**"Methods and Accounting Treatment of HRA"**

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**Abstracts:**

*Human Resource Accounting (HRA) is not a new issue but one of the most discussed impasse in the present accounting world. Many theories have been given and many techniques have been proposed for valuing human resource. The main purpose of preparing this paper is the accumulating these methods and techniques and discussing the various aspects of these techniques and methods. The first phase of the paper I have given a detail discussion that have been proposed for valuing human resource till now. And in the second phase of the report I have discussed the accounting treatment and effect of these calculated human resources.*

***Key word: HR, HRA, Impasse***

**Introduction:**

HRA is struggling for acceptance. It is clearly said that. Human resources accounting is as accounting measurement system and a large body of literature has been published in the last Five decades setting for the various procedures for measurement. At the same time the theory and underlying concepts of accounting measurement have received sizeable attention from academics and substantial body of literature has developed. The conventional accountings of human resources are not recognized as physical or financial assets. Though HRA was introduce in mid 60s, but it started gaining importance all over the world after it was adopted by some companies of North American and South Asian region.

**What is Human resource accounting?**

Human Resource (HR) is though one of the valuable assets of the organization but there is no statutory regulation to report it in the organization's annual report. But sometimes HR value of an organization can exceeds its' tangible assets value but traditional accounting systems provide little chance to record and recognize these values of HR. For instance - a few years back when the Bill Gates declared to retired from the Microsoft Corporation, share price of the company fall in a large amount. But traditional accounting suggests no impact on the financial condition of the company but the actual scenario is totally different. However, The American Accounting Association's (AAA) (1973) has defined ***Human Resource Accounting*** as "the process of identifying and measuring data about human resources and communicating this information to interested parties". And Eric Flamholtz (1971) has offered a similar definition for HRA as "the measurement and reporting of the cost and value of people in organizational resources"1. Moreover, Stephen Knauf (1983) has defined HRA as "the measurement and quantification of human organizational inputs such as recruiting, training, experience and commitment."

Therefore, HRA can be defined as the process of identifying, recording, measuring human resources and communicated related financial information associated with the human resource to the interested users.Thus HRA not only involves measurement of all the costs / investments associated with the recruitment, placement, training and development of employees, but also the quantification of the economic value of the people in an organization1.

**Development of Human Resource Accounting (HRA):**

Research during the early stages of development of HRA was conducted at the University of Michigan by a research team including the late organizational psychologist Rensis Likert, founder of the University Of Michigan Institute Of Social Research and well known for his work on management styles and management theory (Likert, 1961, 1967), faculty member R. Lee Brummet, and then Ph.D. candidates William C. Pyle and Eric Flamholtz. The group worked on a series of research projects designed to develop concepts and methods of accounting for human resources. One outcome of this research (Brummet, Flamholtz & Pyle, 1968a) was a paper representing one of the earliest studies dealing with human resource measurement-- and the one in which the term "Human Resource Accounting" was used for the first time. Brummet, Flamholtz & Pyle (1968b) also published another article in which they assessed the impact that HRA can have on management. Flamholtz's (1969) Ph.D. dissertation, an exploratory study in the area of HRA, developed a theory of an individual's value to an organization and how it could be measured though HRA. Brummet, Flamholtz & Pyle (1969) focused on HRA as a tool for increasing managerial effectiveness in the acquisition, development, allocation, maintenance, and utilization of its human resources. The authors' work represented one of the first attempts to develop a system of accounting for a firm's investments and studied the application of HRA in R.G. Barry Company, a public entrepreneurial firm. The early work in HRA provided inspiration for the next phase of early HRA development, basic academic research developing measurement models. Interest in HRA was evident in the many studies conducted since its inception, as noted in Sackmann, Flamholtz & Bullen (1989), Flamholtz, Bullen & Hua (2002), and Flamholtz, Kannan - Narasimhan & Bullen (2004). *(Source – Bullen and Eyler2)*

But the traces of a rudimentary HRA can be found in the Medieval European practice of calculating the cost of keeping a prisoner versus the expected future earnings from him. The prisoners in those days were seen to be the general property of the capturing side. Consequently, after the victory a quick decision regarding whether to capture a prisoner or to kill him had to be taken based on the costs involved in keeping him and the benefits accruing from killing him. However, these represented very rough measurements with limited use1.

**Why Human Resource Accounting?**

In the recent decades concentration is switching from manufacturing organization to service rendering organization, where human is the main resource. But not only for the service organization but also human resource accounting is also necessary for the manufacturing organization to measure their production personnel's expertise. The necessities of the HRA can be as follows –

**1.** Measuring the expertise of the employees and management of the organization.

**2.** Find out the true value of the assets and liabilities hold by the organization. As the expertise of the employees is considered as assets and value to be provided to the employees are considered as liabilities.

**3.** Applying a strong monitoring process on the human resources of the organization.

**4.** It provides the management a sound basis for controlling the human resource.

**5.** Provide a better basis of determining organizational goal and ways of achieving these goals.

**6.** Provide the investors of the organization, shareholders and debt holders, accurate information for better decision making.

**7.** Find out the true picture of the future prospects of the organization, as the utilization of other resources are fully depend on the human resources.

**8.** Giving the stakeholders information about, how much value addition is done by the organization to country's human resource as part of the corporate social responsibility.

From the above mentioned data is clear that necessity of the human resource accounting is very much important for the organization.

**Methods of Human Resource Accounting:**

There are mainly two types of approaches are used in human resource accounting and there are many theories for measuring human resource under this two approach. Before starting the discussion, let us have a look on the all theories of the human resource accounting.

**The Lev and Schwartz Model:**

Lev & Schwartz advocated the estimation of future earnings during the remaining service life of the employee and then arriving at the present value by discounting the estimated earnings at the cost of capital. The assumptions in this method are realistic and scientific. The method has practical applicability when availability of quantifiable and analyzable data is concerned, but this model is unable to give any method to record the value of human resources in the Books of Accounts.(Ravindra Tiwari).

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 (Vy) = ∑*T=Y* Py (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

Moreover, 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 flows1.

This method has some limitations, which are as follows –

1. This method has no indication about the accounting treatment of human resource.

2. This method only considers wages and salary, but wages and salaries are not only the costs associated with the employees. There are other costs that are associated with the employees.

3. The Model ignores the possibility and probability that individual may leave an organization for reason other than death or retirement. The model's expected value of human capital is actually a measure of expected ‘conditional value' of a person's human capital-The implicit condition is that the person will remain in organization until death or retirement. This assumption is not practical1.

**Flamholtz's model of Determinants of Individual Value to Formal Organizations:**

According to Flamholtz, the ***value of an individual*** is the present worth of the services that he is likely to render to the organization in future. As an individual moves from one position to another, at the same level or at different levels, the profile of the services provided by him is likely to change. The present cumulative value of all the possible services that may be rendered by him during his/her association with the organization is the value of the individual.

Typically, this value is uncertain and has two dimensions. The first is the **expected conditional value** of the individual. This is the amount that the organization could potentially realize from the services of an individual during his/her productive service life in the organization. It is composed of three factors:

**1.** *productivity* or performance (set of services that an individual is expected to provide in his/her present position);

**2.** *transferability* (set of services that he/she is expected to provide if and when he/ she is in different positions at the same level);

**3.** *promotability* (set of services that are expected when the individual is in higher level positions).

These three factors depend, to a great extent, on *individual determinants* like activation level of the individual (his motivation and energy level) and *organizational determinants* like opportunity to use these skills or roles and the reward system.

The second dimension of an individual value is the **expected realizable value,** which is a function of the expected conditional value, and the *probability that the individual will remain* in the organization for the duration of his/her productive service life. Since individuals are not owned by the organization and are free to leave, ascertaining the probability of their turnover becomes important.

The interaction between the individual and organizational determinants mentioned above, leads to *job satisfaction*. The higher is the level of job satisfaction; the lower is the probability of employee turnover. Therefore, higher is the expected realizable value.

**Flamholtz** proposes three methods for valuation of expense centre groups. In all these measures, the surrogate value is used for estimation. The three methods are:

**Capitalization -** The capitalization method involves capitalizing a person's salary and using it as a surrogate measure of human value. This value may be ascertained for groups as well as individuals. The value of the group is essentially the aggregate value of the individuals compromising the group. Capitalization of compensation method is not considered an ideal method of group valuation because it ignores the possible effects of synergy. However, this method may be used to arrive at an approximation of a group's value to the firm.

**Replacement cost valuation -** The replacement cost of a group is defined as the sacrifice that would have to be incurred today to recruit, select, hire, train and develop a substitute group capable of providing a set of services equivalent to that of a group presently employed. This method involves considerable subjective estimates, which reduce its validity and replicability.

**Original cost valuation -** The original cost valuation method involves estimation of the original cost of recruiting, selecting, hiring, training, and developing a firm's existing human organization. The need for using original costs to value groups arises out of the necessity of estimating the cost of developing an effectively functioning team. Teamwork is essential for effective communication, decisionmaking, coordination and several other critical organizational processes. Yet, when the original costs are used to make an estimation of the value of the expense centre, the costs of generating this teamwork are largely ignored.

**Non-Monetary Methods for HRA:**

The non-monetary methods for assessing the economic value of human resources also measure the Human Resource but not in dollar or money terms. Rather they rely on various indices or ratings and rankings. These methods may be used as surrogates of monetary methods and also have a predictive value. The non-monetary methods may refer to a simple inventory of skills and capabilities of people within an organization or to the application of some behavioral measurement technique to assess the benefits gained from the Human resource of an organization.

**1.** The *skills or capability inventory* is a simple listing of the education, knowledge, experience and skills of the firm's human resources.

**2.** *Performance evaluation* measures used in HRA include ratings, and rankings. *Ratings* reflect a person's performance in relation to a set of scales. They are scores assigned to characteristics possessed by the individual. These characteristics include skills, judgment, knowledge, interpersonal skills, intelligence etc. *Ranking* is an ordinal form of rating in which the superiors rank their subordinates on one or more dimensions, mentioned above.

**3.** *Assessment of potential* determines a person's capacity for promotion and development. It usually employs a *trait approach* in which the traits essential for a position are identified. The extent to which the person possesses these traits is then assessed.

**4.** *Attitude measurements* are used to assess employees' attitudes towards their job, pay, working conditions, etc., in order to determine their job satisfaction and dissatisfaction.

**Hermanson's unpurchased goodwill model:**

According to Hermanson, the unpurchased goodwill notion is based on the premise that ‘the best available evidence of the present existence of un-owned resources is the fact that a given firm earned a higher than normal rate of income for the most recent year. Here Hermanson is proposing that supernormal earning are an indication of resources not shown on the balance sheet, such as human assets. Even though his method of valuing human resources is explicitly intended for use in a company's published financial statements rather than for internal consumption, this would necessarily involve forecasting future earnings and allocating any excess above normal expected earnings to human resources of the organization. However, the assumptions would be subject to the uncertainties involved in any forecast of future events.

This method suffers from several limitations: Firstly, since the methods limits recognition of human resources to the amount of earnings in excess of normal, the human resource base that is required to carry out normal operations is totally ignored. As a result, the value of human assets will be an underestimation.

Secondly, the method only uses the actual earnings of the most recent year as the basis for calculating human assets, thereby, ignoring the forecasts of future earnings that are equally relevant for managerial decision making.

**Accounting Treatment of Human Resource Accounting:**

The accounting treatments of human resource under various methods can be done in three parts –

***Real Capital Cost Part*** –

All capital cost associated with the human resource, such as – training cost, should be capitalized by

Human Resource Capital (HRC)                        Dr.

Bank                                                    Cr.

And the cost should be written off during the working life of the employee, as –

Income Statement                                             Dr.

Human Resource Capital (HRC)            Cr.

***Present Value of future salary/wages payment –***

At the time of capitalizing value of human resource according to Lev & Schwartz valuation (whether at the year end or at the during year, whenever we hire human asset or company want to begin accounting for human asset

Human Resource Capital                                   Dr.

Human Resource Reserve                     Cr.

At the time of salary payments

Salary                                                               Dr.

Cash                                                     Cr.

At the year end we should calculate HRC value according to Lev & Schwartz model. Now difference of HRC in books and HRC now calculated shall be debited in the form of HRR and balance amount should be debited in Income Statement to close salary.

Human Resource Reserve                                 Dr.

Income Statement                                             Dr.

Salary                                                   Cr.

If difference is more than salary then balance should be credited to P&L A/C

Now amount debited in HRR should be charged in form of depreciation / amortization from Income Statement.

Income Statement                                             Dr.

Human Resource Capital                      Cr.

***Suggested Use of fund for HRC –***

Fund for HRC should be used only for some specific purposes such as - training of employees, writing off of abnormal losses caused Due to leaving/death of employee, welfare of Employees so that they may be more satisfied etc entry for transferring will be –

Income Statement                                             Dr.

Fund for HRC                                       Cr.

Entry for capitalization of human resource with the same amount will be –

HRC                                                                Dr.

Human Resource Adjustment                 Cr.

In case of abnormal losses generate for many years after leaving/death of Employee these losses can be written off from this fund over these years. Entry will be –

Fund for HRC                                                   Dr.

Income Statement                                 Cr.

Reverse entry at the time of leaving/death of employee will be –

Human Resource Adjustment                             Dr.

HRC                                                    Cr.

Amount capitalized in previous year (in this part) should be basis for incentive for current year.

**Limitations of the Systems**:

The main limitation of the accounting process of the HRA is – It is extremely difficult to calculate the actual value of the human resource of the organization.

**Conclusion:**

It is still extremely difficult to determine the actual value of the human resource of the organization though the different methods and accounting techniques have already proposed for the human resource accounting. And the proposed have some limitations too. There is no standard proposed by any accounting standard committee for this regard. So there is no certain guideline for HRA. As a result any organization has the chance of manipulation the financial statement for the negligence of the accounting standard committees. But this concept is gaining importance day by day as the human resource play the main part of operation and production.

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