

## HUMAN RESOURCE ACCOUNTING MODEL IN INDIAN INDUSTRIES

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### Abstract

*Human Resource Accounting (HRA) involves accounting for expenditures related to human resources as assets as opposed to traditional accounting which treats these costs as expenses that reduce profit. Interest and contributions to growth in HRA have been evident in a number of countries. Since the beginning of globalization of business and services, human elements are becoming more important input for the success of any corporate enterprise. It helps the management to frame policies for human resources. Human resource accounting is a process of identifying and measuring data about human resources. Measurement of the investment in human resources will help to evaluate the charges in human resource investment over a period of time. HRA is not a new issue in the arena of business. Economists consider human capital as a production factor, and they explore different ways of measuring its investment in education, health, and other areas. Accountants have recognized the value of human assets for at least 70 years.*

**Keywords:** Human Resource Accounting Model, Measurements of HRA, Methods of Valuation of Human Assets, Advantages, Problems.

### INTRODUCTION

The past few decades have witnessed a global transition from manufacturing to service based economies. Human elements are becoming more important input for the success of any corporate enterprise. It helps the management to frame policies for human resources. Human resource accounting is a process of identifying and measuring data about human resources. It means accounting for people as an organizational resource. It involves measuring the cost incurred by an organization to recruit, select, hire, train and develop human assets and also involves measuring the economic value of people in the organization. It is concerned with

measurement of cost and value of people in the organization.

Human resource accounting (HRA) is one of the latest concepts adopted by Indian companies in recent times. Most of the enterprises which follow HRA spare a separate section in their annual reports for a detailed account of their human resources. Human asset reporting in India 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. In every business concern physical assets as well as human resources are required for its success. Physical assets like plants, machinery, building etc. are unproductive without human resources.

In the present context, most of the organizations have realized that human resources are their most precious resources. Therefore, they have not only taken measures to develop their human resources but also taken measures to value these resources. This is happening throughout the world including India. Many Indian companies have taken steps for the valuation of their human resources. For example, Infosys Technologies valued its human resources in 1995-96 which was Rs. 184 crores, much more than the value of its physical assets of Rs. 84 crores. Similarly, Balrampur, Chini valued its human resources at Rs. 10.43 crores and BPL Limited at Rs. 125.44 crores. There are numerous such examples. Human resource accounting provides tools for valuation of human resources and measures to take appropriate actions.

Financial accounting has developed various tools that largely measure activities and their results in such areas as costs, profit, etc.; these do not make attempt to measure the value of human assets, more important than financial assets, which make the most difference in the ultimate results. In order to bridge this gap, behavioural scientists have made attempts to measure the value of human assets. An early attempt was made by Likert and Browsers (1969). This attempt was further extended by others to give some concrete shape which has generated human resources / asset accounting. Flamholtz (1974), who has done considerable work in the

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area of human resource accounting, has defined it as follows:

“Human resource accounting is accounting for people as an organizational resource. It involves measuring the costs 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 organizations”.

American Accounting Association (1980) has defined human resource accounting as follows:

“Human resource accounting is the process of identifying and measuring data about human resources and communicating this information to interested parties”

Thus, human resource accounting is primarily involved in measuring the various aspects related to human assets. Its basic purpose is to facilitate the effective management of human resources by providing information to acquire, develop, retain, utilize, and evaluate human resources.

### **HRA - Objectives**

The more specific objectives of human resources accounting are as follows:

- To provide cost-value data for managerial decision regarding acquiring, developing, allocating, and maintaining human resources so as to attain cost-effective organizational objectives.
- To provide information to monitor the effectiveness of human resource utilization.
- To provide information for determining the status of human asset whether it is conserved properly; it is appreciating or depleting.
- To assist in the development of effective human resource management practices by classifying the financial sequences of these practices.

### **HRA - Measurements**

It is known facts that measurement is the process of representing the properties or qualities of objects in numerical terms. But 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 usually employed for this are:

#### **Cost Approach**

It involves methods based on the costs incurred by the company, with regard to an employee. Cost is a sacrifice incurred to obtain some anticipated benefit or service. The various methods of measurements of costs and valuation of human resources are Historical cost method, Replacement cost method, Standard cost method, Present value of future earnings method, Expected realisable value method and Economic value method.

#### **Economic Value Approach**

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 assets and tries to identify the stream of benefits flowing from the asset. The value of an object, in economic terms is the present value of the services that it is expected to render in future. The methods for calculating the economic value of individuals are Lev and Schwartz (1971) model, Eric Flamholtz (1974) model, Jaggi-Lau's model. Of these Lev and Schwartz model become popular. According to this model, the value of human capital represented by a person of age is the present value of his remaining future earnings from his employment. They have given the following formula for calculating the value of an individual. According to this model, the value of human capital embodied in 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-

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

Where,

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

T = the person's retirement age.

Py (t) = probability of the person leaving the organization.

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

R = discount rate.

Most, companies adapt this model to their practical requirements by making necessary alterations. For instance, different organizations use different discount rates for ascertaining the present value of future cash flows.

Thus, the model identifies an individual's expected economic value to the organization to his future earnings for his remaining active service life. His future expected income stream is discounted by an appropriate rate to arrive at the present value of his services. Thus, the model identifies an individual's expected economic value to the organization to his future earnings for his remaining active service life. His future expected income stream is discounted by an appropriate rate to arrive at the present value of his services. Besides this formula Dr. M. Singh (2008) has given his contribution is calculating present value of human resources as follows:

$$PV (r) = \frac{RC + FC + DC + JC + P(Le + Og)}{ESP}$$

Where,

PV (r) = present value of human asset.

RC = recruitment cost.

FC = familiarization cost.

DC = development cost.

JC = job cost.

ESP = expected service period.

P(Le+Og) = probability for loss of efficiency of human resources and for outgoing of the employees.

Human Resource Accounting model consists of two aspects namely:

- a) The investment made in human resources.
- b) The value human resource.

As far as the statutory requirement go, the Companies Act, 1956 does not demand furnishing of HRA related information in the financial statement of the companies. The Institute of Chartered Accountants of India too, has not been able to bring any definitive standard as measurement in the reporting of human resource costs. But there is little organization, however, that does recognize the value of their human resources and furnish the

related information in their annual reports. In India, some of the companies are: Infosys, Bharat Heavy Electrical Limited (BHEL), Steel Authority of India Limited (SAIL), Minerals and Metals Trading Corporation of India Limited (MMTC), Southern Petrochemicals Industries Corporation of India, Associated Cement Companies Limited, Madras Refineries Limited, The Hindustan Zinc Limited, The Oil and Natural Gas Commission, The Cement Corporation of India Limited, etc.

## **METHODS OF VALUATION OF HUMAN ASSETS**

There are a number of methods suggested for the valuation of human assets. Many of these methods are based on the valuation of physical and financial assets while others take into account human consideration. Major methods of valuation of human assets are historical cost, replacement cost, standard cost, present value of future earnings, and expected realizable value.

**Historical Cost:** Historical cost is based on actual cost incurred on human resources. Such a cost may be of two types – acquisition cost and learning cost. Acquisition cost is the expense incurred on recruitment, selection, and placement. While calculating the cost of recruitment and selection, entire cost is taken into consideration including incurred on those who are not selected. Learning cost involves expenses incurred on training and development. This method is very simple in its application but it does not reflect the true value of human assets. For example, an experienced employee may not require much training and, therefore, his value may appear to be low though his real value is much more than what is suggested by historical cost method.

**Replacement Cost:** As against historical cost method which takes into account the actual cost incurred on employees, replacement cost takes into account the notional cost that may be required to acquire a new employee to replace the present one. In calculating the replacement cost, different types of expenses are taken into account which may be in the form of acquisition and learning cost. Replacement cost is generally much higher than the historical cost. For example, Friedman (2000) has estimated that the replacement cost of an executive in middle

management level is about 1.5 to 2 times the current salary paid in that position. Replacement cost is much better indicator of value of human assets though it may present certain operational problems. For example, true replacement of a person may not be found easily with whose cost whose cost the valuation is done.

**Standard Cost:** Instead of using historical or replacement cost, many companies use standard cost for the valuation of human assets just as it is used for physical and financial assets. For using standard cost, employees of an organization are categorized into different groups based on their hierarchical positions. Standard cost is fixed for each category of employees and their value is calculated. This method is simple but does not take into account differences in employees put in the same group. In many cases, these differences may be quite vital.

**Present Value of Future Earnings:** In this method, the future earnings of various groups of employees are estimated up to the age of their retirement and are discounted at a predetermined rate to obtain the present value of such earnings. This method is similar to the present value of future earnings used in the case of financial assets. However, this method does not give correct value of human assets as it does not measure their contributions to achieving organizational effectiveness.

**Expected Realisable Value:** The above methods discussed so far are based on cost consideration. Therefore, these methods may provide information for record purpose but do not reflect the true value of human assets. As against these methods, expected realizable value is based on the assumption, and this is true also. That there is no direct relationship between costs incurred on an individual and his value to the organization at a particular point of time. An individual's value to the organization can be defined as the present worth of the set of future services that he is expected to provide during the period he remains in the organization. Flamholtz has given the variables affecting an individual's expected realizable value (IERV): individual conditional values and his likelihood of remaining in the organization. The former is a function of the individual's abilities and

activation level, while the latter is a function of such variable as job satisfaction, commitment, motivation, and other factors as shown in the figure-1:

### **HRA - Advantages**

Many organizations, particularly in the USA, are following the human resource accounting approach. In our country, too, there is a need for establishing systems which can generate monetary and non-monetary information about human beings in the organizations, particularly about managerial talents whose dearth is felt by business organizations. This is due to the fact that human resource accounting offers following advantages:

- It helps in giving valuable information to the management for effective planning and managing human resources.
- It helps in measurement of standard cost of recruitment, selecting, hiring, and training people and organization can select a person with highest expected realizable value.
- Human resource accounting can change the attitude of managers completely, thereby; they would try to maximize the exempted value of human resources and effective use of human resources in the organization.
- It also provides necessary data to devise suitable promotion policy, congenial work environment, and job satisfaction to the people.

### **HRA - Problems**

There are certain operational problems in human resource accounting because it attempts to measure intangibles. Therefore, subjective factors may play crucial role. Thus, the major operational problems involved in human resource accounting are of the following types:

- There is no well-set standard accounting practice for measuring the value of human resources. In the case of financial accounting, there are certain specified standards which every organization follows. However, in the case of human resource accounting there are no such standards. Therefore, various

organizations that adopt human asset valuation use their own models. With the result, value of human assets of two organizations may not be comparable.

- The valuation of human assets is based on the assumption that the employees may remain with the organization for certain specified period. However, this assumption may not hold true in today's context because of increased human resource mobility.
- There is a possibility that human resource accounting may lead to the dehumanization in the organization if the valuation is not done correctly or results of the valuation are not utilized properly.
- There is also a possibility that trade unions may oppose the use of human resource accounting. They may want parity of wages/salaries with value of employees.

However, many of these problems are of operational nature or if attitudinal nature. These may be overcome by developing suitable organizational climate and culture.

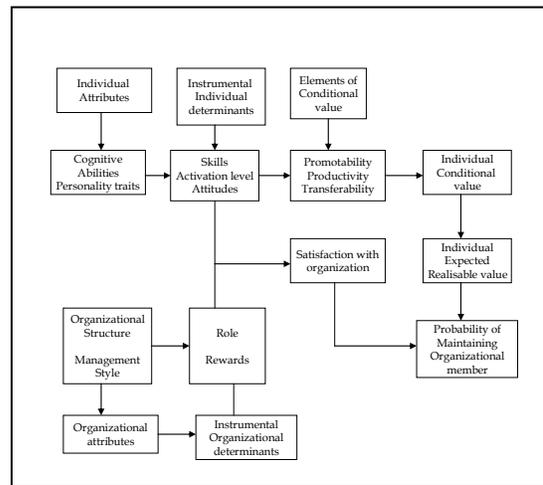
## **CONCLUSION**

Human resource accounting provides information about the value of human assets, which helps the top management to take decisions regarding the adequacy of human resources. The concept of human resource accounting is yet to gain momentum in India. For the betterment of the organizations, it is necessary to evaluate the worth of human resources in a systematic manner and record the information related to them in the financial statement of the organization to communicate their worth time to time to the users of the financial statement. When proper valuation and accounting of the human resources is not done then the management may not be able to recognize the negative effects of certain

programmes, which are aimed at improving profits in the short run. If not recognized on time, these programmes could lead to a fall in productivity levels, high turnover rate and low morale of existing employees. The HRA concept itself represents a new way of thinking about people as assets. It has a great potential for future organization to understand the value of human forces and the same should be mentioned in the financial statements.

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**Figure-1:** Model of the determinants of an individual's value to an organization