

**PUTTING THE PEOPLE COMPONENT
OF THE
BUSINESS ENTITY
ON THE
BALANCE SHEET**

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INTRODUCTION

“Finally, I would like to thank all our loyal employees who made these outstanding results possible. Our people are our greatest asset.” How many times have these words or similar words appeared in the Chairman’s Report? **Our greatest asset.** The closest our greatest asset will get to the balance sheet is if an employee happens to be a professional soccer player whose registration was acquired from another club for a fee. Even then it is not the player; it is his registration that is treated as the asset in the financial statements. Why is it that the human asset is not reflected on the balance sheet of the enterprise? Is it custom and practice? Is it because of an accounting standard or convention? Is it because as yet a suitable valuation method has not been devised? Is it because of an aversion to placing a monetary value on humans? Is it because employees are considered to be expendable? Would it serve any useful purpose to reflect human assets (and human capital) in financial statements? This paper considers these questions and suggests three possible formulations as to how this may be achieved.

EMPLOYEES AS HUMAN ASSETS

It has been suggested that Chairmen’s references to employees as the “company’s greatest assets” is nothing more than a figure of speech, not to be taken literally. This may be so but surely the chairman sees the employees as having some sort of capital value, otherwise it would be a pointless remark. In some cases it is perhaps a little bit over the top and is said with tongue in cheek but there are many chairmen who strongly and sincerely do see the employees of the company as the company’s major asset. Rensis Likert, a social psychologist and early pioneer of human resource accounting advocated its inclusion in the formal accounting system. As a

minimum measure it was suggested that outlays on recruiting and training managers should be capitalised and then amortised over the expected useful lives of the employees. (Horngren 1972:157). Few companies have heeded his call but, nevertheless, the Barry Corporation, a manufacturer of leisure footwear in Columbus, Ohio, U.S.A. produced an ancillary statement to its 1969 financial statements showing investments in human resources similar to Likert's advocated minimum measure. Whilst such accounting puts something on the balance sheet, it is somewhat insignificant in relation to the value of the total human asset of the enterprise. It has been argued by some accountants that since employees are not **owned** by the company and that the balance sheet purports to reflect what a company owns, it would be wrong to include employees as an asset, even if it were possible to place a value on the human asset. But is the balance sheet an exposition of what a company owns or what the company as an entity is worth? Marx divided society into labour and capital, which he saw as antagonists and thereafter business has been a dichotomy. Is not the business enterprise a synthesis of labour and capital, rather than a conflict, that needs to be expressed as such in accounting terms? Economist Ralph Turvey (1971:70) describes a balance sheet as an extraordinary historical hodge-podge, reflecting the history of the company, the development of inflation and the wisdom of the Inland Revenue about the depreciation appropriate for tax purposes. Presumably if the gobbledegook on one side equals the gobbledegook on the other then presumably everybody is happy. Some economists, including John Stuart Mill (Schultz 1961), have asserted that people should not be considered as assets, because assets exist for the service of people and to treat people as assets themselves demeans them. But is not the human the **sublime** asset, greatly superior to the machine because, relatively speaking, even the unskilled worker has a versatility no machine can match? On any sensible analysis employees are usually the largest single element of operating costs, the organisation's main source of innovation, improvements, consumer service and competitive advantage (Johanson & Larsen 2000:170). The sheer magnitude of the human asset makes its quantified inclusion on the balance sheet very compelling. There are those who believe a balance sheet

should reflect what an enterprise is worth in terms of current values and should also reflect premiums such as goodwill on acquisitions, which when written off deplete the shareholders funds. What these individuals are looking for is the determination of a meaningful denominator to form the basis of the key ratio, **return on capital employed**. On the other hand there are others who believe in writing off as much as possible, particularly in years where profits are high, so that subsequent years show an improved return on capital employed. It is obvious that the lower the reported capital employed, the higher will be the return on capital employed and “brownie points” are earned by high returns on capital employed. Such creative accounting practices, where the intent is to make the management of the company appear to be more competent or professional, borders on fraud, according to Trener (1996:157). With the onset of information technology, companies have emerged with very little capital employed and high profit that makes nonsense of the return on capital employed ratio. The only assets such companies have are the “human assets” that do not appear on the balance sheet. If nothing else, a simple reason for developing the concept of human asset/human capital is to make the return on capital employed more meaningful.

DEFINITION OF AN ASSET

The accounting definition of an asset is important in the context of human resource accounting and perhaps goes some way towards explaining why accountants have not given very much attention to the subject and why most of the research has been undertaken by sociologists and human resource specialists. The definition of an asset in the context of generally accepted accounting practice is:

“...rights or other access to future economic benefits **controlled** by an entity as a result of past transactions or events.” This means that the ability to enjoy benefits does **not necessarily imply an ownership interest**, and the phrase “rights or other access” is sufficiently broad enough to imply that the benefits may be uncertain (Davies, Paterson & Wilson: 1997:97). The key word in

this context is **control**, which means the ability to obtain economic benefits and **restrict the access of others**. The idea of a human asset appears to meet the definition except for the control issue, which becomes debatable. It can be argued that since the employee is free to leave the entity, the control criterion is not met, thus future benefits are not assured, and therefore the employee fails the asset test. A countervailing argument is that whilst future benefits are not assured they are nevertheless probable, since employees and employers enter into a business relationship with the intention of it being for some considerable time into the future and in most instances this is the case. If the human asset is referred to collectively the control definition is perhaps more likely to be satisfied, since access to this large aggregation would be restricted, control being effected by the entity being able to replace employees who leave and discard employees not required. The entity therefore has almost **total control** of the human asset in its collective form, since it can shape and structure it to suit the entity's requirements. Whether human asset accounting stands or falls on this definition of control, which goes into the definition of an asset, ought not be an issue. The magnitude of the people component of the entity is such that it is essential for it to be recorded and properly understood through conceptualising it as an asset and including it in the financial statements. The definition per generally accepted accounting practice might therefore be made more flexible to accommodate the argument advanced earlier or a revised definition could be compiled. Whilst accounting standards are essential for consistency and uniformity and are generally well reasoned, they are not tablets of stone; they sometimes need to be reconsidered and amended. To dig in based on this definition of control frustrates progress towards recognising and acknowledging in an accountancy sense the importance of the people component in the entity.

DEFINITIONS OF THE HUMAN ASSET AND HUMAN CAPITAL

For purposes of developing the concept of human asset/capital accounting, the following definitions will be used. They are by no means exhaustive and if they can be improved upon it will be useful. They nevertheless put the proposed models into context.

- Human asset is the total value to an enterprise of its employees, plus the value of any other assets owned by the company for the exclusive benefit of employees.
- Human capital is the equivalent of the total value to an enterprise of its employees.

The concept is based on the premise that human capital is owned by the employees and is rewarded by remuneration and employee benefits, in much the same way as loan capital is rewarded with interest. Alternatively, employee remuneration and benefits are the equivalent of amortisation or rent, which can be used to calculate human asset. The enterprise has control over but not ownership of the human asset.

ARRIVING AT HUMAN ASSET/CAPITAL VALUES USING FINANCIAL MODELS

Much of the academic work in this field has been via the human resource management specialists and sociologists rather than the accountancy discipline. According to Meyer (1980:148) there is no provision within generally accepted accounting principles for the disclosure of human assets *per se* unless they are acquired by purchase. Meyer also makes the point that “the very concept (of human asset accounting) raises the question whether conventional financial statements’ portrayal of economic resources may be ignoring the most vital resource an organization possesses.”(1980:149). Accountants have, however, found ways to recognise the human asset in special circumstances, such as accounting for the registrations of professional soccer players (Szymanski & Kuypers: 1999:197), accounting for patents, copyrights and other intangible assets, within the framework of generally accepted accounting practice (FRS 10). However those responsible for creating accounting standards have not seen fit to devise a standard for human asset/capital accounting, rather their rationale has been to justify opposition to it.

In 1971 Flamholtz proposed a model that would trace the movement of an employee through organisational positions, providing a specified quantity of services in a specified time period.

Also in 1971, Lev and Schwartz proposed a model to determine the individual's economic value as the present worth of a person's earnings over their useful life (adjusted for the probability of mortality).

In 1973 Morse evaluated and synthesised these models producing a model of greater complexity. This synthesising model is of particular interest since it is a direct attempt to value the human assets in a formal organisation. It is as follows:

What must be obvious is the complexity and abstract nature of this type of model, the seriousness of the research and the unlikelihood of accountants being able to use them to put a human asset on the balance sheet of a company, because of their impracticality in the sense of being reasonably easily understood. This is not to detract from the excellence of the work of Flamholtz and others, who were not prescribing that accountants should use their models or variants of them to add a dimension to balance sheet accounting. Nevertheless it is possible to theorise along more simple lines. As Edward de Bono observes "There is never any justification for things being complex when they could be simple." (1998:16). With this in mind three models are proposed:

- Calculation of human capital by treating the annualised cost of the human resource as interest and assuming that the cost of human capital is the same as the cost of financial capital. (Model 1)
- Calculating the cost of the human asset by applying the period of the average working life of all employable people in the country (and further assuming that such people are on average at the mid point of their working lives) to the annualised cost of the human resource. (Model 2)
- Calculating the cost of the human asset by applying the period of the average working life of all people in the service of the specific entity to the annualised cost of the human resource. (Model 3)

Model 1

$$H = \frac{A}{C}$$

Where H = Human capital

A = Annualised human resources cost as at the balance sheet date

C = Cost of capital expressed as a percentage

Putting some figures to the model, if the annualised human resources cost at the balance sheet date is R1 000 000 and the cost of capital is 15% then,

$$\begin{aligned} H &= \frac{1\,000\,000}{0.15} \\ &= R6\,666\,667 \end{aligned}$$

Model 2

$$H = (A) \left(\frac{T}{2} \right)$$

Where H = Human asset

A = Annualised human resources cost as at the balance sheet date.

T = Average working life of any employed person.

Putting some figures to the model and supposing the estimated average working life of any employed person is 17 years, then

$$H = \frac{(1\,000\,000)(17)}{2} = R8\,500\,000$$

Model 3

$$H = (A)(T)$$

Where A = Annualised human resources cost as at the balance sheet date.

H = Human asset

T = Average working life of an employee in the service of the specific entity.

Using the example as before and, assuming that the average time an employee spends in employment with the enterprise is 5,5 years, then

$$H = (1\,000\,000)(5.5) = R5\,500\,000$$

REVIEW OF THE THREE MODELS

Each of the models gives a different answer. Model 1 raises a number of questions. Can the cost of human capital be the same as the cost of commercial capital? If not, why not? How does risk apply in this formulation? Does the entity pay a premium over and above commercial capital, because the human capital is more flexible? Does the cost of human capital vary from entity to entity?

Model 2 uses a generalised working life of an employed person and applies it to all entities uniformly. This facilitates performance comparisons between long established entities and newer entities and those entities with significant non-human assets and those with nearly all human assets such as consultancies and information technology enterprises. The ability of the entity to

retain and develop human capital is not reflected in this model, rather it is a model that enhances the use of the return on capital employed ratio.

Model 3, by using the average working life of an employee specific to the entity, gives another dimension to measuring the human asset. A stable well managed enterprise with a low turnover in employees; well-developed skills will tend to keep its employees longer. Consequently a high asset value will be reflected giving rise to a lower return on capital employed. New enterprises that have no track record or proven ability to sustain performance and retain employees will show up well because of a higher return on capital employed. The return on capital employed measure where this model is used therefore needs to be viewed and treated with circumspection. In this model the human asset still belongs to the employee but it reflects the strength of the relationship with the employer. A long average working life with the same employer is indicative of a merging of interests. It may also reflect that the employee's interest in the enterprise as a stakeholder is stronger than that of the shareholder whose interest is transitory as investments are moved around. Nevertheless, a stable well managed company with good labour relations, well-developed skills, and consistent high performance will tend to attract large institutional investors looking to avoid excessive risk.

It is necessary to be quite clear from the outset that one is not calculating a value for the human asset and human capital in order to state how valuable the company is, from the point of view of the shareholder. The shareholder does not own the human asset, although he may well benefit from it. Rather the intention is to build into the balance sheet a missing component of the business entity, which will have the effect of reducing the return on capital employed, whilst making it a more meaningful ratio and expanding its scope for comparisons of companies where the asset mix differs. The value of a company is what investors are prepared to buy its shares for (**market capitalisation**). Building into the balance sheet the human asset and the human capital

will not make the market capitalisation equal the capital components of the company, although if this concept were standardised and widely applied it could well influence market capitalisation.

OTHER FACTORS IN USING THE HUMAN ASSET/HUMAN CAPITAL CONVENTION

The schedule of employees and their earnings and related costs could be stratified in groupings based on skills, for example, or some other dimension. This would show the constituents of the Human Asset.

The Human Capital brings a third dimension into the gearing of the enterprise. Shifts in the interest rate would also have the effect of changing the Human Asset/Human Capital amounts, the lower the interest rate the higher the amounts, using the first formulation. In the second formulation the figures are less likely to fluctuate, although downsizing and expansion will obviously have an effect. Similarly changes in the average working lives of people will also have the effect of reducing the value of the asset/capital in this formulation, for example, HIV/AIDS which is predicted to bring about a huge reduction in average life expectancy in South Africa and will seriously reduce the average working life of an employee.

Fixed assets such as passenger cars and residential property provided for the exclusive use of employees could be grouped with the Human Asset category, but the corresponding capital then would be matched by shareholder's funds or loan capital depending on the manner of the financing.

WHAT WOULD THE BALANCE SHEET LOOK LIKE INCORPORATING HUMAN ASSET/CAPITAL ELEMENT?

An example of a balance sheet reflecting the people factor is presented as Appendix 1 together with a supporting schedule Appendix 2.

CONCLUSION

It is generally accepted that the human resources of an enterprise are assets in the sense that they are a major financial component of the enterprise but in financial reporting they are not identified as assets. This paper puts forward three methods of calculating and incorporating the collective human resource of an enterprise into its balance sheet, showing the constituent parts of the human asset, expanding the scope of the return on capital employed measure and, perhaps bringing into play other measures were the convention to become generally recognised. Returning again to Meyer “perhaps once substantive concepts and measurement techniques are developed, some definitive ramifications for the financial reporting may emerge as a result” (1980:149). In the meantime? Perhaps Professor John Hunt of the London Business School should have the last word. He argues that the importance of human assets in the dot-com sector (particularly since they often have very little else!) makes reliable measures of those human assets essential. In ten years’ time, he says, valuing human assets will be normal. And in a wake up call to the accounting profession, he concludes by saying that it is of marginal interest whether accountants will play a role (Price Waterhouse Coopers LLP 2001:251).

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APPENDIX 1

The XYZ Company Ltd Balance Sheet as at 31 December 2001

	R millions
Human Assets	812
Fixed Assets*	329
Net Current Assets	<u>201</u>
	<u>1 342</u>
Equity	350
Loan Capital	320
Human Capital	<u>672</u>
	<u>1 342</u>

*Excludes fixed assets forming part of human assets

Note:

Gearing: 26% Equity 24% Borrowings 50% Human Capital

APPENDIX 2

HUMAN ASSETS

	R millions
Capitalised Human Resources (Note 1)	672
Cars provided for employees	18
Residential Property	22
Employee Amenities	<u>100</u>
	<u>812</u>

Notes:

1. The capitalised human resource was calculated by multiplying the notional annualised employee remuneration and other employee costs and benefits as at the balance sheet date by the average years of service per current employee.

$$R112 \text{ million} \times 6 = R672 \text{ million}$$

2. Employee movement report

No. of employees as at 31.12.2000	38 000
Employees engaged during year	<u>2 500</u>
	40 500

Exits:

Retirements	1 700	
Dismissals	300	
Retrenchments	400	
Resignations and other	<u>1 100</u>	<u>3 500</u>

No. of employees as at 31.12.2001	<u>37 000</u>
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3. The notional annualised employee remuneration and employee costs and benefits increased by R14 million over the year and the average years of service per employee decreased by 0.2 years.

