Human Resource Accounting
Identification, Measurement and Communication of the Cost and Value of the People

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Abstract

The concept of Human Resources Accounting (HRA) is of recent origin. Working on the idea that human assets in an organisation are no less important than its material assets, human resources accounting refers to the method of reflecting the rupee value of the human assets in the company's balance sheet. A balance sheet that does not reveal the current value of a company's human assets does not, to say the least, portray the true and fair picture of the company's affairs. This is because the present and future earnings of a company always depend upon the quality of its human organisation. Although Indian accounting laws don't yet require human assets to be shown on the balance sheet; so, many companies have started formally evaluating their human resources and showing these figures in their annual reports.

Costs incurred on locating, selecting and training employees are the capital component of investment in human resources. There are various methods of measuring the value of human resources. Companies having low manpower costs as a percentage of total costs often have a much-needed competitive advantage. Therefore, monitoring and control of manpower costs have assumed great importance in the modern era of global competition. Despite of all these, 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.

***Key words**: Economic Cost Method, Human Resource Accounting, Human Resource Productivity, Management by Objectives, Management Tool.*

Introduction

To ensure growth and development of any organization, the efficiency of people must be augmented in the perspective. Men, material, machines, money and methods are the resources required for an organization. These resources are broadly classified into two categories, viz., animate and inanimate (human and physical) resources. Men, as properly known as human resources are considered to be animate resources. Other resources, namely, material, machines, money and methods are considered to be inanimate or physical resources. The term, human resources at macro level indicates the sum of all the components such as skills, creative abilities, innovative thinking, intuition, imagination, knowledge and experience possessed by all the people.

Employees are the greatest assets of an organisation, and its success or failure depends on the quality and performance of the employees. But, traditional accounting systems fail to indicate the value of this most valuable asset. Is this value increasing. decreasing or remaining constant? What return, if any, is the firm earning on its human assets? Financial and cost accounting do not provide answer to these questions. All expenses incurred on recruitment, training, familiarisation and development of employees are charged against the revenue of the accounting period in which they are incurred. This is an obvious violation of the 'Accrual Principle'. A typical balance sheet does not disclose 'human assets'. According to Prof. Rensis Likert, expenses incurred on human resources are fixed costs which do not render immediate return. Instead the return is spread over the time the employee stays with the firm. Therefore, these costs should be capitalised and amortised over the entire period. By not capitalising these expenses, accountants are concealing assets and net worth to that extent. The current practice tends to create secret reserves. This is a blatant negation of the cardinal principle of "True and Fair Disclosure' in published accounts.

The need for the value of human resources being shown in the company's balance sheet has been very nicely brought out in the following poem by Webster:

"Though your balance sheet is a model of what balance sheets should he;

Typed and ruled with great precision in a type that all can see;

Through the grouping of the assets is commendable and clear;

And the details which are given more than usually appear;

Though investments have been valued at the sale price of the day;

And the auditor's certificate shows everything O.K.;

One asset is omitted, and its worth I want to know;

The asset is the value of the men who run the show."

Human Resource Accounting: Assessment of the Cost and Value of the People

"Human Resource Accounting" is the offshoot of various research studies conducted in the areas of accounting and finance. Human resource is an asset whose value gets appreciated over the period of time provided placed, applied and developed in the right direction. The traditional concept suggested that expenditure on human resource is treated as a charge against revenue as it does not create any physical asset. At present, there is a change in this concept and the expenses incurred on any asset (as human resource) should be treated as capital expenditure as it yields benefits that can be derived for a long period of time and could be measured in monetary terms.

Human resource accounting may be defined as the measurement and reporting of the costs incurred in recruit, hire, train, and develop employees and their present economic value to the organisation. It involves assessment of the costs and value of the people as organisational resources. According to the American Accounting Association, "HRA is the process of identifying and measuring data about human resources and communicating this information to interested parties." Thus, HRA is primarily a management tool that informs the management about the changes that are taking place in the human resources of an organisation. The basic purpose HRA is to facilitate the effective and efficient management of human resources by providing information required to acquire, develop, allocate, conserve, utilise, evaluate and reward human resources.

Objectives of Human Resource Accounting

Rensis Likert, one of the earliest proponents of HRA, has specified the under mentioned objectives of an HRA system:

- To provide cost value information for managerial decisions about acquiring, developing allocating and maintaining human resources so as to attain cost effective organisational objectives.
- To enable management personnel to monitor effectively the use of human resources.
- To provide a determination of asset control, i.e., whether human assets are conserved, depleted or appreciated.
- To assist in the development of effective management practices by classifying the financial consequences of various practices.

Advantages of Human Resource Accounting

HRA provides useful information about the value of human capital, which is essential to managers for taking right decisions, e.g., choice between (a) direct recruitment and promotion, (b) transfer and retention, and (c) retrenchment and retention, etc. It facilitates human resource planning by highlighting the strength and weakness in the workforce. For example, management can judge adequacy of the human resources and need for further recruitment.

Management can evaluate the effectiveness of its policies relating to human resources. For instance, high costs of hiring and 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 a manager on his own performance. HRA provides valuable information for present and potential investors. Investors and other users of financial statements want to know the value of firm's human assets. The present law does not require the value of the human asset to be shown in the Balance Sheet. But, if two companies earning the same return issue securities, information on their human assets can enable investors in choosing the better investment opportunity. HRA provides a more accurate accounting of return on the total resources employed in a firm.

HRA provides information about utility of cost reduction and budgetary control programmes in view of their possible impact on human relations. It is helpful in controlling labour costs for improving profitability. It HRA may help to improve the motivation and morale of employees by creating a feeling that the organisation cares for them.

Limitations of Human Resource Accounting

No doubt HRA provides valuable information both for management and investors, yet its development and application has not been very encouraging due to the following reasons:

- There are no specific and clear-cut guidelines for 'cost' and 'value' of human resource of an organisation. The existing valuation systems suffer from many drawbacks.
- The life of human resources is uncertain and, therefore, valuing them under uncertainty seems unrealistic.
- There is a possibility that HRA may lead to dehumanising and manipulation in employees. For example, a person having a lower value may feel discouraged and this, in itself, may affect his competency in work.
- 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.
- Human resources, unlike physical assets, are not capable of being owned, retained and utilised at the pleasure of the organisation. Hence, treating them as 'asset in the strict sense of the term, would not be appropriate.
- There is a constant fear of opposition from the trade unions. Placing a value on employees would prompt them to seek rewards/compensation based on such valuation.

- In what form and manner, should their value be included in the financial statements? Is another question on which there is no consensus in the accounting profession?
- If a valuation has to be placed on human resources, how should it be amortised? Should the rate of amortisation to be decreasing, constant or increasing? Should it be the same or different for different categories of personnel?

The Costs of Human Resources

Costs incurred on locating, selecting and training employees are the capital component of investment in human resources. These are similar to the costs of fixed assets, e.g., purchase price and cost of installation. Some of these costs are direct (e.g., time spent on training) while others are indirect (administrative expenses on training). The costs of human resources may be classified as follows:

I. **Recruitment Costs:** The costs are incurred to identify the possible sources of employees, e.g., advertising travel, fees of employment agency, company's recruitment, etc.

II. **Selection Costs:** Cost of application forms, testing, interviews and allocated administrative overheads.

III. **Hiring and Placement Costs:** Travel expenses to select employees, expenses for moving to the firm's place, etc.

IV. **Orientation Costs:** Costs incurred to familiarise the new employees with policies, facilities, products, etc. of the firm.

V. **Training Costs:** Trainer's salary, training facilities, low productivity during training, etc.

VI. **Development Costs:** Costs incurred to increase the employee's capabilities beyond immediate skills required for the job, advancement, e.g., fees and expenses for attending seminars and executive development programmes.

Methods of Valuation of Human Resources

The main methods of measuring the value of human resources are given below:

1. **Historical or Actual Cost Method:** Under this method, the amount actually spent on the recruitment, familiarisation and development of employees is capitalised and amortised over the period for which the benefits are expected to flow to the organisation. Outlays which are not having value beyond the current accounting

period are treated as operating expenses. Costs on recruitment, selection and placement are called acquisition costs while the costs of orientation and training are known as learning costs.

The advantage of this method is that the effect of human resource accounting can be shown on conventional Balance Sheet and Profit and Loss Account because the information in these statements is also stated on historical cost basis. The drawback of this method is that the human resource is equated resulting in undervaluation.

2. **Replacement Cost Method:** In this method human assets are valued at which it would cost to replace the existing human resources with human resources capable of rendering equivalent services. This method can assist the process of manpower planning by providing estimates of the costs involved in obtaining employees for different positions. Decisions about the quality of the personnel to hire and the training programme to be arranged for them, can be taken into account. This method suffers from several drawbacks. First, management may be unwilling to replace the human asset because the present value is greater than its scrap value. Secondly, there may be no similar replacement for a certain asset. Thirdly, this method is inconsistent with the historical cost of valuing assets. However, this problem could be solved if all the assets are valued at replacement cost.
3. **Standard Cost Method:** This method envisages establishment of a standard cost per grade of employee, updated every year. Variances produced should be analysed and would form a useful basis for control. Replacement costs can be used to develop standard costs of recruitment, training and developing individuals. Such standards can be used to compare actual results with those planned.
4. **Current Purchasing Power Method:** Under it, instead of taking the replacement cost to capitalise, the capitalised historic cost of investment in human resources is converted into current purchasing power of money with the help of index numbers. Its great advantage is its simplicity even though it might produce only approximate answers and approximately correct data.
5. **Present Value Method or Economic Cost Method:** Under this method the future earnings of various grades of employees are estimated upto the age of retirement and are discounted at the rate of cost of capital to obtain their present value.

The model may be expressed as follows:

$$V_r = \frac{T\Sigma E(t)}{t-r\ (i+r)}$$

where V_r, the human capital value of a person r years old.

E(t) the person's annual earnings up to retirement, represented by the earnings profile.

r = discount rate (cost of capital).

T = retirement age.

Values are arrived at on the basis of average earnings for each category of employees. Human capital calculated in this manner is useful since comparison with non-human capital will give an idea about the degree of labour intensiveness. Depending on the rate of growth in human capital one can also say whether an organisation has an ageing labour force or a younger labour force.

This method suffers from the drawback of equating the total earnings to the human capital. There may be under- or over-fixation of salary. The discount rate to be used cannot be calculated with a high degree of objectivity. It is also difficult to apportion the company's earnings among human and other factors of production.

6. **Asset Multiplier Method**: This method is based on the assumption that there is no direct relationship between costs incurred on an individual and his value to the organisation at any particular point of time. This is because motivation, attitude and working environment affect the value of an individual. Under this method organisational employees are divided into four categories: top management, middle management, supervisory management and operative or clerical employees. Wages and salary bill for each category is multiplied with an appropriate multiplier to calculate the total value for each. Multiplier is a means for relating the personal values of the employees to the total assets value of the organisation. Highest multiplier should be checked for consistency with the total value of the business as a whole. If the value of human assets is greater or less than the goodwill, multiplier is inaccurate and should be adjusted.

Controlling Costs of Human Resources

Manpower costs constitute a significant part of the operating costs in many industries. Companies having low manpower costs as a percentage of total costs often have a much-needed competitive advantage. Therefore, monitoring and control of manpower costs has assumed great importance in the modern era of global competition. Some of the approaches used to analyse and control costs of human resources are being discussed here under:

1. **Management by Objectives (MBO):** In the area of human resource management, measurement has been the weakest area due to most of the variables being qualitative. Peter F. Drucker has suggested that measurement is very important to the performance of an organisation. Therefore, professionals in human resource management have applied MBO.
2. **Ratio Analysis:** In this approach, some key performance indicaters concerning the human resource function (e.g., cost of training) or utilisation of manpower (e.g., labour cost as a percentage of total cost) are used. These indicaters called human resource ratios may relate to the following areas:
   i. **Cost per Hire:** This ratio is used to measure the costs of recruitment. It is expressed as follows:

$$\text{Cost per hire (in Rs.)} = \frac{\text{Costs of recruitment}}{No.of\ recuitees\ retained/hired}$$

Costs of recruitment consist of (a) cost of time spent by human resource in recruitment process, (b) cost of advertisement. (c) fees, if any, paid to recruiting agency, (d) costs of conducting tests and interviews, (e) costs of medical examination, and (f) administrative costs, e.g., telephone, stationery, etc.

Cost per hire helps to analyse and improve the efficiency of recruitment. It may suggest use of employment exchanges to reduce cost of advertising, calling fewer candidates for interview, in house recruitment to save fee of recruiting agency, greater care in offering jobs so that more recruitees are retained, etc.

   ii. **Recruitment Cycle Time**: It means the time taken from the beginning to the end of recruitment process. It helps to determine the lead time required to initiate and complete the process of recruitment. Analysis of time taken at each stage of recruitment will indicate the need for the steps required to reduce the cycle time. Clear job specification, sound design of application blank, computerisation of applications, maintaining list of active job seekers are some of the steps that can help to reduce the recruitment cycle time.
   iii. **Turnover Rate**: It is expressed as follows:

$$\text{Turnover Rate (\%)} = \frac{\text{Number of separations}}{\text{Average number of employees}} \times 100$$

Separation pay, cost of exit interview and administrative expenses are the direct costs of labour turnover. Deterioration in motivation and morale are the indirect costs. Replacement costs include all costs of recruiting an employee. In addition, interruption in work performance, orientation and training of new employee are additional costs.

iv. **Cost per Trainee**: This ratio is expressed as follows:

$$\text{Cost per trainee} = \frac{Total\ cost\ training}{No.of\ employees\ trained}$$

It is difficult to evaluate training. Wasteful training costs should be reduced but cost reduction in training should not be at the expense of quality of training.

3. **Human Resource Productivity:** Analysis and control of human resource costs alone is not adequate. It is essential to monitor and improve the productivity of human resources. If the percentage increase in human resource productivity is higher than percentage increase in personnel costs, per unit cost of personnel may be reduced. Human resources have a tremendous potential to improve productivity. In several multinationals and Indian companies, wages and salaries have been increased continuously but the per unit cost of labour has been kept constant. Many firms have considerably cut down idle time, over time, and idle capacity through better utilisation of manpower. O&M studies, productivity bargaining, technology upgradation, paper work simplification, quality circles are some of the techniques through which human resource productivity has been raised.
4. **Human Resource Reports and Budgets:** Reports provide useful information for controlling human resource costs. A human resource budget is a human resource programme expressed in monetary terms for specified period of time. It covers human resource costs like compensation, employee facilities, training and development. etc. Comparison of actual cost with budgeted figures will help to decide corrective action.
5. **Employee Relations Index:** This is a quantitative technique of measuring the overall effectiveness of the total human resource programme. This composite index consists of several strategic items such as absenteeism, separations, occupational health, suggestions, formal grievances, work stoppages, etc. Weights are assigned to each item according to its relative importance. An employee relations index of less than 100 indicates poor industrial relations.
6. **Human Resource Audit:** It is a systematic and comprehensive analysis of all human resource activities and results. It involves a formal, comparative and

indepth investigation of all human resource policies, practices and functions. A compressive personnel audit covers every phase of human resource management. These phases may be classified as under:

i. Human resource policy organisation and administration.
ii. Procurement Job analysis, recruitment, selection, placement, induction.
iii. Training and Development-Career planning and counselling, training, executive development, promotion, appraisal.
iv. Compensation-Wage and salary administration, wage incentives, profit-sharing, fringe benefits.
v. Utilisation-Job changes, productivity.
vi. Maintenance-Safety, healthy, employee services, social security.
vii. Integration-Employee communication, motivation, morale, job satisfaction.
viii. Labour relations Collective bargaining, workers' participation in management, trade unions, research.

Human Resource audit offers several advantages. It improves understanding of human resource policies and practices. It highlights the gap between goals and achievements. It serves as a check on the activities of human resource department stresses the need for line cooperation. It generates valuable ideas for improving human resource management system.

Summing-up

Human Resource Accounting is the process of identifying and measuring data about HR and communicating this information to interested parties. It is the measurement of the cost and value of people for the organisation. We may opine that it is an attempt to identify and report investments made in human resources of an organization that are presently not accounted for in conventional accounting practices. Basically, it is an information system that tells the management what changes over time are occurring to the human resources of the business".

The value of the human resource in the organization is dependent on three things: transferability, promotability, productivity. Transferability refers to set of services a person is expected to provide in different types of transfer a person, which is likely to get in his future expected work life. Promotability is a set of services an individual is expected to provide after his promotion to higher positions. Productivity refers to the service an individual provides while occupying the present position in an organization.

Till recently, human resource management activities had commonly been evaluated in behavioural and statistical terms. The need to evaluate HRM activities in economic terms is becoming increasingly important. Developing such measures requires an inter-disciplinary approach wherein information from accounting, finance, economic and behavioural science, has to be incorporated and delivered in the language understood by the business world.

Classical accounting system treats human resource as current costs. Whatever the organization is paying in form of salaries, incentives, benefits are chargeable to revenue and cannot be carried as asset in the balance sheet. The modern concept of HRA treats resources as capital. They render future services that have economic value. The value of human resources depends on how the resources are utilized. Finally, it is a good sign that business arena has comprehended the need and utility of HRA. The concept has grown, developed and being followed by firms in practice at an accelerated pace.

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