Human Asset Accounting Treatment and Corporate Profitability Evaluation-A Literary Reflection

Dr Lawyer Chukwuma OBARA
Senior Lecturer, Department of Accounting, Faculty of Management Sciences, Rivers State University of Science and Technology, Nkpolu, Oroworukwo, Port Harcourt, Rivers State, Nigeria.
E-mail: lcobara_phd@yahoo.com
Phone: 08037081915

Justin Mgbechi Odinioha GABRIEL
Lecturer, Department of Management, Faculty of Management Sciences, Rivers State University of Science and Technology, Nkpolu, Oroworukwo, Port Harcourt, Rivers State, Nigeria.
Email: justinpozy@yahoo.com or gabriel.justin@ust.ng
08033154656

Abstract

With the growing emergence of the knowledge economy, the traditional evaluation of organization's human resource has been a subject of intellectual controversy due to the recognition that human asset is an increasingly important part of an enterprise's total value. Chen and Lin (2003:16) observed that the succession of the human intellect over machines and equipment in the contribution to industrial value makes a financial statement that relegates human asset expenditure to expenses inadequate if not obsolete. Hence, this paper discusses scholarly opinions concerning the treatment of human assets accounting and the valuation of corporate profitability. Drawing from literature that is already awash with scholarly thinking on the subjects, the paper reveals that the current method of relegating all the company's inputs in human resources to expenses is misleading since it does not separate human capital investment from human capital expenses. The paper winds up on the note that Human capital investment relates to the long-term value creation aspirations of organization, as such must be identified, measured and reported appropriately in the books of account to eschew distortion of reported corporate profit.

Keywords: Human Assets Accounting Treatment, Corporate Profitability Evaluation, Human Resource, Assets.

1 CONCEPTUAL OVERVIEW

The success or failure of every enterprise is based largely on the effective utilization of the entity's resources, be it financial, material, machine or manpower resources. Under the Generally Accepted Accounting Principle (GAAP), financial statements lack proper reporting, measurement and disclosure of items in newly emerging fields such as human capital (Wintermantel and Maltimore, 1997:17). Against this background, it has been observed that until recently, the "value of an enterprise as measured within traditional balance sheets, for example, buildings, production plant, fixtures and fittings, vehicles etc was viewed as a sufficient reflection of the enterprise's assets. However, with the growing emergence of the knowledge economy, this traditional valuation has been called into question due to the recognition that human asset is an increasingly important part of an enterprise's total value (Westphalen and Nychas, 1998:50).

It is not unusual to see managers and accountant pay much attention to detailed information about the physical and financial assets of the entity. Yet, over the years, they have tended to ignore or to half-heartedly pursue similar accountability for an organizations employees, which are even a key element for success (Caper, 2002:1). Chen and Lin (2003:16) observed that the succession of the human intellect over machines and equipment in the contribution to industrial value makes a financial statement that relegates human asset expenditure to expenses inadequate if not obsolete.

Kieso et al (1992:47) stressed that if the purposes of financial statements are to provide useful information to investors and creditors, and also to evaluate company's resources and claims to resources by creditor and shareholders, it means that financial statements compiled according to GAAP do not properly disclose company's investment in human asset and knowledge asset created by it. Seetharaman et al (2002:128-148) also posited that the current accounting and financial analyses have not kept pace with the vast changes in the business world.

However, interest in human assets accounting treatment has been on the increase because of the need for more information about the constitutive factors for the value of a company. It is a detailed analysis of the various treatments of human assets accounting that can provide such information.

Conceptually, the various human asset accounting models proposed to date can be divided into four separate classifications or combinations thereof (Carper, 2000:1). These are: (1) Historical or original acquisition cost (2) Replacement Cost (3) Economic Value Model and (4) Non-monetary measures.

Historical cost represents the original cost of human asset in the conventional accounting sense. It includes such costs as personnel recruitment, training and development. Replacement cost is a current financial measure of the expenditure required for a business entity to replace its existing investment in human asset.

Economic value refers to the appropriately discounted amount of net cash inflows generated by the human asset of a firm over their economic service lives. Non-monetary measures of human asset refers to a simple inventory of skills and capabilities of people within an organization, to a list of professional credentials of key personnel within an organization or to the applications of some non-monetary behavioural measurement techniques for assessment of the contributions of various individuals or groups to an entity (Carper 1973; 1983). These four measurement alternatives have their strengths and weaknesses. However, the replacement cost alternative was selected by a number of early human asset accounting researchers as the most realistic method currently available for measuring the future service potential embedded in human beings (Carper, 2002:19).

The relevance of human asset accounting treatment can be deduced from the fact that organizations can actually find out how much they can earn from an individual as the human assets of a company are often worth three or four times the tangible book value. Human asset also provides expert services such as consulting, financial planning and assurance services, which are valuable and very much in demand. Realizing this, many companies world-over are making Human Asset Accounting a necessary element on their balance sheet (Westphalen and Nychas, 1998:5085). Reslender and Fincham (2003:383) also noted that, what interest human asset accounting treatment is attracting is largely a consequence of the recognition that what it relates to is of growing importance to the long-term value- creation aspirations of organizations. It therefore needs to be identified and as far as possible, managed in an effective way.

2. THE CONCEPT OF HUMAN RESOURCES ACCOUNTING

The concept of human capital is the basis for human resources accounting. This concept, at the enterprise level is not of recent origin. Investment in human capital was considered in the writing of Adam Smith (Brument et al, 1970:22). Many other economists and social scientists have sought to understand the nature and casual aspects of industrial growth. The contribution of human factor to this growth had generated great interest among researchers.

The focus of studies in these areas had been to assess the cause and effect relationships of relative investments in human capital and other forms of capital and rates of economic and social change in different countries of the world. The significance of human resources in organization or at the enterprise level has also been recognized in the literature of organizations and management theory and practice throughout history, but the accounting process has been limited largely to financial and physical resources (Tailor and Glautier, 1974:112).

In the early 1960s specific suggestions started to appear for inclusion of human resources representations in routine assessments of enterprise condition. In the 1940s emphasis on recruiting, training employee motivation, work environment, the use of employee attitude and perception surveys; attest to the increasing recognition of the role of human resources in organizational effectiveness. Hermanson (1964:62-66) argued that financial statements would be more complete and more useful for managers and investors if they included such resources.

As far back, Likert (1967:83) emphasized: the importance of the human elements in organizations and the significant failure of accountants to deal with it as asset. This failure, he stressed was more noticeable in the balance sheet of corporate organizations. He traced the wide gap of differences between market and book value of the owner equity in many corporations to manager's inappropriate decisions due to lack of information about the firm's human assets. Likert (1967:82) drew attention to human resource accounting which is also called human asset accounting, particularly by personnel and behavioral experts.

Identification of Human Resources

Human resources accounting has been defined as "the process of identifying and measuring data about human resources, and communicating this information to interested parties (Carper, 2002:2). The three major components involved in this definition include:

(I) Identification of human resources as assets;
(2) Measurement of asset data about human resources; and
(3) Communication of this information to interested parties.

The issue of whether employees of an entity constitute an asset, and the possible attributes of individuals to be valued, has been at the centre of discussion on human resources accounting.

Historically, accountants have viewed assets from diverse standpoints, some of which are: Things of value owned, Deferred charges, A combination of the two and economic view.

- **Thing of Value Owned**

The perception of asset as things of value owned was a dominant view in the mid-20th century. Assets were variously defined to reflect this view. For example, asset was defined at this period as: Any consideration, material or otherwise, owned by a specific business enterprise and of value to that enterprise" (Paton and Stevenson, 1922:18). It was also viewed from this perspective by another scholar as:

> **"The most commonly accepted (means to distinguish between capital expenditures and charges against revenues) is that in so far as the transaction results in an addition of substantial and permanent character which increases the value of the plant, such increase should be made to construction account". …Money paid out should not be reckoned as asset. If paid for property that is on hand, the property is an asset. If expended in a way that has enhanced the value of the general assets, it is included in its valuation. If so expended as to have brought no property and no enhancement of that on hand, then it is a loss, and should not be counted as an asset** (Hatfield, 1920:73)

This view of an asset persisted till the early 1950s where asset was defined as "any object, consideration, or right which has value and is owned by a business enterprise" (Schmidt and Bergstrom, 1952:7).

- **The Deferred-Charge Approach**

This was another approach to asset identification. Using this approach, Paton and Littleton (1940:25) described assets as: **Factor acquired for production which have not yet reached the point in the business process where they may be appropriately treated as cost of sales, or expense … and are presented as such in the balance sheet.**

Earlier, another writer applying the same approach had defined it as:

That which is owned and invested in business, that which is earned, although not received and constitutes a collectable claim (and) that which has been expended for the benefit of future periods (Esquere, 1919:136).

Still following the same trend, in the 1930s, Gilman (1930:270) viewed asset in these terms:

A most helpful accounting concept, particularly in relation to profit determination, is the one which considered non cash- assets as being equivalent to deferred charges". Such asset account may well be thought of as a deferred charge to operations or a prepaid operating expense similar in a great many respects to prepaid rent or insurance – charged to the operations of the period in which the services are rendered.

Carper (2002:14) stressed that the deferred-charge approach continued to find consideration support as late as 1960. This could be confirmed through definition of asset during the 1960s. Killaritseh (1960:488) considered asset as:

A new definition for the general purpose balance sheet … would make clear that (its) purpose is not to reveal the financial position, but rather it is to show the deferred charged position, but rather it is to show the deferred charges and the unconsumed or unapportioned value for future operations and their financing.

- **An All-inclusive Approach**

An all-inclusive approach to asset definition was made by the committee of terminology for the American Institute of Accountants as it was known. This committee defined asset as:

Something represented by a debit balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting (provided such debit balance is not in effect a negative balance applicable to a liability on the basis that it represents either a property right or value acquired, or one expenditure made which has created a property right or is properly applicable to the future.

Thus, plants accounts receivable, inventory and a deferred charge are all assets in balance sheet classification (AICPA, 1953:13). In 1965, the same definition was presented in accounting research study No. 7, inventory of generally accepted accounting principles for business enterprises, published by the American Institute of Certified Public Accountants (Grady, 1965:227)

- **The Economic Approach**

The economic approach to definition of an asset considers its future service potential or economic value rather than its source of ownership or its cost applicable to future time periods. One of the earlier writers who viewed an asset from this perspective was Canning (1929:22) who defined asset as:

Any future service is money or any future service convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons such a service is an asset only to that person or set of persons to whom it runs

Later, in 1942, Nelson (1942:136) made two significant modifications to Cannings approach. He stressed that the future service of an object need to be legally or equitably secured to the entity in order to constitute an asset of that entity. Also, a distinction must be made between agents and assets.

(a) As things possessed, directly or indirectly or physical assets;
(b) As rights over things and persons for use, for services or for exchange;
(c) As incomplete contracts, where of our (the entity's) part have been performed in whole or in part or contractual assets;
(d) As the result of services previously given, or cost;
(e) As the present worth of expected services to be received;
(f) As capital for the conduct of business operations;
(g) As investment in the hands of another who uses it as capital (Sprague, 1972:47).

Accountants also began to identity certain prerequisites which an item had to meet to qualify as an asset prominent among which is that

(1) It must be a scarce resources attachable to the entity and
(2) It must be expressible in terms of money, (Sprouse and Moonitz, 1962:8).

Viewed from this perspective, an asset is further described thus:

Economic resources are those elements of wealth that posses economic value by virtue of possessing the characteristics of utility, scarcity and exchangeability and it is such items which should be recognized as assets in the balance sheet … for an economic resource to be recorded as an asset, it should also be measurable in monetary terms" (Anderson et al., 1972:48).

3. MEASURES OF CORPORATE PROFITABILITY

Corporate profitability is often evaluated by the use of profitability ratios. These ratios are used to assess the economic condition of a firm. Profitability ratios assist in measuring the returns of a firm in relation to either sales, assets or shareholders equity and are usually given in percentages. Profitability ratios include: Net Profit Margin, Return on Investment and Return on owners' equity, (Ikoku, 1993:42-43).

- **Net Profit Margin**

The net profit margin measures the return per financial value of sales and indicates managements' efficiency in manufacturing, administering and selling its products. Net profit margin is expressed as net profit divided by sales. If the net profit margin is relatively low it may imply management's inability to manage its activities efficiently. A high ratio is more desirable.

- **Return On Investment (ROI)**

Return on investment measures the efficiency with which a firm has utilized the total funds provided by the creditors and owners of the firm in generating profit. Here total capital or funds employed could be measured by total assets. Therefore the ratio is expressed as net profit divided by total assets; the higher the ROI the better for all capital suppliers.

- **Return on Owners Equity (ROE)**

Return on owners' equity relates with return to owners' capital, and it is one of the important measures in financial analysis. It indicates how efficiently a firm has used the resources of the shareholders. The ratio is computed by dividing net profit by shareholders' equity. A low ratio may imply management is not satisfying its function and main objective of maximizing the owners' wealth. A high ratio is most desirable.

A close look at the three measures of corporate profitability shows that corporate profitability can be calculated in several ways. In each case a measure of profits (or capital income) is in the numerator and the denominator varies: Dividing by sales generates profit margins, dividing by shareholders equity produces return on equity, while dividing by total capital produces return on capital. Fox News Video (2004:3) emphasized that return on capital is the measure emphasized for several reasons, some of which are:

(1) From an investor's viewpoint, what matters most is how much earnings are being generated relative to invested funds – either total capital or equity. Margins may be useful for competitive and cyclical perspective, but what investors care about is how productive their assets are.

(2) While an equity holder will want to know return on equity, the ability to generate return on total capital financed by both equity and debt provides the starting point

(3) Changes in inflation and accounting rules have periodically distorted conventional measures.

To distinguish between return on investment and return on equity it is essential to note the following observations as espoused by Lynch (1967:325). The assets available to management typically derive from three sources: creditors, owners (direct investment) and retained earnings. The last two sources reflect claims by owners on the assets of the business. Capital from borrowers ordinarily is repaid with a return calculated at a contractual rate in the form of interest. Management uses the assets from all sources to carry on the operations of the business; a borrowed fund buys as much as one belonging to the owners.

Management must first maximize its return from its operations on all the assets used before the residual return to shareholders can be maximized. Hence, management has come to recognize that the relationship of profit from operations to the total assets used is an extremely important gauge of effectiveness of its performance in the pursuit of the ultimate economic goals. Performance can be measured by the ability to increase the ratio of the assets returned to the amount of assets used. This measure is variously and commonly referred to as the return on investment (ROI), Return on Asset used (ROA), Return on Capital Employed (ROCE), Return on Net Assets (RONA) (Lagerstrom, 2002:27).

Return on investment depicts the effectiveness of all the operative decisions, from the routine to the critical made by management at all levels of the organization from shop foremen to the managing director (Lynch 1967:326). On the other hand, return on equity concentrates on the returns due to equity shareholders only. It excludes debt capital since preferred stockholders receive a fixed return. Using ROI, the company's financial performance is assessed from the perspective of its total financial base – liabilities plus equity or simply total assets (Wild, et al, 2001:583)

4. HUMAN ASSET ACCOUNTING AND CORPORATE PROFITABILITY

Realizing the importance of human asset accounting treatment (HAAT), many researchers in UK (e.g. Wall, 2002:25; Collier, 2001:437; Wall et al, 2002:320) and many in Scandinavia (e.g. Johnson et al, 2001a:718 and Mouritsen et al, 2001b:735) have carried out intensive research on various aspects of HAAT. One of the best examples is that of the Denmark Government. The Danish ministry of business and industry has issued a directive that with effect from the trading year 2005, all companies registered in Denmark will be required to include in their annual reports information on customers processes and human asset.

A minimum of five measures for each is required and comparison with the previous two years must be shown. Figure for investment in human asset must be shown and compared with the previous two years. A narrative should accompany each set of figures. Information for investors about human asset both current and future should occupy at least one third of the report. In India, there are also few companies like Bhel, Inlosys and Reliance Industries, which have implemented HAAT and some are working on it (Roslender and Fincham, 2003:383).

Despite these upsurges in the development of HAAT and the attendant benefit, it does appear that companies in Nigeria are yet to embrace the full concept of it. Some of the reasons that prevent companies from including human asset in the balance sheet include numerous attempts to measure or value human capital over the last two decades, which, have ran into the difficult problem of pricing such assets (Strassman, 1998:26). This problem taught practitioners that the value of human asset is in its use not in its costs.

It is widely understood that cost of acquiring knowledge and the profit generation potentials of such knowledge are unrelated. This accounts for why attempts to include human asset in the balance sheet have failed (Seetharaman et al 2002:133). There seems to be more problems in capitalizing human assets in the financial statements than expected. There is the uncertainty surrounding the possibilities to realize assets that are capitalized at cost (Carper, 2002:13). If human assets were capitalized on economic value (future discounted cash flow) then another set of problems would emerge. Prominent is the subjective nature of the cash flow projections, which is strongly dependent on changes in interest rates, inflation and future outlook.

Despite all these difficulties a few companies have measured and reported on their human asset especially in Europe. Research carried out by Leadbeater and Demos in the UK revealed that methods used to measure human assets depend on which user group the report is for. Leadbeater and Demos (1999:6) opined that for internal user such as managers, they would like to have more information, which allows human asset to be managed more effectively. Therefore for them a new range of performance measurement and internal corporate reporting which attempts to link financial performance such as cash flow to intangible drivers such as employees quality and morale, customer satisfaction and so on, are sufficient.

5. CONCLUSION

By investing in human asset, companies improve on production efficiency of product or service quality and product differentiation thereby obtaining strategic competitive advantages (Ruchalla, 1997:20). The definition of uniqueness varies in accordance with different industrial sector. But the model provides a guide on how to differentiate between human asset investment and human asset expenses. Many chief executives have had to cut expenses associated with important human asset investment because of the wrong notion that they are expenses that should not be allowed to exceed the limit permitted by available funds for the particular financing year.

However, from the perspective of the definition of human asset, if these human capital accounting items are presented as assets and disclosed in companies' annual reports and categorized as notes to financial statements, the applicability and comprehensiveness of information provided by companies will be enhanced. A company can lose its competitiveness when making cost reduction decision by cutting down on human asset investment instead of human asset expenses, such action could lead to depletion in human asset of the company. The organization effectiveness in performance can be better assessed when human asset investment can be correctly identified and measured.

From the foregoing, the current method of relegating all the company's inputs in human resources to expenses is misleading. This is because it does not separate human capital investment from human capital expenses. Human capital investment relates to the long-term value creation aspirations of organization. It therefore needs to be identified measured and reported appropriately in the books of account. Wrong accounting reporting of human asset investment and human asset expenses will surely distort reported corporate profit. Consequently, there is the need to provide an alternative method capable of capturing the distinction between human asset investment and human asset expenses with the view to measuring their effectiveness in terms of corporate profitability. This is the focus of this study.

REFERENCES

Brummet, R. L. (1970): Accounting for Human Resource: The New York Certified Public Accountant, July, pp. 550 – 51

Canning, J. B. (1929): The Economics of Accountancy (New York): The Ronald Press Company

Carper, W. B. (1973): An Inquiry into the Nature of Accounting for Human Resources and the Feasibility for CPA Firms: A Dissertation (Tuscaloosa A. L.: The University of Alaba)

Carper, W. B. (2000): Harmonization of International Accounting Standard: The Urgent Need for Improved Accounting for Human Resources and the Environment. The American University in Cairo

Carper, W. B. (2002) :The Early Development of Human Resource Accounting Including the Impact of Evolving Asset Valuation Theory: A Manuscript Submitted to Ninth World Congress of Accounting Historians, Deakin University Melbourne Australia

Chen, H. M. and Lin, K. J. (2003): The Role of Human Capital Cost in Accounting Taipei, Taiwan, Tani Kang University Graduate Institute of Management Sciences.

Collier, P. M. (2001): Valuing Intellectual Capacity in the Police" Accounting Auditing and Accountability Journal, Vol. 14 No. 4, pp. 437 – 55

Esquerre, P. J. (1919): The Applied Theory of Accounts (New York), The Ronald Press Company, p. 136

Fox News Vidoe (2004): Saas Solution Provides Insight into Corporate Profitability http://www.bized.co.uk

Gilman, S. (1939) : Accounting Concepts of Profits, New York: The Ronald Press Company

Grady, P. (1965): Inventory of Generally Accepted Accounting Principles for Business Enterprises, New York: American Institute of Certified Public Accounts, p. 227

Hatfield, H. R. (1920): Modern Accounting, New York: D. Appleton and Company, p. 73

Hermanson, R. H. (1964): Accounting for Human Resources The Journal of Accountancy, December, pp. 62 – 66

Ikoku, C. C. (1993): Financial Statement Analysis and Interpretation for Alert Investors. Owerri, African Educational Services. Pp 42-43

Johnson, U.; Martensson, M. and Skoog, M (2001a): "Measuring Change Through The Management Control of Intangibles" Accounting Organizations and Society, vol. 26 Nos. p. 718

Kieso, D. E. and Weygandt, J. J. (1992): Intermediate Accounting, 7th Edition, John Wiley and Sons, New York

Killaritsch, F. P (1962): "Can the Balance Sheet Reveal Financial Position" The Accounting Review, July

Largerstrom, M. (2002): "Performance Measurement and Management Control Systems" Profit-Oriented Hogskolan Lunds University. Pp 1-64

Leadbeater, C (1999): "New Measures for the New Economy" Demos, Available at: www.oecd.org, June

Likert, R. (1967): The Human Organization: Its Management and Value, New York, McGra-Hill Book Company

Lynch, R. M. (1967): Accounting for Management: Planning and Control. New York. Mcgraw-Hill Inc. pp. 325-327

Mouritsen, J.: Larsen, H. T. and Buch, P. N. D. (2001a): "Intellectual Capital and The Capable Firm" Narrating Visualizing and Numbering for Managing Knowledge Accounting Organizations and Society, Vol. 126 No. 5, 7/8, pp. 735 – 62

Nelson, E. G. (1942) "The Relation between the Balance Sheet and the Profit and Loss Statement" The Accounting Review

Paton, W. A. and Littleton, A. C. (1940): "An Introduction to Corporate Accounting Standards Evanston, IL: American Accounting Association, p. 25

Paton, W. A. and Stevenson, R. A. (1922): Principles of Accounting, New York: The Macmillan Company, p. 18

Roselender, R. and Fincham, R. (2003): "Intellectual Capital: Who Counts, Controls Proceedings of the Third Critical Management Studies Conference, University of Lancaster

Ruchala, L. V. (1997): "Managing and Controlling Specialized Assets" Management Accounting, Vol. 79 No. 4 pp. 20 – 24

Schmidt, L. A. and Bergstrom, W. N. (1952): Fundamental Accounting, Chicago: Richard D. Irwin Inc. p. 7

Seetharaman, A.; Soria, H. H. B. Z. and Sara Vanan, A. S. (2002): Intellectual Capital Accounting and Reporting in the Knowledge Economy Malaysia, Journal of Intellectual Capital, Vol. 3 No. 2 Emevald Publication, pp. 128 – 148

Sprague, C. E. (1972): The Philosophy of Accountants. Karsas Lawrence: Scholars Book Co. pp. 47 – 8

Strassmann, P. A. (1998): "The Value of Knowledge Capital" Available at: www.strassmann.com, March.

Taylor, P. J. and Glautier, M. W. E. (1974): Accounting Information and Industry Relations Social Implications and Costs and Benefits Implications

Wall, A. P.; Kirk, R. and Martin, G. (2002): Intellectual Capital – Measuring the Immeasurable Report to the Chartered Institute of Management Accountants, London

Westphalen, S and Nychas, C. (1998): "Human Resource Accounting: Interest and Conflict" CEDEPOP Ponorama, 508

Wild J. J. Bernstein, L. A. and Subramanya, K. R. (2001): McGraw-Hill Irwin, pp 580-588

Winter Mantel, R. E. and Mattimore K. L. (1997): "In the Changing to Mission" Human Resource Management, Vol. 36 No. 3, pp. 337 – 42.