. The paper concluded that major item is missing in the statement of financial position i.e. human capital as a result of the difficulty encountered in measuring human capital and the value of human capital is very subjective. The paper recommended that human capital should be valued, but perhaps the financial statements are not the proper place for such a number. It might be a good idea to have a separate human capital report that would provide statistics and other facts about a company’s stock of human capital.

Keywords: Human Capital Accounting, Measuring, Statement of financial position, Valuable assets

Introduction
What is the difference between Dangote and the average individual? If your answer is that he earns so much every year more than the rest of us, then you are absolutely correct. However, if your answer is that Dangote has superior business ability and talent, then you are also correct. Currently, in relation to business, Dangote’s talents, skills and knowledge, or human capital, are amongst the best in the continent. Could a man found walking down the street go out on the business line and replace Dangote? The truth is that anyone can go out there and do business. But, not everyone possesses the stock of human capital necessary to do the business as well as Dangote does. If he were traded from one organization to another, neither organization would be the same anymore. The value of one organization would significantly increase, while the other would decrease. The organization that lost Dangote might have gained another good business tycoon, but that businessman does not possess the human capital that Dangote has. Dangot’s human capital is a valuable asset to the organization and creates value for them. Why does the organization need him? They want him to use his wealth of talent, skills and knowledge to produce results. In essence, they just want to enhance their profitability. An organization doesn’t triumph by possessing tangible things
such as expensive buildings or machines. An organization triumphs because it possesses the people who contain the greatest stock of human capital. In the business world, financial statements provide the most comparable means of valuing a company. However, there is increasing discussion about the financial statements, specifically statements of financial position, becoming outdated because they are missing something. How are outsiders supposed to know if a company has a Dangote and thus, the competitive advantage necessary to triumph? A company’s statement of financial position does not reflect its greatest asset—human capital.

Human Capital Accounting (HCA) involves accounting for the company’s management and employees as human capital that provides future benefits. In the HCA approach, expenditures related to human capital are reported as assets on the statement of financial position as opposed to the traditional accounting approach which treats costs related to a company’s human capital as expenses on the income statement that reduce profit. The purpose of this paper is to determine if people who are currently in the accounting field believe that human capital should be valued on the statement of financial position, and if so, to examine where on the statement of financial position they feel it should be classified.

**Literature Review**

Human capital is the knowledge, skills, abilities, and capacity to develop and innovate possessed by people in an organization. It is an aspect of intellectual capital—the stocks and flows of knowledge available to an organization—and is associated with the concepts of social capital—the knowledge derived from relationships within and outside the organization—and organizational capital, the institutionalized knowledge possessed by an organization which is stored in databases, manuals, etc. It hence contributes to the market value of an organization through its contribution to intellectual value, which also accounts for the value of brand and reputation. Human capital is knowledge that transforms raw materials and makes them more valuable. Intellectual capital includes the talent of staff, the value of proprietary knowledge and processes, and the value of relationships with customers and suppliers. Conventional accounting fails to measure the value of intellectual capital, but markets clearly reward it (Passard, Kaitlin, and Vyas, 2012).

Human capital consists of the skills, competencies, and abilities of individuals and groups. These range from specific technical skills to “softer” skills, like salesmanship or the ability to work effectively in a team. An individual’s human capital cannot, in a legal sense, be owned by a corporation; the term thus refers not only to individual talent but also to the collective skills and aptitudes of a workforce. The information age is upon us. Society, along with the economy, has undergone a massive transformation from an industrial age, dominated by the logic of standardized mass production and epitomized by the assembly-line to an age of information and knowledge-intensive services that are propelled by brainpower and the constant demand for innovation (Felin, Teppo, Zenger, & Tomsik (2009: 555). This post industrial society has witnessed a change from a goods-producing to a service economy that is based on, —The growing power of ideas and virtual value – the turn from steel and hamburgers to software and intellectual property. (Peters, 2010: 20). Production factors, such as raw materials and physical input that were used throughout the industrial age are now being outweighed by other production factors including human capital.
The compilation of talents, skills and knowledge of a company’s workforce is the general definition of human capital (Wyatt, Anne and Frick 2010: 200; Berkowitz, 2001: 14). With the transition to the information age, and as the significance and reliance on intellectual capabilities grows, traditional accounting practices may need to be modernized to account for factors such as human capital. Employees are now holding jobs that require the manipulation of information as skilled workers as opposed to the manipulation of material as unskilled workers (Spender & Marr 2006: 266).

Take a look at the items that are accounted for on any company’s statement of financial position and notice that you see items such as cash, inventory, land, buildings, machinery, patents, etc. However, note that neither an item nor a value exists on the statement of financial position for “People. How are financial statement users supposed to make well-informed decisions when some of the most important, and potentially most valuable, information is missing? Not only is the value of human capital important for financial statement users, the stock of human capital embodied in people produces value for a company’s final product or service and contributes to the company’s earning power (Abdelkhalik 2003: 661). As mentioned above, human capital comprises the talents, skills and knowledge of a company’s workforce. Most companies could not achieve their missions without the pure brainpower of its workforce and yet, there is no generally accepted accounting standard for measuring or reporting the value of human capital. There are several reasons for which human capital has not made it onto the financial statements. Knowledge, skills and talents are difficult to quantify. Even when a value is conjured up, elements of the computations tend to be subjective.

Human Capital: A Cost or an Asset
When organizations treat people as costs, they assume:

- That people need to be incentivized to work harder.
- That it is only worth investing in training if there is an immediate need.
- That the removal of people from the organization is primarily a cost decision.
- That people should be bought in with the highest possible value for the lowest possible cost.

When people are assets, organizations assume:

- People will work better when they have interesting and challenging work to do.
- People work harder when they are motivated and committed to their work, experiencing high levels of satisfaction.
- People should be brought into the organization on the basis of their potential to develop and grow.
- Investment in training and skills is worthwhile, if there is likely to be a return on that investment in the medium to long term.

Human Capital Accounting and International Financial Reporting Standards
In last decade United States GAAP has been moving toward adoption of more complex measurement methods in financial reporting compared with the traditional historical cost approach to asset measurement, including a focus on the measurement of the time value of money and present value calculations. Certain current assets are now reported at their fair market values at each balance sheet date, and many items on the balance sheet that are noncurrent are measured at the present value of the estimated future cash flows. While the IFRS do not currently have standards requiring HRA, it could be argued that they are moving closer to providing more flexible approaches to accounting measurements and reporting.
example, the international standards IAS 38 Intangible Assets and IFRS 3 on Business Combinations allows for the recognition of the intangible asset goodwill, which indicates a willingness to allow for valuation of assets that are not traditional tangible assets, such as human resources. Thus, the movement toward fair value accounting seen in recent years for both U.S.GAAP as well as for international standards indicates a more sophisticated approach to the measurement of assets, tangible as well as intangible. This might suggest a willingness to recognize the need for, and consider the measurement and use of HRA in future external financial reporting.

Human Resource Accounting in Managerial Reporting and Decision-Making

In addition to external financial reporting, HCA 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. As opposed to external financial reporting, managerial reporting does not require adherence to a strict set of GAAP in specific financial statements in acceptable format reported to the public (Bullen, 2007, p. 89). However even if human assets are not reported on the face of external financial statements, HCA can play a crucial role in internal managerial decision-making, and HCA measures can be used to show that investments in a company’s human resources may result in long-term profit for the company. When managers go through the process of HCA measurement treating human resources as capital assets, they are more likely to make decisions that treat the company’s employees as long-term investments of the company.

The HCA measurement process as a dual function attempts to increase recognition that human capital is paramount to the organization’s short and long-term productivity and growth. When managers go through the process of measuring human resources, they are more likely to focus on the human side of the organization and are more likely to consider human resources as valuable organizational resources who should be managed as such (Bullen, 2007, p. 89). Layoffs may affect future long-term profits from lost productivity, costs of rehiring and retraining when business returns, and costs of lower morale of existing workforce. If management quantified the actually costs of layoffs, management might be less inclined to use layoffs as a way to cut costs and boost short-term profits at the expense of long-run productivity and profits (Bullen, 2007, p. 90). Flamholtz, Bullen & Hua (2003) utilized the HCA measure of expected realizable value, and found that employees’ participation in a management development program increased the value of the individuals to the firm. Toulson & Dewe (2004) conducted a survey study utilizing component analysis and found two reasons why measuring human resources is important. The first is that measurement reflects the strategic and competitive importance of human resources, and the second suggests that to earn credibility, human resources must be expressed in financial terms. Moore (2007) suggests that the value of human capital should be more fully considered when making decisions about the acquisition and disposal of people.

HCA Measurement Models

Human Capital Accounting may be measured in terms of human resource cost or in terms of human resource value. Human resource costs may be explained in terms of the two major categories of acquisition costs and learning costs. Acquisition costs include the direct costs of recruitment, selection, hiring and placement, and the indirect costs of promotion or hiring from within the firm. Learning costs include the direct costs of formal training and orientation and on-the-job training. In a human capital accounting system, these costs are
reported in asset accounts with future economic benefits rather than as expenses. The major approaches to measuring human capital: the cost-based approach, the replacement cost approach, the present value of future earnings and expense model.

**Cost Based Approach**
This approach is also called as acquisition cost model. This method measures the organization’s investment in employees using the five parameters: recruiting, acquisition; formal training and, familiarization; informal training, informal familiarization; experience; and development. This model suggests instead of charging the costs to profit & loss accounting it should be capitalized in balance sheet. The process of giving a status of asset to the expenditure item is called as capitalization. In case of human resource it is necessary to amortize the capitalized amount over a period of time, so here one will take the age of the employee at the time of recruitment and at the time of retirement. This method is the only method of human resource accounting which is based on sound accounting principles and policies.

**Limitations**
- The valuation method is based on false assumption that the naira is stable.
- Since the assets cannot be sold there is no independent check of valuation.
- This method measures only the costs to the organization but ignores completely any measure of the value of the employee to the organization (Cascio, 1991).
- It is too tedious to gather the related information regarding the human values.

**Replacement Cost approach**
This approach measures the cost of replacing an employee. Replacement cost include recruitment, selection, compensation, and training cost (including the income foregone during the training period). The data derived from this method could be useful in deciding whether to dismiss or replace the staff.

**Limitations**
- Substitution of replacement cost method for historical cost method does little more than update the valuation, at the expense of importing considerably more subjectivity into the measure.
- This method may also lead to an upwardly biased estimate because an inefficient firm may incur greater cost to replace an employee (Cascio, 1991).

**Present Value of Future Earnings**
This is the economic valuation of employees based on the present value of future earnings, adjusted for the probability of employees’ death/separation/retirement. This method helps in determining what an employee’s future contribution is worth today.

**Limitations**
- The measure is an objective one because it uses widely based statistics such as census income return and mortality tables.
- The measure assigns more weight to averages than to the value of any specific group or individual (Cascio, 1991).

**Importance of Human Capital Accounting**
Human Capital Accounting provides useful information to the management, financial analysts and employees as stated below:-
- a) Human Capital Accounting helps the management in Employment and utilisation of Human Capital.
- b) It helps in deciding transfers, promotion, training and retrenchment of human capital.
c) It provides a basis for the planning of physical assets vis-a-vis human capital.
d) It helps in evaluating the expenditure incurred for imparting further education and training of employees in terms of the benefits derived by the firm.
e) It helps to identify the causes of high labour turnover at various levels and taking preventive measures to contain it.
f) It helps in locating the real cause for low return on investment, like improper or under-utilisation of physical assets or human capital or both.
g) It helps in understanding and assessing the inner strength of an organisation and helps the management to steer the company well through the most averse and unfavourable circumstances.
h) It provides valuable information for persons interested in making long term investments in the firm.

Limitations of Human Capital Accounting

Human Capital Accounting is the accounting methods, systems, and techniques, which coupled with special knowledge and ability, assist personnel management in the valuation of personnel in their knowledge, ability and motivation in the same organisation as well as from organisation to organisation. Human capital accounting facilitates decision making about the personnel i.e. either to keep or to dispense with their services or to provide mega-training. There are many limitations which make the management reluctant to introduce HCA. Some of the limitations are:-

a) There is no proper clear cut and specific procedure or guidelines for finding costs and value of human resources of an organisation. The systems which are being adopted have certain drawbacks.
b) The period of existence of Human Capital is uncertain and hence valuing them under uncertainty in future seems to be unrealistic.
c) As human capital are incapable of being owned, retained, and utilised, unlike the physical assets, there is a problem for the management to treat them as assets in the strict sense.
d) There is a constant fear of opposition from the trade unions as placing a value on employees would make them claim rewards and compensations based on such valuations.
e) In spite of all its significance and necessity, the Tax Laws don’t recognise human beings as assets.
f) There is no universally accepted method of the valuation of Human Resources.

Conclusion

The paper concluded that major item is missing in the statement of financial position i.e. human capital as a result of the difficulty encounter in measuring human capital and the value of human capital is very subjective. This would lead to incomparability and opportunities to inflate a company’s assets. If there were a consistent way to measure human capital, it would have been included in the statement of financial position. For now, however, because there is no consistent way to measure human capital, individuals in the accounting field do not want this value on the statement of financial position. Human capital management, measurement, and reporting are increasingly vital capabilities that all organizations will need to acquire. Although human capital can be valued, perhaps the financial statements are not the proper place for such a number. It might be a good idea to have a separate human capital report that would provide statistics and other facts about a company’s stock of human capital.
Maximizing human capital through acquisition, retention, growth should be a major priority of all executives, not an area left to the Human Resource department alone.

References