Accounting For Human Assets: Some Issues

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Abstract

Inspite of the technological advancement and increasing importance of computerization, human resources continue to play a dominating role in the effective use of physical and financial resources. Even though human resources are the most important element of business process but their value is not shown among assets in a traditional statement of financial position. Failure of conventional accounting to treat human resource as an asset has led to the development of 'Human Resource Accounting'. The present paper tries to touch some of the issues like whether human resources can be considered as assets and the various methods in practice to value this asset. The paper also throws light on the present scenario of valuation of human resources in India particularly focused on practices followed by ONGC.

Introduction

The real strength of an organization lies in the quality of its human resources. There can hardly be any difference of opinion about the fact that " People are the most important assets of an organization". These are branded as 'mother resources', through the medium of which other scarce resources viz. machines, materials and money are organized, coordinated, directed and controlled to achieve the objectives of an organization. If the human force of an organization has sincerity and efficiency, the organization is likely to have a competitive edge over others irrespective of the type of human resources. Successful business organizations built on productive employees who impart knowledge, skill, talents and aptitudes to the best of their ability.

People are the most important assets of an organization. The importance of measuring this asset and valuing it in monetary terms will be evident if one poses a question to the chief executive of a company, "how much would it cost you, if you took away the work force from your organization and recruit, hire, train and build a fresh, a new work force at the same level of effective performance". The answer of the executive to whom the above question was asked by the famous behavioural scientist Rensis Likert in the course of a study was that it would cost them anything between three or five times the annual pay roll. Their estimate was not based on any quantitative measurement since human resources were not measured and recorded in any of the accounting records or mentioned in financial statements. If such an important asset is not quantified and shown in the company's balance sheet as an asset, it is all more difficult for managers to justify any further investment in human resources.

Yet accounting has concentrated on the physical and financial resources of an entity, without bringing this vital ingredient of social systems into its fold forgetting in the process that the performance of the enterprise itself is the product of human activity and the failure of most of the companies is due to the poor performance of its people. The limitation of conventional accounting has led to the development of new field of enquiry in accounting called "Human Resource Accounting".

Concept of Human Resource Accounting

The concept of human capital is not a recent discovery. Its origin dates back to the late seventeenth century when the economists, Sir William Petty first attempted to estimate the monetary value of population of England in 1681. He considered labour as the father of wealth and stressed that it should be included in the estimate of the total national wealth. The credit for recognizing the value of human resources as an "asset" goes to William Paton (1922) when he commented, "in a business a well organized and loyal personnel may be a more important asset than a stock of merchandise". The fact remains, however that it was Rensis Likert (1967) Social Psychologist, The Institute for Social Research, University of Michigan, who first use the term "human asset" a term since replaced by human resources. So he originally developed it.

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The American Accounting Association (1973) defines Human Resource Accounting as "the process of identifying and measuring data about human resources and communicating this information to the interested parties" Eric Flamholtz (1974) defines HRA as "accounting for people as an organization resource. It involves measuring the cost incurred by business firms and other organizations to recruit, select, hire, train and develop human assets. It also involves measuring the economic value of people to the organization".

Robert L Woodruff (1970) viewed that HRA is the identification, accumulation and dissemination of information about human resources in dollar terms.

From these definitions we may state that Human Resource Accounting is concerned with.

- Identification of data regarding human resources of an organization.
- Measurement of the data in terms of cost and value.
- Communicating this information to the decision makers.

Human Resource Accounting emphasizes that human resources should be treated as assets like physical and financial assets because the quality and caliber of the people working in an organization are the real assets for a firm. This conceptual issue needs to be clarified that:

Are Human Resources "Assets"?

In dealing with this issue two questions comes into our mind that:

- What is the definition of asset and what are the characteristics that are common to all assets?
- Do the human resources qualify to be called " assets" i.e. do they possess these characteristics?

John. B. Canning (1929) defines an asset as, " any future service in money or any future service convertible into money-the beneficial interest in which is legally or equitably secured to some person or set of persons. Such service is an asset only to that person or set of persons to whom it runs".

Meigs (1977) suggest that assets are economic resources, which are owned by business and are expected to benefit future operations.

From these definitions of assets following main characteristics common to all economic resources are revealed.

1. Assets possess future service potential.
2. Assets are owned by the enterprise.
3. Assets are maintained by the enterprise.

1. The essential criteria for human resource to be classified as an asset relates to the notion of future service potential. As far as human resources are concerned, they definitely have the future service potential, as they cannot render their total service in one accounting year. Based on this criterion, it can be said that employee's service resources that have potential to provide economic benefits to the firm can justifiably be treated as assets. Jauch and Skigen however contend that no assurance of future benefits from these resources is available, and that there is no stored value of these resources but the same may be partially true in case of physical assets. For technological development, fall in demand and many other external factors. Thus human resources are assets because they possess this characteristic of future service potential like other physical assets.

2. The ownership of human resources remains a debatable point for treating human resources as assets. All the physical assets, like plant & machinery, land & building, furniture, etc. possess the characteristic of ownership but human resources do not, as employees cannot be claimed to have 'owned' by the enterprise because a firm does not have control nor does it expect to gain control over particular human's resources. There are people who think that human beings cannot be kept in an organization by force or without their consent. Jauch and Skigen, Glautier, and Clark are among those who stressed the legal ownership of the assets.

Lev & Schwartz hold an opposing view that the labour force as a whole is constantly associated with the firm and it can be constructively regarded as being owned by it. Moreover, when accountants can treat goodwill as an asset even when the status of legal ownership cannot be attached to it, why human resources cannot be treated as assets? An asset acquired under hire purchase agreement in which case ownership of the assets lies with the seller till the payment of the last installment is made but accepted accounting practices permit recording of such items of assets in the inventory of assets and treat them at par with others owned by the enterprise. So if the test of ownership can be relaxed for physical assets there is no reason why the same cannot be relaxed in case of human resources.

3. Organizations maintained human resources by various training and development programmes. As different new techniques and innovations are made for machinery not to be obsolete, similarly, HR has to be maintained by training and development.

The American Accounting Association defines 'asset' as the "economic resource devoted to business purposes within a specific accounting entity, they are aggregates of service potentials available of or beneficial to expected operations". If this definition of asset is accepted, the human resources will have to be treated as an asset.

Irrespective of the definitional problem, employees do constitute an important asset because plants, computers, offices, automated equipments and all else that a modern firm uses are unproductive except for human effort and direction.

HRA-Measurement Approaches/ Models

The biggest challenge in HRA is that of assigning monetary values to different dimensions of HR costs, investments and the worth of employees. The two main approaches Human Resource Cost Accounting (HRCA) and Human Resource Value Accounting (HRVA) are usually employed for this.

In HRCA, the expenses incurred on acquisition, training and development of human resources are treated as investment and hence shown in the balance sheet as an asset and periodical write offs out of these investments are charged to profit and loss account. Historical Cost Approach, Pyle, Brummet & Flamholtz (1969), Replacement Cost Approach, Flamholtz (1973), Opportunity Cost Approach, Hekimian & Jones (1967), Standard Cost Approach, David Watson, etc. are to be used under HRCA.

HRVA is based upon the economic value of human resources to an organization. In this area notable models used are Hermanson's (1964), Present Value of Future Earnings Model, Lev and Schwartz (1971), Stochastic Rewards Valuation Model, Flamholtz (1971), Net Benefit Model, Morse (1973), Jaggi and Lau's Model (1974), The Ogan's Model (1976), Human Asset Multiplier Model, Robinson and Giles (1972), Human Resource Valuation Model, Chakraborty (1976).

HRA practices in India

In India Human Resource Accounting has not been introduced so far as a system. At present companies in India are expected to furnish information relating to their employees such as name, age, qualification, designation, remuneration, date of commencement of employment and experience etc. as per Section 217 (2A) of the Companies Act 1956. This information regarding the particulars of employees form part of the Director's Report. However, there is nothing in the Act that prevents a Company from providing the details about the Human Resources by way of supplementary information attached with its financial statements.

In India, Bharat Heavy Electrical Limited (BHEL) was the pioneering organization in installing the Human Resource Accounting System in 1974-75. Prior to 1981-82 BHEL was using the Lev and Schwartz model without making any changes where as afterwards it value its human resources on the basis of a modified version of the model proposed by Lev & Schwartz i.e. on the basis of compensation (both direct and indirect). But now BHEL stopped reporting about HRA in their annual reports. Tata Steel also now furnishes only information relating to their employees as required under section 217(2A) of the Companies Act. Oil India Ltd, Minerals and Metal Trading Corporation, NIIT, National Thermal Power Corporation, Infosys, The Cement Corporation of India Ltd, Hindustan Petroleum and Chemicals Ltd, Electronics India Ltd, Engineers India Ltd, Madras Refineries, Cochin Refineries Ltd, Oil and Natural Gas Commission etc. are some of the organizations that started valuing their human resources and disclosed this information in their annual reports as annexure to directors report. Some of the organizations stopped reporting now but few are concentrating till now on valuing this most important asset.

ONGC is still valuing its human resources. If we will see the annual report of 2006-07 of ONGC in directors report they have mentioned that human resource is the priceless asset, and therefore beyond the mechanics of accounting. There are, however, methods to measure the potential ability of all employees across the ranks, to produce value out of their knowledge and skills. ONGC used Lev & Schwartz model for valuation as disclosed in Table1 and Table2 with following assumptions:

- The employees continues at the same position till superannuation;
- All direct and indirect employees costs are considered with escalations limited to corporate compensation practice and general economic conditions;
- NPV for the remaining years of service is calculated by applying a discounting factor of 8%;
- The valuation has been worked out for regular employees covering technical and non-technical categories.

Based on these assumptions, ONGC human resource has been valued at 285,120.4 million as on 31st March 2007. Table1 & Table2 forms part of the annexure to director's report showing HRA valuation. Table1 shows the employees

Table-1: Number of employees as on 31st March 2007 in ONGC.

Employee group	Age Distribution				Total	
	<31	31-40	41-50	51-60	2006-07	2005-06
(A) Technical						
Executive	533	1,919	10,257	5,596	18,305	18,684
Non-Executive	73	1,042	3,307	650	5,072	5,194
Total (A)	606	2,961	13,564	6,246	23,377	23,878
(B) Non-Technical						
Executive	142	422	1,977	1,824	4,365	4,474
Non-Executive	137	1,044	3,054	1,833	6,068	6,370
Total (B)	279	1,466	5,031	3,657	10,433	10,844
Grand Total (A+B)	**885**	**4,427**	**18,595**	**9,903**	**33,810**	**37,722**

Source: Annual Report of ONGC

Table-2: The valuation as on 31st March 2007in million of rupees.

Employee group	Age Distribution				Total	Value per employee	
	<<31	31-40	41-50	51-60		2006-07	2005-06
(A) Technical							
Executive	8,788.1	28,178.9	105,987.6	29,175.4	172,130.0	9.4	9.0
Non-Executive	815.7	10,137.7	25,732.9	2,472.2	39,158.5	7.7	7
Total A	9,603.8	38,316.6	131,720.5	31,647.6	211,288.5	9.0	8.6
(B) Non Technical							
Executive	2,268.3	6,084.4	18,958.6	9,036.0	36,347.3	8.3	8.0
Non-Executive	1,459.0	9,480.7	20,649.2	5,895.7	37,484.6	6.2	5.5
Total B	3,727.3	15,565.1	39,607.8	14,931.7	73,831.8	7.1	6.5
Grand Total (A+B)	**13,331.1**	**53,881.7**	**171,328.2**	**46,579.3**	**285,120.4**	**8.4**	**7.9**

Source: Annual Report of ONGC

as on 31st March 2007 and Table2 relates with the valuation of employees. This information can be used to take various decisions regarding human resources.

Conclusion

A proper reporting of human resources in the financial statements of a company will go a long way in giving a fair and complete view of the accounting information, boost the morale of people working in the organization and help the management in fulfilling their social responsibility. In India though the model used by various organizations to account for human resources is the same i.e. the Lev & Schwartz model, but the way the model is operationalised differs widely. There is no uniformity of practices regarding calculation of mean salary, determination of expected tenure, calculation of present value using a discount rate. There is a need for evolving a method, which could be largely acceptable to do the comparison of valuation made by different organizations. There is also a need to be aware about the importance of human resources for Indian organizations

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