Human Resource Accounting : Indian Scenario

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Abstract

It is a fact that human resources are no less important than other resources. The recognition, however, of the importance of people in organizations as productive resources by the accountants is a recent origin. In the management terminology, this is termed as Human Resource Accounting (HRA). In the simplest form, HRA involves the identification of the costs of recruitment, training and maintenance of an entity's human assets. According to American Accounting Association, "HRA is a process of identifying and measuring data about human resources and communicating this information to interested parties." Characteristics like personality, self-control, devotion, quality, skills, talents, loyalty and initiatives differentiate the Human Resource from the physical resources. In a nutshell, HRA involves (a) measurement and valuation of human resources and (b) communicating the information so generated for internal and external decision-makers. In 1995-96, companies like Infosys went out to value its human resource which was Rs. 184 crores, much more than the value of its physical assets of Rs. 84 crores. The valuation of human resources has received widespread recognition. In course of time, various accounting models have been developed to evaluate human resources of an organization. Lev and Schwartz Model is widely used by many Indian firms. To make valuation of human resource objective and comparable, there must be a universally acceptable method of valuation.

Introduction

Today, growth and development are aims of every organization and to ensure that the efficiency of people must be trained in the right perspective. The other resources of an organization cannot be operationally effective without human resources. The Organization's health is indicated by the human behaviour variables, like group loyalty, motivation, skill and capacity for effective communication, interaction and decision making. Whilst the physical properties and investments are of vital importance for an organization, the skillful and specialized human resource proves to be an equally valuable asset. The success of the organization depends on how the physical resources are utilized by the human resources. The quality, caliber, skills, perception and the character of the people, that is, the human resources define the efficient and effective utilization of inanimate resources. An organization may fail miserably unless it has the right set of people to manage its affairs even though it possesses abundant physical resources. Thus, the importance of human resources cannot be ignored. Human Resource

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Accounting (HRA) involves accounting for the company's management and employees as human capital that in turn provides future benefits. In the HRA approach, expenditures related to human resources are reported as assets on the balance sheet as opposed to the traditional accounting approach which treats costs related to a company's human resources as expenses on the income statement that reduce profit. HRA suggests that in addition to measurement, the process has relevance in organizational decision-making. Although the origin and early development of HRA occurred mostly in the United States, interests and contribution to the field have been evident in a number of other countries. Interests in measuring human capital have also been evident in India. Mahalingam notes that "Pundits of today assert that while the other forms of capital, including material, equipment, tools and technology only represent inert potentialities. It is the human capital that converts this potential and energizes the creation of wealth." In 1995-96 companies like Infosys went out to value its human resource which was Rs. 184 crores, much more than the value of its physical assets of Rs. 84 crores. In the past few decades, a global transition from manufacturing to service based economies has been observed. Human elements are becoming more important input for the success of any corporate enterprise , they are more significant in the service sector. Human resource accounting is a process of identifying and measuring data about human resources. It refers to accounting for people as an organizational resource, involves not just measuring the cost incurred by an organization to select, recruit, hire, train and develop human assets but also measuring the economic value of people in the organization. HRA is one of the latest concepts adopted by Indian companies in recent times and in Indian scenario human asset reporting usually includes a profile of human assets, the compensation pattern, training and development, human asset productivity, human asset value and the total wealth of the organization.

Importance of HRA

HRA is a managerial tool and can be used for effective management of human resources. Human resource data as a part of management information system help in making meaningful choices between various types of investments on human resources and other assets in the field of managerial decision-making. At different points of time, the measure of the value of human resource can reveal whether the management is building up human resources or depleting them. The information generated through HRA can help the management in formulating policies and programmes for the development of human resources. This information can be useful for making decisions in all the areas of management including:

a) Planning of Manpower

b) Appraisal Decisions

c) Identification of the need of training program

d) Cost reduction programmes in view of their possible impacts on human relations.

e) Studying the impact of budgetary control on motivation and morale of employees.

f) Facilitating allocation, conservation and reward of human resources.

In India, some companies viz. Infosys, Steel Authority of India (SAIL), Bharat Heavy Electrical ltd. (BHEL), have recognized the value of human resources and include related information in their annual report. Southern Petrochemicals Industries Corporation of India Ltd, Mineral and Metals Trading Corporation of India, Hindustan Zinc Ltd, Associated cement Companies Ltd, Madras Refineries Ltd, Oil India ltd, Oil and Natural Gas Commission and the Cement Corporation of India have also been giving information on human resources.

Models of HRA

One of the reasons why human resource accounting has taken a long time to be incorporated in the company's final report is the difficulty of assigning monetary value to various human asset cost, investment and employees' worth. Mainly, there are two methods that are used in assigning the monetary value to employee cost, investment or worth such as:

- The cost approach
- The economic value approach

The cost approach is based on the actual cost borne by the company in relation to the employee, while the economic value approach considers human resources as an asset and tries to identify the future earnings resulting from the use of this human asset.

The Cost Approach

It involves methods based on costs incurred by the company with regard to an employee.

Cost is the amount of cash or equivalent given to acquire property or services. Various methods of measurements of costs and valuation of human resources are as follows :

Historical Cost Approach

In this method, the cost of acquisition i.e. recruitment, selection, hiring and training employees are capitalized and written off over the expected useful life of the employee. If the employee decide to leave the job before anticipated period, then the amortized portion of the cost remaining in the company's book is recorded in the profit and loss account in that year. If the employee stays beyond the expected term of service then amortization of cost is rescheduled. While it has merits that it is easy to work upon and simple to understand, it follows the traditional concept of matching cost with revenue and can provide a basis of evaluating a company's return on investment in human resources. Limitations are that the economic values of human resources increase or decrease with experience and this is not considered in the aggregate value of potential services.

Opportunity Cost Approach

The value of the human resource is determined according to its alternative use and hence, an estimate of alternative use of the human resource is required. The value of the human resource is the price that the alternative use is ready to pay for it. The approach proposes the capitalizing of additional earning potential of each human resource within the company. The opportunity cost approach requires at least two departments or cost centers both desiring services of the same person or a group of people. This certainly poses some limitations and it cannot value employees who have no alternative use. Also it is believed that valuation of employees on alternative use and competitive bid is inaccurate and misleading.

Standard Cost Approach

The method was developed by David Watson. The approach advocates for a standard cost per grade of employees updated every year. Replacement cost can be used to develop standard costs of recruiting, training and developing individuals. Such standards can be used to compare results with those planned.

Economic Value Added Approach

This approach utilizes the concept of the present value. The value of human resource is considered as the present value of future benefit expected to be received from employees' service. It includes methods based on the economic value of the human resources and their contribution to the company's gains. This approach looks at human resources as an asset and tries to identify the stream of benefits flowing from the asset. The approach suffers from few limitations viz. it ignores the possibility of a human resource leaving employment other than death or retirement. It is also difficult to establish the actual benefits from employment because some of the determining factors like trade unions activities which cannot be controlled. Present value also does not incorporate any concept about the Teamwork.

Flamholtz Model

The Flamholtz model considers the value of human resource as the present worth of services likely to be rendered by an employee in future. The profiles of services offered keep changing when an employee moves from one position to the other within the level or to different levels. The present cumulative value of all possible services to be offered by the employee within his/her career at the organization will contribute to the value of individual. The value of individual however, cannot be determined with certainty.

The Lev and Schwartz Model

According to the Lev and Schwartz Model, human capital is valued as the present value of future earnings from employment. This model is widely used by many Indian firms. The present value of a person who is 'Y' years old, is the present value of his/her future earnings from employment and can be calculated by using the following formula-

$$E(V_y) = \sum_{T=Y} P_y(t+1) \sum_{T} I(T)/(I+R)^{t-y}$$

Where,

$E(V_y)$ = expected value of a 'Y' year old person's human capital.

T = the person's retirement age.

$P_y(t)$ = probability of the person leaving the organization.

I (t) =expected earnings of the person in period I

R = discount rate.

The model determines human resource value by computing the present value of future payment to the employee. Both direct payment and indirect payment are included in future payment. Most Indian firms that use this model make common assumption i.e. normal career growth, pattern of employees' compensation and weightage for efficiency. Companies make alteration to this model in order to find out to their practical requirement e.g. firms use different discount rate in determining the present value of future cash flow. Different companies have different risk based on beta or other measure of risk such as standard deviation of returns. This makes the discount rate to differ from one company to the other. Further, the cost of capital (discount rate) is determined using weighted average cost of capital (WACC). Since different firms have different capital structure, the cost of capital must vary.

Hekimian and Jones Competitive Bidding model

The value of human resource is based on internal market for labor and the value is determined by manager through the bidding process. Manager bid against each other for workers available in the firm and the highest bidder win the resource. While bidding, no specific criteria are used and managers are expected rely on their own judgment.

Human resource accounting and the Indian practice

Human resource accounting for the first time was used in public sector by Bharat Heavy Electrical ltd (BHEL) in the fiscal year 1972-73. Later on other organization both in public and private sector started to furnish information related to human resource in their annual report. These organizations include;

- Infosys
- Steel authority of India (SAIL)
- Southern Petrochemicals Industries Corporation of India Ltd
- Mineral and Metals Trading Corporation of India
- Hindustan Zinc Ltd
- Associated cement Companies Ltd
- Madras Refineries Ltd
- Oil India ltd
- Oil and Natural Gas Commission
- Cement Corporation of India.

Human resource accounting even though was introduced back in 1970s, did not gain acceptance and popularity during that time. Only after the introduction of the concept by Infosys in 1990s, the concept started gaining popularity. There are different modifications made in computation techniques and lot of objectivity while making estimates. Hence, comparison can only be made within the same (inter-period) firm but not between firms. Lev and Schwartz's economic model has been used by all the companies that have introduced HRA.

All companies that furnished information about human resource value included such report as a separate report from the main financial statement i.e. the income statement and the balance sheet. This implies that human resource accounting is not still considered as part of financial statement but additional materials for annual reports. Hence, human resource accounting is in need of further development in order for human resource data to receive equal weightage as other items present in the balance sheet and income statements. In order to have human resource accounting significance and to be part of financial statement the value of human resource as computed by various companies should be incorporated in the balance sheet. Only then, the balance sheet will be complete and lead to better analysis. For instance, the case of Infosys, before incorporating the value of human resource, the ROA in 2009 was 27% but after incorporating the value of human asset, ROA droped to 4.8% which is the actual return on asset. In addition, the earlier calculation indicates a growth in return on asset by 1% while calculation incorporating human resource value indicated a growth in ROA by 0.8% between 2009 and 2009. This example indicated that human resource accounting can lead to better analysis of financial performance of a company.

Investors can use human resource ratios to analyze the performance of the company over the period and thus understand whether the performance of the company is improving or deteriorating. As for Infosys, total income/human resource ratio was 0.21 in 2009 compared with 0.17 in 2008. This indicates an improvement in performance of the company. Other human resource ratios which illustrated improvement in performance include value added to human resource which increased from 0.15 to 0.19 and return on human resource value which increased from 4.7 to 5.9. Based on human resource ratios the company performed better in 2009 compared to 2008 and this information can be used by the investor to make an investment decision. However, other ratios of profitability, liquidity, efficiency and leverage need to be included while analyzing the financial health of a company. Otherwise, the use of a single category of ratios can mislead users of accounting information.

The information provided by human resource accounting is of great importance to the management. Breakdown of the workforce in term of professionalism can help managers to decide whether they have right mix of workforce to drive organizational growth. A change in the mix can be necessitated by the change of business or acquisition and merger. In a technology firm like Infosys, a large portion of the workforce is expected to be professionals and lesser unskilled workers. But for a manufacturing firm the number of semi-skilled workers is expected to be on the higher side. Comparison of the level of professionalism between firms in the same industry can pinpoint weaknesses or competitive advantage that one firm have over the other. In technology industry, if the managers find that the number of semi-skilled and unskilled worker is high than technical staff and other professionals, it is an indication that the organization has insufficient skills to sustain growth in a highly competitive market. Infosys for instance in 2009 had 97,349 software professionals compared to 7,501 support staff which indicates that the firm has the right mix of workforce and it can be expected that future growth in both the categories of workforce will be proportional.

Discussion

HRA may be accepted an attempt to identify and report investments on human resources of the organization that are not presently accounted for under conventional accounting practice. It basically is an information system that tells the management what changes over time are occurring to human resources of business. To make human resource accounting more meaningful and to facilitate its inclusion in financial statement, the personnel cost should be classified into two categories namely capital expenditure and revenue expenditure. Capital expenditure will include costs such as acquisition, retention, development, up-gradation or update and hiring cost (recruitment and training). Revenue expenditure will include salaries, wages, commission, bonus, allowance, efficiency maintenance cost and short term motivation. Capital expenditures should be capitalized and recorded in the balance sheet as intangible assets and amortized over the useful life of a human asset. This amortization should be recorded as expenses in the income statement. Revenue expenditure should be charged against revenue in the income statement. This will be the only way that human resource cost is represented in the financial statements i.e. the income statement and the balance sheet rather than a separate report in the annual statement.

Conclusion

Human resource accounting provides quantitative information about the value of human resources which helps the top management to take decisions regarding the adequacy of human resources. Based on these insights, further steps for recruitment and selection of personnel are taken. Outside the organization, quantitative data on the most valuable asset has an impact on the decision of investors, clients, and potential staff of the company. When proper valuation and accounting of human resources are not done, the management may not be able to recognize the negative effects of certain programs which are aimed at improving profits in the short run. If not recognized on time, this programs could lead to a fall in productivity level, high turnover rate and low morale of existing employees. There are several areas in which non-monetary measurements may be evolved in accounting and human resource accounting is probably one of these. To make valuation of human resource comparable, there must be a universally acceptable method of valuation.

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