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HUMAN CAPITAL AS AN ASSET AND FINANCIAL REPORTING

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Abstract

Though work product can be quantified and translated into salaries and wages, the value of employees is not easily reduced to numbers. To an individual investor, human capital may be the present value of all future wages; the most valuable asset that an individual owns; and the best protection against inflation. Also, with a strong professional skill set, one can usually demand a fair wage, no matter how inflated the local currency becomes. Hence, human capital can be defined as the knowledge that individuals acquire during their life and use to produce goods and services or ideas in market or non-market circumstances. An organizations human capital asset is the collective sum of the attributes, life experience, knowledge; inventiveness, energy, and enthusiasm that people choose to invest in. On the other hand, the objective of general purpose external financial reporting is to provide information that are useful to present, potential investors, creditors and others in making investment, credit, and similar resource allocation decisions. With the important role that human capital investments play in economic growth at a societal and individual level, the current accounting and reporting system should be examined.

Keywords: Human Capital, Asset, Financial Reporting, Value, Investment, Employee Training

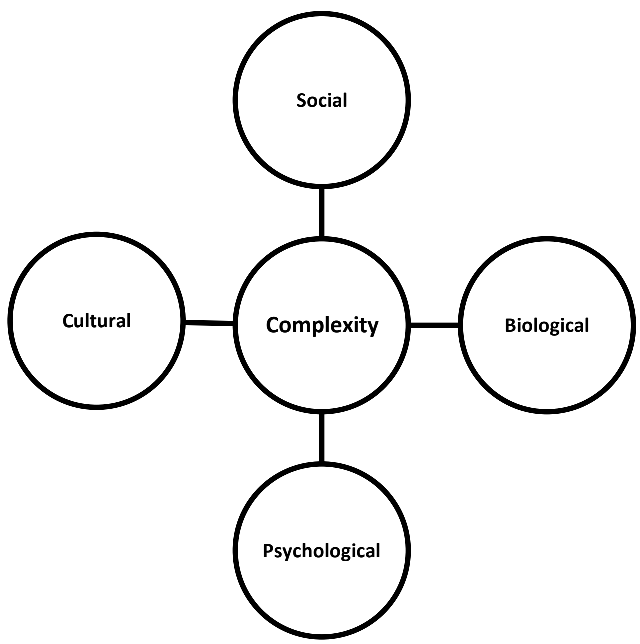
INTRODUCTION

Human capital is not actually the people of an organization, because people exercise control over human capital and are free to invest it however wanted in different aspects of lives: family, community interest groups, observance of religious beliefs, physical fitness pursuits, other outside interests, and work (Appelian, 2009).Many theories explicitly connect investment in human capital development to education, and the role of human capital in economic development, productivity growth, and innovation has frequently been cited as a justification for government subsidies for education and job skills training (Becker, Huselid, & Ulrich, 2001).An organizations human capital asset is the collective sum of the attributes, life experience, knowledge, inventiveness, energy, and enthusiasm that its people choose to invest in work. The objectives of financial reporting also entails helping existing and potential investors, creditors and other users to assess the amounts, timing, and uncertainty of prospective net cash inflows to the enterprise.

HUMAN CAPITAL

Human Capital is an aggregate economic view of the human being acting within economies, which is an attempt to capture the social, biological, cultural and psychological complexity as they interact in explicit and/or economic transactions (Schroeder, Clark, Cathey, 2011). This is depicted in Figure 1.

Figure 1: Complexities of Human Capital



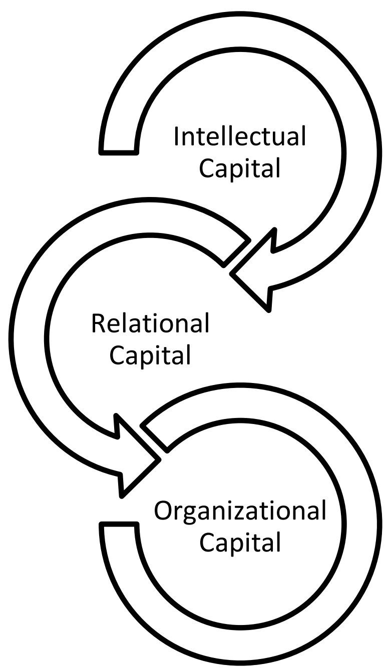
Source: Schroeder, Clark, Cathey (2011)

Human capital simultaneously represents the single greatest potential intangible asset and the single greatest potential liability that an organization will acquire as it goes about its business (Apelian, 2009). While there are other intangible assets, human capital is the only intangible assets that can be influenced, but never completely controlled, invested in wisely, or wasted thoughtlessly, and still have tremendous value. These distinguishing features are what make human capital unique, and also what makes it an indefinable asset. It is the standard of competencies, knowledge, social and personality attributes, including creativity, embodied in the ability to perform labor so as to produce economic value.

Morse (1973) noted under the proprietary and entity theories of the organization that accountants focuses more on the influence of the value of human assets, but there should be a recognition that changes in how the value of human capital affects human asset values.

Human Capital within organizations is employee capability, knowledge, innovation, adaptability, and experience' noting that it is typically represented as one element in a tripartite framework of intellectual capital, the other two being relational capital and organizational capital as shown in Figure 2.

Figure 2: Representation of Human Capital in a tripartite Framework



This suggests that there is a general under-investment in human capital; the average firm tends to invest less than the efficient amount in its people (Berkowitz, 2001).Firms started thinking of employees as investments rather than costs, and the transition continued towards full accounting of human capital investments as assets that produce returns over an extended period of time. Human capital is the accumulated present value of employee investments like salaries, benefits, and training invested on behalf of the organization. The question is how to go about putting a definitive value on that investment. Today's societies have moved from an industrial society, where the primary source of wealth was machinery, to a knowledge society, where the primary source of wealth is human capital (Apelian, 2009).

Currently, a firms' human capital investments most notably, spending on employees' development are treated as a hidden cost that is hidden in overhead usually in the general expenditure category labeled selling, general, and administrative expenses. This treatment makes information on human capital investments difficult to obtain (Becker et al., 2001). With the important role that human capital investments play in economic growth at a societal and individual level, the inability of the current accounting and reporting system to provide the necessary information should be examined. In an examination on the effects of different forms of training, it was found that the returns on technical training and basic skill training exceeded the returns on other major forms of training. This suggests that investments in human capital are especially important for firms that are making an above-average effort to leverage technological advances and/or upgrade the skills of the workforce.

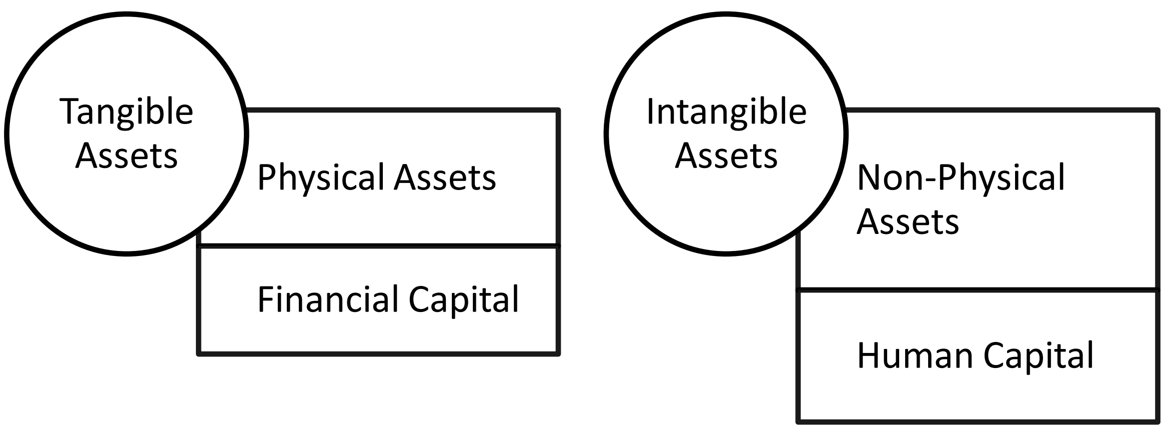
The strategic argument is that while firms as well as workers may be willing to pay for general skills training, it is expected that workers should not be willing to pay for firm-specific training. Becker (2001) and most subsequent, arguments assume that training enhances the productivity ofworkers and their firms. This means that firms are willing to invest in training workers to develop firm-specific skills that are productive at the current firm but not at other firms. Also, firms are unwilling, however, to invest in general skills training for workers because of not being able to recover investments in general skills training since workers can simply move to new firms if paid less than expected marginal value product wanted (Huggett & Kaplan, 2012).

A recent review of the literature that uses firm-level data to identify the impact of human capital investments on firm performance concludes that increasingly, studies provide evidence that training generates substantial gains for employers. If training activity by firms generates economic returns then it should ultimately be reflected in the firm's equity valuation. The value that the stock market attaches to firm training activities should arise regardless of the channel of how training affects productivity through increased output per worker, reduced costs per worker, improvements in worker morale, reductions in turnover, or improved use of technology (Huggett & Kaplan, 2011).

DEFINITION OF AN ASSET AND TRAINED EMPLOYEES

In financial accounting, assets are economic resources, tangible or intangible capable of being owned or controlled to produce value and held to have positive economic value, and trained employees meet this definition. This means that assets represent value of ownership that can be converted into cash, but cash is not an asset (Becker et al., 2001). A firms' balance sheet records the monetary value of the assets owned by the firm. For example, money and other valuables belonging to an individual or business. The two major asset classes are tangible assets and intangible assets. Tangible assets contain various subclasses, including current assets and fixed assets. Current assets include inventory, while fixed assets include buildings and equipment. Intangible assets are nonphysical resources and rights that have a value to the firm because of the advantages derived in the market place. Some examples are: goodwill, patents, human capital. Intangible assets have been argued to be one possible contributor to the disparity between company value as per accounting records, and company value as per market capitalization (Cohn, 2011). This is depicted in Figure 3.

Figure 3: Defining Assets



Source: Cohn (2011)

Schroeder at al. (2011) explains an intangible asset as an asset, other than a financial asset, that lacks physical substance. The lack of physical substance would therefore seem to be a defining characteristic of an intangible asset, which specifically excludes monetary assets. This is necessary in order to avoid the classification of items such as accounts receivable, derivatives and cash in the bank as an intangible asset. However, tangible assets are financial assets or financial capital such as cash and marketable securities. Physical assets include such tangible assets as property, plant and equipment, and other furnishings.

SUGGESTED ACCOUNTING TREATMENT OF THE VALUE OF TRAINED EMPLOYEES

Organization for Economic Co-operation and Development (OECD) (1998)suggests that human capital helps to focus on the productive capacity arising from knowledge and the utility of improving the methods for assessing the productive capacity of human capital. Human capital accounting is a method of systematically identifying, measuring and presenting information about the human resources of an organization (Apelian, 2009). It is related to and sometimes confused with other concepts such as: intellectual capital, intellectual potential, knowledge management, human resources accounting (HRA), human capital management (HCM), intangible investments and or intangible assets which range from the intellectual property rights of patents, trademarks, copyright and registered design through contracts.

Also, OECD (1998) noted that firms do not have the capabilities or financial means to pursue assessments that are often imprecise or expensive; nor do they have the negotiating experience to allow them to enter into contracts that explicitly validate the estimated value to the firm of a person's acquired skills. In the absence of nation-wide efforts to establish appropriate and affordable human capital information and decision-making systems, firms are unable or unwilling to develop such systems on their own; and likely to suffer from lower productivity growth and reduced ability to compete because they will be less effective and efficient in acquiring and using human-embodied knowledge (Huggert & Kaplan, 2011).

OBJECTIVE OF FINANCIAL REPORTING

Financial reporting should provide information to help present and potential investors and creditors and others in assessing the amounts, timing, and uncertainty of the entity's future cash inflows and outflows. This information is essential in assessing an entity's ability to generate net cash inflows and provide returns to investors and creditors. To help present and potential investors and creditors and others in assessing an entity's ability to generate net cash inflows, financial reporting should provide information about the assets, liabilities, and equity (Schroeder et al., 2011).

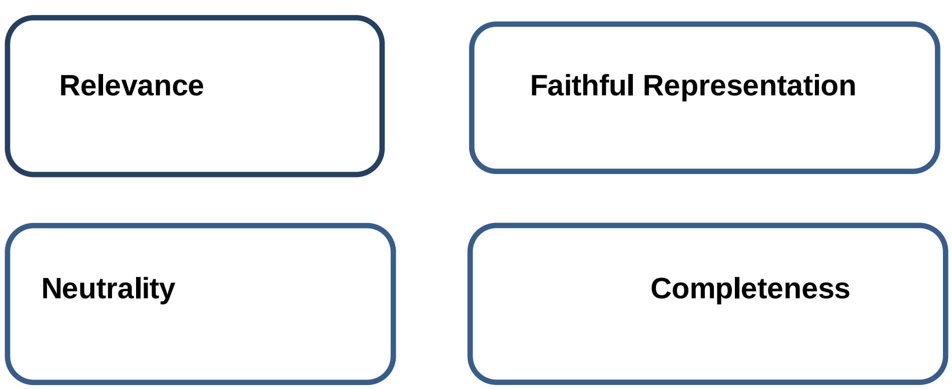
Moreover, the objectives of financial reporting in the Financial Accounting standards Board (FASB) Statement of Financial Accounting Concepts No. 1, are to provide information that are: (a) useful to existing and potential investors and creditors and other users in making rational investment, credit, and similar decisions; (b) helps existing and potential investors and creditors and other users to assess the amounts, timing, and uncertainty of prospective net cash inflows to the enterprise; (c) identifies the economic resources of an enterprise, the claims to those resources, and the effects that transactions, events, and circumstances have on those resources (Williams & Carcello,2007). This information would include not only the amount of resources and claims at a particular point in time but also changes in resources and claims that occur over periods of time.

ASSUMPTIONS

In developing financial reporting standards, standard setters presume that those who use the resulting information will have a reasonable knowledge of business and economic activities and be able to read a financial report (Higson, 2003). Standard setters also presume that users of financial reporting information will review and analyze the information with reasonable diligence. Also, standard setters presume that preparers of financial reports will exercise due care in implementing a financial reporting requirement. Exercising due care includes comprehending the reporting requirements for a transaction or other event and applying them properly, as well as presenting the resulting information clearly and concisely (Barth, Landsman, & Lang, 2008; Schroeder et al., 2011).For example, a garbage-bin is expenditure for long-lived assets but of relatively minor value. Here, the question is if such expenditures should be capitalized and depreciated over its useful life or if the cost of record keeping exceeds the benefit? Of course, one would think most businesses will simply choose to expense small costs as incurred. This is based on materiality concept that regardless of how cost is accounted for, it is not appropriate to accept anyone’s decision-making process about the company. In effect, this shows the extent to which professional judgment is necessary in the accounting process (Thibodeau & Freier, 2011).

QUALITATIVE CHARACTERISTIC OF ACCOUNTING INFORMATION

Figure 4: Qualitative Characteristic of Accounting Information



RELEVANCE: This means to be useful in making investment, credit, and similar resource allocation decisions, information must be relevant to those decisions. Relevant information is capable of making a difference in the decisions of users by helping them to evaluate the potential effects of past, present, or future transactions or other events on future cash flows (predictive value) or to confirm or correct their previous evaluations (confirmatory value). Timeliness in making information available to decision makers before it loses its capacity to influence decisions is another aspect of relevance.

FAITHFUL REPRESENTATION: To be useful in making investment, credit, and similar resource allocation decisions, information must be a faithful representation of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and the transactions and other events and circumstances that change them. To be a faithful representation of those economic phenomena, information must be verifiable, neutral, and complete.

NEUTRALITY: This is the absence of bias intended to attain a predetermined result or to induce a particular behavior. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent economic phenomena.

COMPLETENESS: This means including in financial reporting all information that is necessary for faithful representation of the economic phenomena that the information purports to represent. Therefore, completeness, within the bounds of what is material and feasible, considering the cost, is an essential component of faithful representation (SFAS, 1980; Barth et al., 2008).

CONCLUSION

One of the constraints on financial reporting is materiality. Information is material if its omission or misstatement could influence the resource allocation decisions that users make on the basis of an entity's financial report (Booth, 2003). Materiality depends on the nature and amount of the item judged in the particular circumstances of its omission. A financial report should include all information that is material in relation to a particular entity; information that is not material can, and probably should, be omitted. To muddle a financial report with immaterial information risks the concealment of more important information, consequently, making the report less useful in the decision making process, hence, capitalization of garbage-bin can be a distraction from other critical discussions of higher significant value for success and growth of businesses.

Human capital is an asset, an economic resource controlled by the entity with an objectively measurable acquisition cost that is measurable by the output potential of specific competences and is, therefore, predictable (Apelian, 2009). Also, the produce of investment in human capital can be appropriated by the investor as they accrue, the cost of buying or granting can be objectively determined, day-to-day transactions recognize estimates of the value of the output potential of human capital investments. OECD (1998) noted three ways of measuring human capital as; testing people for competencies, evaluating the cost of acquisition of certified knowledge, and estimating productivity based on achievement indicators such as personal income, job security, occupational status, and past references which is based on the inconsistent assumption that competency is accurately reflected by labor market status. In effect, OECD(1998) concluded that without a sanctioned or generally accepted financial record, the costs and benefits of human capital acquisition and utilization cannot become fully transparent with predictable elements of monetary transaction-based information for use in decision-making systems (Schroeder et al., 2011).The argument is that the measurement of human capital is indefensible because human-embodied knowledge is non-physical, non-appropriable, immeasurable, and inherently incompatible with the conventions of institutions that guide the day-to-day transactions recorded by financial accounting and reporting.

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