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HUMAN RESOURCE ACCOUNTING AND HUMAN CAPITAL VALUATION IN NIGERIA: PROSPECTS AND CHALLENGES

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Abstract

Organisations nowadays operate within a competitive economic environment, which require that their management utilises appropriate information to make timely, effective, and efficient decisions, driven mainly by the intellectual capacity of their human capital. As valuable however, as the human capital is considered to be, it is usually neglected in the valuation of the assets of the firm. This study analysed the prospects and challenges of valuing human capital through Human Resource Accounting (HRA) in Nigeria. The study established HRA information as a key driver of strategic human resource planning and budgeting by being a key source of input in making meaningful choices between various types of human resource investments, and investment in other assets. The use of HRA is however limited by lack of universal approach to its reporting and low level of awareness and acceptance of the technique. The study recommended that a universal model/approach for reporting human capital measurement should be agreed upon, while campaigns and similar publicity given to International Financial Reporting Standard (IFRS) should also be given to the application of HRA in the valuation of human capital in Nigerian organisations.

Keywords: Human Resource Accounting, Human Capital Valuation, Human Resource Investments, International Financial Reporting Standard, Nigeria

INTRODUCTION

The phenomenon of globalisation has impacted impressively on the competitive environment of businesses all over the world, and one major fall-out of this trend, is that the drivers for value creation in business have changed from financial and physical capital, to human capital (Cuganesan, 2006). As a result of this change, organisations now require the information regarding these drivers and the evolution of Human Resource Accounting (HRA) fulfils this need (Bokhari et al, 2012).

Human Resource Accounting (HRA) provides useful information to both internal and external users of accounting information. It helps internal users (like management) in making decision on employment and utilization of human resources and also in deciding transfers, promotion, training and retrenchment of human resources. It provides a basis for the planning of physical assets vis a vis human resources, as well in evaluating the expenditure incurred for imparting further education, training and development in employees in terms of the benefits derived by the firm, among others. For external users (such as potential investors), HRA provides useful information for making investment decisions.

Many studies have been conducted on the behavioural and organizational aspects of accounting, but a lot of criticisms have developed in the area of HRA (Topomy, 2009). Organizations usually declare that their labour force is their most important asset, but at the same time, they fail to recognize it in planning, decision-making and in published annual reports. Moreover, the potential usefulness of HRA information would seem to be even greater for the external decision-makers than for the company's management (Bratton and Gold, 2003).

There are two reasons for including human resources in accounting (Ripoll and Labatut, 1994). Firstly, people are a valuable resource to a firm as long as they perform services that can be quantified. The firm need not own a person for him to be considered a resource. Secondly, the value of a person as a resource depends on how he is employed. So management style will also influence the human resource value.

It may be said further that HRA is in itself a way of communicating to the people of an organization that their role is considered valuable and that managers are going to be evaluated, at least in part, on the basis of their contribution to the development of the human resource under their control. If this communication is effective, it will most certainly affect decisions and human resource management practices of the organization. The assessment of human resource conditions is likely to encourage managers to take long run view of their decisions (Catasus et al., 2009).

HRA is not useful to the management alone in achieving its economic goals. It could also be the source of important information for external user like investors in investment decision purposes. The inclusion of appropriate human resource data in published financial statements would, in probability, make such statements far more meaningful in predicting future performance which is, of course, the principal concern of investors (Lal, 2009). When managers go through the process of HRA measurement, treating human resources as capital assets, they are more likely to make decisions that treat the company's employees as long-term investments of the company. However, the value of human capital (HC) to the organization can be said to be the present value of all future services that it is expected to provide during the period that it remains in the organization (Flamholtz, 1972).

Although valuing human capital is, in recent times, gaining popularity, and there has been many theories and techniques proposed for doing this, most organizations in developing countries like Nigeria are yet to key in into this process . This study is an exploratory analysis of the prospects and challenges of valuing human capital using the tool of human resource accounting.

THE CONCEPT OF HUMAN CAPITAL

Human capital, according to Bontis, Dragonetti, Jacobsen and Roos (1999), is the human factor in the organization; the combined intelligence, skills and expertise that gives the organization its distinctive character. It is the knowledge and skills which individuals create, maintain and use (Armstrong, 2006). The innate abilities, behaviour and personal energy possessed by people are those elements that make up the human capital they bring to work (Davenport, 1999), and it is the human elements of the organization that are capable of learning, changing, innovating and providing the creative thrust which, if properly motivated, can ensure the long-run survival of the organization *(*Bontis et al 1999*)*.

THE CONCEPT OF HUMAN RESOURCE ACCOUNTING

The American Accounting Association (2005) defined Human Resource Accounting as the process of identifying and measuring data and communicating the information to interested parties. This definition considers HRA as the process of recognition and the quantification of human resources for the purpose of assisting the effective management of an organization. Flamholtz (1985) gave more specific definition of HRA, as the process of measuring the cost incurred by business firms and other organizations to recruit, select, hire, train and develop human assets. This definition specifies what expenditure on human resources should be recognized for valuation and reporting purposes. In other words, Flamholtz (1985) regards HRA as involving the measurement of economic value of people to organizations. Friedman and Lev (1974) and Lau and Lau (1978) consider HRA as a method for systematically measuring both the asset value of labour and the amount of asset creation that can be attributed to personnel activities. Considering the contribution aspect of human resources, this definition incorporates the economic benefit attributable to the human resources, in addition to recognizing their cost implication. Human Resource Accounting (HRA), also tagged Human Capital or Intellectual Asset Accounting, is an extension of the accounting principles of matching costs and revenues, and of organizing data to communicate relevant information in financial terms (Monti–Belkaoui and Riahi–Belkaoui, 1995).

According to Fajana (2002), HRA is a response to the criticism of traditional accounting system for failing to meet the needs of a variegated number of users, and the accepted practice of regarding all expenditures on human capital formation as an immediate charge against income, is inconsistent with the treatment accorded to comparable outlays on physical capital. HRA is thus an extension of accounting principles that requires revenue to be matched with expenses incurred to earn that amount of revenue and of organizing data to communicate relevant information. Quantifying the value of human resources helps the management to cope with the changes in its quantum and quality, so that equilibrium can be achieved in between the required resources and advantages of such resources.

HUMAN CAPITAL VALUATION MODEL

The original cost of human capital refers to the sacrifice that was incurred to select, hire, and develop people (Andrade and Sotomayor, 2011). However, human capital is valued according to the age and skills as average annual compensation is determined for different age groups (Lev and Schwartz, 1971). Although, different models of valuing human capital have been given, some of them still suffer some drawbacks. Some of the valuation models include:

Lev and Schwartz Model (1971) which aims to determine the value of human capital with a particular age associated with an organization. The drawback is that it failed to give the correct value of human capital and also does not measure their contributions to achieving the organizational effectiveness

Stochastic Model of Eric Flamholtz (1972) which takes into account the possibility or probability of the movement of an employee from one function to another in his career, and also his untimely departure from the company through death, sickness or retirement. The drawback to Stochastic Model of Eric Flamholtz is that it ignores the fact that individuals who operate in a group may have a higher value for the organization, compared to individuals working independently. In the analysis of operational capability, the approach falls short of practical value, to the extent that the odds have to be determined for each individual occupying various states of service, and these probabilities must be determined for all periods and employees on an individual basis.

Pekin Ogan Model (1996) which aims to determine the value of human capital that renders professional services only. Its major limitation is that it only applies to organizations that provide professional services.

PROSPECTS OF VALUING HUMAN CAPITAL THROUGH HRA

Though HRA could be used in some form to improve financial reporting, probably the most important benefit of HRA is that it is a managerial tool for decision making, particularly those related to human resource acquisition and utilisation. If management has gone through the process of measuring and acquiring HRA information, it is likely that important management decisions such as those involving job cuts and layoffs will be made differently. A related point is that the very process of measuring and acquiring HRA information can have the effect of placing more emphasis on it. Hence, HRA can be thought of as having three major functions:

- providing numerical information about the cost and value of people as organizational resources;
- serving as an analytical framework to facilitate decision making
- motivating decision-makers to adopt a human resource perspective.

Flamholtz (1979) described the HRA paradigm in terms of the "psycho-technical systems" (PTS) approach to organizational measurement. The PTS approach holds that there are two functions of measurement: i. Process functions in the process of measurement; and ii. Numerical or informational functions from using the numbers or measurements. Thus, one role of HRA is to provide numerical measures, and an even more important role is the measurement process itself. The HRA measurement process helps to increase recognition that human capital is paramount to the organization's short and long-term productivity and growth.

When managers go through the process of measuring human resources, they are more likely to focus on the human side of the organization and are more likely to consider human resources as valuable organizational resources who should be managed as such (Bullen, 2007). Flamholtz, Bullen & Hua (2003) utilized the HRA measure of expected realizable value, and found that employees' participation in a management development program increased the value of the individuals to the firm. The HRA measure represented both a paradigm and way of viewing human resource decisions, and the set of measures for quantifying the effects of human resource management strategies upon the cost and value of people as organizational resources.

Davidove and Schroeder (1992) indicate that although many business leaders still view training as an overhead expense, with thorough ROI evaluations, training departments can convince businesses to view them as partners in creating the assets crucial to organizational success. Johanson & Mabon (1998) indicate that expressing human resource interventions in financial terms and or cost benefit terms is more effective than using soft accounting information such as data on job satisfaction.

Toulson & Dewe (2004) conducted a survey utilizing component analysis and found two reasons for human resource accounting to be important measurement. The first is that it reflects the strategic and competitive importance of human resources, and the second suggests that to earn credibility, human resources must be expressed in financial terms. McKenzie & Melling (2001) suggested that, if properly implemented, the human capital planning and budgeting process will become a key driver of strategy as strategic human capital planning and budgeting ensures that the best resources are mobilized for each internal process.

Moore (2007) suggests that the value of human capital should be considered when making decisions about the acquisition and disposal of people, and accounting practices currently employed by companies can have an undue influence in driving the strategic decisions of these companies. The author notes that there are links between the process of acquiring an employee (a human capital asset) and that of acquiring a fixed capital asset. However, while most companies acknowledge the contributions of its employees, they do not think of the acquisition or disposal of human capital assets in the same way or with the same thoughtful planning or strategic thinking as they do fixed capital assets.

However, in the field of managerial decision-making, the human resource data as part of management information system helps in making meaningful choices between various types of human investments and investments in other assets. By measuring the value of human resources at different points of time, HRA can reveal whether the management is building up human resources or depleting them. The information generated through HRA can help the management of human resources in the following areas:

i. It helps the management in employment and utilization of HR
ii. It helps in deciding transfers, promotion, training and retrenchment of HR
iii. It provides a basis for the planning of physical assets vis-a-vis HR
iv. It helps in evaluating the expenditure incurred for imparting further education and training on employees in terms of benefits derived by firm
v. It helps to identify the causes of high labour turnover at various levels and taking preventive measures to contain it

CHALLENGES OF HUMAN RESOURCE ACCOUNTING

The problems of HRA rest majorly on the reporting companies themselves. The obstacles that make it difficult to report human capital values by companies, as articulated by Gates (2002) are as follows:

(a) The main obstacle to reporting human capital externally is that the information reported could be sensitive and the reporting companies may regard it as something that should not be shared externally, as it may give important insight to competitors or could lead to a negative interpretation on the part of the various stakeholders.

(b) Companies do not attach first priority to the measurement of human assets; rather they focus on issues that they regard as more urgent like human resource requirement and allocation.

(c) Where the human resource manager does not attach importance to the concept of HRA, the senior management will accord it even less importance and resources, leaving no time for measurement.

(d) Managers think that the formal establishment of indicators of performance hardly adds any value to the external stakeholders. In other words, there is no return observed by many managers on the investment and effort required in reporting the human capital.

(e) Another disincentive to the acceptance of HRA is the lack of universal approach to its reporting, thereby defining the standards that would allow for valuable and meaningful comparisons. Because there is a current absence of universal definition, the companies that are proactive enough to measure, do it 'their way'.

Jasrotia (2004) also looked at the trends in the field of HRA and came up with some factors that deter the progress in the area and the application of the concept. Such factor includes low level of awareness and acceptance of HRA as against the awareness given to the adoption of International Financial Reporting Standard (IFRS). IFRS was given proper awareness and was adopted in Nigeria in the year 2010. The adoption was however in phases, ranging from Publicly Listed Entries (mostly companies quoted in Nigerian Stock Exchange) who adopted by December 2012, mandatory adoption by other Public Interest Entities by 2013, and Small and Medium Size Entities by December 2014 (David, 2013). Other deterrent factors include the absence of an industry standard, extensiveness of the research involved, and dynamism of some industries e.g. information technology, due to frequent discoveries and technological advancement.

Other researchers (Kodwani and Tiwari, 2007; Abubakar, 2006; Roslender, 2004; and Flamholtz, 1999) also identified some special attributes of human resources which make their valuation so peculiar and problematic. These attributes include:

i. Uncertainty of the service period- because of the free mobility of employees, an employee can leave a job for another one at anytime without notice.

ii. Uncertainty of the contribution level of employees- an employee's contribution level is too difficult to be estimated and forecasted with much reliability because employee productivity fluctuates and depends on many factors.

iii. In valuing human resources, the payments in terms of salaries and/or wages count to a large extent. An employee that is valued in terms of the future salaries and wages determined today may have his value affected whenever the government changes policy affecting his reward system, or whenever there is an action from the workers union regarding the reward system.

CONCLUSION AND RECOMMENDATIONS

Failure to see the human resource as an asset rather than liability has significantly limited the application of HRA information by users. Nevertheless, application of HRA in organizations can yield beneficial results by providing valuable input to management when taking key human resource decisions such as when to select and train HR, cost of developing HR, when to invest more on employees and the returns to be expected (Return on Investment) on a trained employee. As a way of overcoming some of the challenges of HRA therefore, the study recommends that campaigns and similar publicity given to International Financial Reporting Standard (IFRS) should be given to HRA application in Nigerian organisations by the appropriate bodies. Also, the valuation of human capital through HRA can be made possible if the reporting companies and the professionals in the area of accounting agree on a universal model/approach for reporting human capital, and the immediate communication of this approach for adoption.

As a way forward, there is need for more empirical studies to examine the impact of HRA information on investors' decision making, and also the utility of HRA as a managerial tool for decision making on human resource acquisition, utilisation, development, and retention.

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