

Corporate Social Responsibility

Chapter 5

Assessing The Importance of Human Capital Cost in Organisation

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Concept of Human Capital Cost

Accounting is aimed at streamlining financial processes and elements. However, the principal asset, which undertakes this essential element, is Human Capital (HC), which has not been given proper importance or scope in the accounting framework in the 19th century. Though individual firms are now aware and include Human capital cost to their annual reports (human capital as assets both from investment and expenditure perspective), still, it was not well accepted either by organizations, employees, and employee unions. Human capital accounting, also known as human asset accounting, are information systems that involve the process of identifying, capturing, measuring, and analyzing the potential and the value of human capital in the firm and communicating the resultant information to the stakeholders of the firm. Human Capital cost is the method by which a cost is assigned to every employee when recruited and the value that the employee would generate in the future. It reflects the potential of the human capital of an organization in monetary terms, in its financial statements. Human Capital cost can also be explained as the measurement, which helps to recognize the costs and the value of employees as an organizational resource. This definition explains the knowledge and intellectual capabilities of employees which is becoming significant in firm decision making and firm performance.

Human Capital cost helps in improving the efficiency of staff. The employees come to know of the cost incurred on them, and they give the return in the form of output, which will motivate them to increase their worth. The use of Human Capital Cost information in financial statements has been gradually increasing and has created a significant impact on the individual, decision-making process, and firm performance. Human Capital information can play an important role in internal managerial decision-making. According to Islam, Kamruzzaman and Redwanuzzaman, (2013) costs relating to Human capital cost includes (i) social cost (ii) acquisition cost such as cost of recruitment, hiring, selection and placement of staff (iii) job training costs, include Earned staff cost, directors cost, salaries paid to the employees during their probationary period (iv) formal training development costs of staff (v) separation costs of employees (vi) costs incurred for gravid female employees. Human Capital Cost can either be measured in terms of Human capital costs or in terms of Human capital value. Flamholtz (1999), the model for measurement of human capital costs, opined that Human capital costs might be explained in two major categories, which are acquisition

Corporate Social Responsibility

costs and learning costs. Acquisition cost includes the direct costs of recruitment, selection, hiring and placement, and the indirect costs of promotion or hiring from within the firm while learning costs include the direct costs of formal training, orientation, and on-the-job training.

Human capital has long been recognized as a vital asset and value creator to companies. More recently, Swart (2006, p. 137) refers to "core competence, knowledge creation, and innovation creating value over and above physical and financial resources." To develop a competitive advantage, it is essential that firms genuinely leverage on the workforce as a competitive weapon. A strategy for improving workforce productivity to drive higher value for the firms has become an important focus. Firms seek to optimize their workforce through comprehensive human capital development programs not only to achieve business goals but most important is for a long term survival and sustainability. To accomplish this undertaking, firms will need to invest resources to ensure that employees have the knowledge, skills, and competencies they need to work effectively in a rapidly changing and complex environment. In the current business environment, human capital is regarded as a critical source of competitive advantage. With the knowledge agenda, companies view their employees as an essential resource and invest heavily in them. But the value of human Resource, or human capital, may not be adequately reported to stakeholders partly due to strict recognition criteria for intangible assets that do not allow human Capital to be shown as an asset in the balance sheet (Tayles et al., 2007).

Nevertheless, information on human capital and its development is vital to financial analysts and fund managers, who need to assess the future direction, potential, and values of companies. Ishikawa and Ryan (2002) suggest that it is the stock of human capital that predominantly determines the earnings of individuals. In the opinion of Mayo (2001), the essential difference between HCM and Human Resource Management (HRM) is that the former treats people as assets, while the latter treats people as costs.

In traditional accounting concepts, every human-resource-related expenditure is treated as a cost that reduces profit. However, Bullen and Egler (2010) stated that Human capital Cost involves accounting for expenses related to Human capital assets. Woodruff (1973) defined Human Capital Cost as the identification, accumulation, and dissemination of information about Human capital in dollar (Naira) term. He further explained that Human capital Accounting is the systematic accumulation of information about changes in investments made in human resources and reporting back the information to operating managers to assist them in making better decisions than they would have been able to make without such additional information. Seth (2009) stated that Human Capital Cost (HCC) means accounting for people as primary resources. According to him, it is the measurement of cost and value of people for an organization. It is also a way of thinking about the management of people informal organization. He confirmed that knowledge of workers is essential resources for a typical modern business firm and that, with the growing complexities of business organizations, the need for competent people continues to increase while financial reporting ignores such resources.

Corporate Social Responsibility

Parameswaran and Jothi (2011) referred to the American Accounting Association's definition of human capital cost as the process of measuring data of human capital and communicating the information to the interested parties. Going by the various definitions above, Human capital accounting, in simple terms, is accounting for the value of people in the organization to enhance information for decision making by the users of financial information. The belief that individual employee performance has implications for firm-level outcomes has been prevalent among academics and practitioners for many years. Interest in this area has recently intensified; however, as scholars have begun to argue that collectively, a firm's employee can also provide a unique source of competitive advantage that is difficult for its competitors to replicate. For example, Wright and Mcmahon (1992), drawings on Barneys (1991) resource-based theory of the firm, contended that Human capital could provide a source of sustained competitive advantage when four basic requirements are met. First, they must add value to the firm's production processes; levels of individuals' performance must matter. Second, the skills the firm seeks must be rare. Since human performance is usually distributed, Wright and McMahan (1992) noted, all human resources meet both of these criteria. The third criterion is that the combined human capital investments a firm's employee represents cannot be easily imitated. Although, human resources are not subject to the same degree of limit ability as equipment or facilities, investment in firm-specific Human capital can further decrease the probability of such limitation by qualitatively differentiating a firm's employee from those of its competitors.

Finally, a firm's resources must not be subject to replacement by technological advances or other substitutes if they are to provide a source of sustainable competitive advantage. Although labour-saving technologies may limit the returns for some forms of investment in Human capital, the continuing shift towards a service economy and the already high levels of automation in many industries make such forms of substitution increasingly less probable. Wright and McMahan's (1992) work points to the importance of Human capital in the creation of firm-specific competitive advantage. The issue, then, is whether, or how, firms can capitalize on this potential source of profitability. Bailey (1993) contended that human resources are frequently "underutilized because employees often perform below their maximum potential and that organizational efforts to elicit discretionary effort from employees are likely to provide returns over any relevant costs. He argued that Human Capital Management (HCM) practices could affect such discretionary effort through their influence over employee skills and motivation and through organizational structures that provide employees with the ability to control how their roles are performed. Human resource management practices influence employee's capabilities through the acquisition and development of a firm's human capital. Recruiting procedures that provide a large pool of qualified applicants, paired with a reliable and valid selection regimen, will have a substantial influence over the quality and type of skills new employees possess. Providing formal and informal training experiences, such as necessary skills training on-the-job experience, coaching, mentoring, and management development can further influence employee development.

Corporate Social Responsibility

History of Human Capital Accounting

The concept of considering human beings as an asset is an old one. The importance which Emperor Akbar gave to the nine jewels (courtiers) is a piece of strong evidence for the same. The history of our freedom movement will not be complete without mentioning the names of distinguished freedom fighters such as Shri Motilal Nehru, Mahatma Gandhi, Sardar Vallabh Bhai Patel, and several others but no effort was made to assign any monetary value to such individuals in the Balance Sheet of the Nation. Sir William Petty was the pioneer in this direction. He made the first attempt to value human beings in monetary terms in 1691. Petty considered that labour was 'the father of wealth' and it must be included in any estimate of national wealth without fail. William Far made further efforts in 1853, Earnest Engle, in 1883. The real work started only when behavioural scientists vehemently criticized the conventional accounting practice of not valuing the human resources along with other resources. As a result, accountants and economists realized the fact that an appropriate methodology has to be developed for finding the cost and value of the people to the organization. For an extended period, a number of experts have worked on it and produced certain models for evaluating human resources. The most important among them are Shultz, Flamholtz, Lav and Schwartz, and Kenneth Sinclair.

Human Capital Cost was first started with simple measures of trying to convert output data into contributions. When an HC programme had effected a change in the output especially for organizations operating on a profit basis, its value was determined by calculating the profit contribution. Rensis Likert in the 1960s was the first to research in HC and emphasized the importance of intense pressures on the HC's qualitative variables and its benefits in the long run. According to Likert's model, human variables can be divided into three categories: (i) causal variables, (ii) intervening variables: and (iii) end-result variables. The interaction between the causal and intervening variables affect the end-result variables by way of job satisfaction, costs, productivity, and earnings. Historically the first major systematic effort at evaluation was made by RG Barry Corporation of Columbus in 1967. Their annual report detailed the inauguration of HCC procedures developed by the company to enable them to report accurate estimates of the worth of the organization's human assets. Accumulated costs under the categories, namely recruiting and acquisition; formal training and familiarization; informal training and familiarization; experience; and development were accounted for. Costs for the expected working lives of individuals (or sometimes shorter periods) were amortized, and unamortized costs (for example, when an individual left the company) were written off. That is today, known as the Historical Cost Approach to employee valuation. An improvement over the years has helped evolve other bases of assessment, which have been providing supplemental information.

Today they fall under three major categories, namely replacement cost, the present value of future earnings, and present value to the organization, i.e., profit contribution. Creating a portfolio by every company establishes the necessity of accounting for the same. Human resources are one of the most valuable assets and needless to say that human beings co-ordinate the best of machines, men and money. Computers, of course, may challenge the human resources, but the computer is not a brain, and it

Corporate Social Responsibility

merely carries out human commands. Therefore, accounting for such human capital is essential for the organization.

According to Singh and Singh (2009), the first attempt to value human beings in monetary terms was made by Sir William Petty (1623-1687). Petty (1961) attributed the profitability of an organization to the labour of the people. However, the origin of human capital accounting, they highlight, is found in the work of Rensis Likert, who was the first person to use the term "human asset" in the late 1950s. He described "human assets" as the human resources available to a firm. In contrast, the origin of the term "human capital" is attributed to is Theodore Schultz, a political economist, who before the 1960s, dealing with the concept of the organizational workforce (Okpala & Chidi, 2010). He stated that all human abilities can be considered either innate or acquired and that all attributes which can be augmented by appropriate investment are human capital. Human capital comprises behavioural, knowledge, experience, attitude and morale, corporate culture, and so on which, when put together, become of economic value to the organization. Schultz (1961), as cited in Okpara and Odogwu (2010), notes that human capital cost was developed in the 1960s and that human capital can be defined as the ability and skills of specific people or an individual that have values. However, human capital accounting, though designated as human resource accounting was implemented by Barry Corporation, Ohio (USA) in 1967, under the guidance of Likert and Pyle (Singh & Singh, 2009). However, its implementation was greeted by controversy, with many people opposing the idea, stating that it treated people as assets management ownership or control of employees". Human capital accounting, however, was further popularized with companies shifting emphasis from production-oriented to service-oriented operations.

i. Training and Development Cost

Staff training is vital to the growth and development of an organization as blood is essential to human existence, so is the training of staff essential to the success of an organization. Training, both physically, socially, intellectually, and mentally are essential in facilitating not only the level of productivity but also the development of personnel in any organization. According to Abiodun (1999), training is a systematic development of the knowledge, skills, and attitudes required by employees to perform adequately on a given task. Employee training and development are seen as the most important formation of any competent management. The reason is not far-fetched; the ever-increasing technological sophistication, especially in this age of computer technology, has made it compulsory for organizations to meet changing situations. Training for capacity building is central to sustaining economic growth and development because human capital is the greatest asset of any organization. The capacity building could also be defined as the internalization of the knowledge, skills, and processes that enable the formation, implementation, monitoring, and evaluation of set goals in an efficient manner. Training is one of the main functions that directly contribute to the development of employees. Research suggests that the organizations investing considerably in training justify their investment by the contribution training makes to improve individual and firm performance (Khan, 2010).

Corporate Social Responsibility

The availability of skilled human capital is fundamental to creating and sustaining the momentum of Financial System Strategy 2020. There is an immediate need to enhance the skills of the current workforce in the medium to long term need and to develop a continuous pipeline of quality human capital for the Nigerian Financial Services Industry. This will depend heavily on the reformation of the collapsing educational and institutional structures in Nigeria and on the collaborative and competitive attitude that the existing players in the Financial Services industry decide to adopt. Human capital is the knowledge and know-how that can be converted into value. Human capital consists of know-how education, vocational qualifications, training, trading programs, union activity compensation plan, and shares options scheme. Training and development cost being employed by organizations help them to enhance employee skills and firm performance (Solke & Chaudhary, 2011; Delaney & Huselid, 1996). Rajashekharaiyah (2014) asserts that training and development are also attracting, developing, and retaining a diverse workforce that helps in providing the different skills required to maintain and improving the firm performance. Chow (2005) also opined that training and development are the components of human capital accounting. The elements of training and development activities, including formal training, develop employee skills and impart knowledge beyond the current position off the job training, the induction training program for newcomers, and training programs for present employees. In the work of Rajashekharaiyah (2014) and Chow (2005), they found that training is positively contributed to organizational performance.

ii. Employees Acquisition Costs

The current economic environment has forced CEOs to focus almost all of their attention on revenues and profitability. They must be very aware of what competitors are doing - competitors can be anywhere in the world. Additionally, executives are watching the government for an indication of changing regulations and tax issues. In many ways, the recent economic troubles serve to shine a spotlight on workforce management issues for many executives. Whether it was navigating layoffs, reducing labour costs, cross-training employees, or merely keeping the workforce morale up, many leaders found that their organizations were not as dexterous or flexible as they would like. (Retrieved on 15 APRIL, 2017 form HR Newsletter software online posted in February 2011). Labour costs (compensation and benefits) account for nearly one-third of operating costs, so how HR manages the workforce has a direct impact on achieving profitability objectives. One of the best ways to set your HR strategy is to align workforce management goals with corporate objectives. That means keeping an eye on how your programs and decisions will impact the bottom line. Aligning labour costs with the quality of the workforce can dramatically improve financial performance. A 2009 study found leaders in talent management enjoyed superior financial results, including 54% higher net profit margin and 18% better EBIDTA (Toulso, 2004). To add strategic value, HR leaders should step outside the human resources arena and genuinely understand the business. What does the company do? How much does it cost to deliver products? How does the competition do it?

Who is your customer? Develop a workforce that supports the company's goals and customers. Help the executive team stay ahead of HR issues by finding answers before

Corporate Social Responsibility

they ask questions. Are HR departments fulfilling the mission today? According to HR professionals, the answer is still no (Steven, 1993). Strategic executives avoid nifty - gritty details of the day - to - day human resources issue, preferring to take a broader perspective. Executive priorities include recruiting and staffing turnover and succession, compensation, and benefits. These are the most expensive functions of human resource and organizational challenges having the greatest impact on company objectives. Finding and hiring the right employees is essential to business success. The right hire can bring a team together and deliver brilliant new ideas. The wrong hire can be a disaster, resulting in lower team morale and missed objectives. A CEO needs his or her company to be seen as an employer of choice by potential candidates. According to Flamholtz (1973), acquisition cost includes the direct cost of recruitment, selection, or hiring cost of the firm. The CEO needs to know the big picture of what is going on with recruiting. How many openings do we have? Is that creating any backlogs in production? What will it cost to fill the position? A staffing report provides an excellent overview without getting into the individual details of each hiring decision or new vacancy. The costs associated with recruiting, selecting, hiring, training, placing, and developing an employee may differ from one individual to another within a firm (AAA, 1973).

iii. Earned staff Costs

The actual amount paid for all staff which includes the wages, salaries, commissions, and employer-paid insurance premiums and pension deposits as well as the cost of all other fringes. The first thing to remember is that staff cost is not only about salary payment; many other expenses are relevant and must be factored in too. Consider the following: social security payment, pension contributions, travel expenses, training and development cost, human resource expenses, holiday pay, sick pay, and healthcare cost. The full benefits report to every employee or staff should be issued twice a year; this will keep all employees clear that after working for hours, there is a take-home pay. Revenue per employee is a measure of how efficiently a particular company is utilizing its employees. A firm's human resource practices must develop employee's skills, knowledge, and motivation such that employees behave in ways that are instrumental to the implementation of a particular strategy (Ekundayo & Odhigu, 2016). In general, relatively high revenue per employee is a positive sign that suggests the firm is finding ways to squeeze more sales (revenue) out of each of its workers to ensure economic growth and stability in the industry.

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