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Performance Pay Plans

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How should human resources be accounted for? This has been a question for a long time. Employees can be viewed as a company's biggest asset, but because the value of human resources can be difficult to measure, it is often not reported. When the value of human resources or assets is not recognized on the financial statements, the value of the organization is understated (Edmonds & Rogow, n.d.). Human resource accounting (HRA) is the response to the problem of accounting for employees and human resources. According to the American Accounting Association, HRA is a “process of identifying and measuring data about human resources and communicating this information to interested parties.” There are many different approaches that have been developed for human resource accounting.

For years there have been attempts to integrate the value of human resources into accounting and financial statements. In the 1960's, human resource accounting theory was developed which has led many others to evaluate the accounting of human resources (Edmonds & Rogow, n.d.). In the early part of the 1970's, HRA was one of the most popular areas studied by accountants. The research was not very beneficial and seemed to slow. It has since improved and become an important focus (Toulson & Dewe, 2004).

The need for human resource accounting is to assign value to employees. There are mainly three objectives of HRA. The first objective is to provide companies with information about the cost and value of its human resources. The second objective is to provide companies with a guide for human resource decisions. The last objective is to motivate managers and decision makers to look at decisions through a human resource point of view (Toulson & Dewe, 2004). Assigning value to human resources may improve decision making. The definition of HRA according to AAA is a “process of identifying and measuring data about human resources and communicating this information to interested parties.” There are two different types of “parties” that would find the information about human resources useful. Investors are one of the main...
types that can use the information about human resources. Decisions have been changed based on information about human resources, though it has not been proven if these decisions about investments are better. Managers represent the other main type of "party" that may find information about human resources valuable. HRA information would provide more information about costs associated with human resources. If this information about human resources was used, then managers would be held more accountable for decisions involving human resources (Ebersberger, 1981).

There is debate as to whether human resources are an asset and should be included in financial statements. Employees do not fit into the classical definition of an asset as something owned by a firm. Assets can also be defined as having utility, scarcity, and exchangeability. Because humans are not exchangeable, they do not fit into this definition. If assets are defined by tangibles or intangibles that have specific characteristics whose usefulness or value is shown on the financial statements, then humans can be assets. By this definition, an asset is something that is obtained for the added value it provides to a company (Edmonds & Rogow, n.d.).

Once human resources are recognized as an asset, the biggest challenge is determining the value of the asset. There are many different methods of HRA. The different methods should be used depending on the purpose of the information and who will be the user of the information (Ebersberger, 1981). According to Dawson (1994), there are six different approaches used as a basis for determining the monetary value of human resources:

- economic cost model
- historic cost model
- replacement cost model
- total organizational model
- a bidding model
- stochastic reward valuation model

Each approach uses different types of methods to determine the value an employee has to a company. The economic cost model comes from the human capital theories. The historic cost and replacement cost models are based on accounting. These models calculate an employee's worth using the total historic or replacement costs associated with obtaining an employee (Dawson, 1994).

The historic cost method is one of the more popular methods because of
its similarities to normal accounting procedures. This method requires accruing the cost of the investment in the employee. One of the problems with this method is that decisions must be made about what costs to expense and what costs to capitalize (Ebersberger, 1981). One way of deciding what to expense or capitalize is to classify human resource costs as either training or educational. With this approach, training cost would include anything associated with the current job, and it would be expensed. Educational costs would be anything associated to the preparation or advancement, and these costs would be capitalized. Another approach that could be used includes all the costs of recruiting, testing, training, and development. The decision of whether to capitalize or expense is based on how long the cost will benefit the company. If the cost will lead to a benefit for longer than twelve months, then the cost will be capitalized (Edmonds & Rogow, n.d.). It is important with this method that the users of the information do not view it incorrectly. Historic costs do not represent the worth of an employee; they are merely an assessment of past costs. Instead, the benefits from historic cost allow rate of return on investments and turnover costs to be computed. There are also other problems with the historic cost method. One problem is that anything that an employee learns outside the job will not be included in the costs. Another limitation is that employees may apply training at different levels (Ebersberger, 1981). Due to the inability of historic cost to aid in making decisions concerning the present and future, some prefer to use the replacement cost approach (Edmonds & Rogow, n.d.).

Replacement costs can be defined as the costs that would be encountered today to replace current human resources (Tang, 2005). Replacement costs include three types of costs. They include the cost of hiring new employees for existing jobs, the cost of training new employees to the proper level, and the cost of moving employees to new positions or out of the company. One benefit of this model is that it is based on solid facts: the costs of recruiting and training. One problem with replacement cost approach is that does not take into account the work ethics of employees (Ebersberger, 1981). Replacement costs are based on the current value of an employee to a company. This value is the present value of the future services that an employee is expected to provide (Edmonds & Rogow, n.d.).

The total organizational model takes the value of the company as a whole and divides it between the different inputs to the company, and then it divides
the amount associated with labor between the different clusters of employees in the company. Unlike the other models, in the bidding model, the managers in an organization determine the value by bidding for the human resources that are in the organization. The last approach is the most complex. It is the stochastic rewards valuation models. This approach calculates the value of an employee “as the discounted sum of the values of the ‘service states’ that the individual will occupy during his/her career with the organization” (Dawson, 1994). According to Dawson (1994), the stochastic rewards valuation model requires five different pieces of information:

- the mutually exclusive service states that the individual may occupy within the organizational system;
- the value of each of these service states to the organization;
- the estimated tenure of the person in the organization;
- the probability that the individual will occupy each service state at specified future times;
- the discount rate to be applied to future cash flows to determine their present value.

Some of this information may be difficult to determine, such as the value of the service states. The creator of this model, Flamholtz, recommends using his “price quantity method” or “income method” to determine the values of the service states. Flamholtz’s “price quantity method” requires determining what the “product of the price per unit of human services and the quantity of the services.” The “income method” of Flamholtz requires predicting the “expected earnings of a firm and allocating them between human and other resources and further allocating them among specified people.” Flamholtz admits that some of these measures may be hard to determine and that in certain situations “surrogate measures” should be used (Dawson, 1994).

The use of human resource accounting does come with potential problems. These problems may arise in three different areas: the managers, the employees, and the process. The problems that are created with managers can be related to the character of the manager. If more emphasis is placed on the value of employees, a manager may take advantage of the situation. The manager could lower an employee’s value as a form of control or to punish the employee. Managers may also manipulate the appearance of the balance sheet for their department by having an employee with a high human resource value relocated to their department at the end of the period. One of
the problems with employees that may appear with the use of human resource accounting is the demand for more pay. Employees who have a high human resource value to the company may require that their pay reflect that value. Implementing HRA would give employees more bargaining power. Another potential risk with HRA for employees is related to the morale of employees who know their value. The last area of concern associated with HRA is the process itself. The process of assigning value to human resources has the possibility of becoming circular. If the human resource value is based partly on salary and potential, and salary and promotability is based on the human resource value, then human resource value will be based on human resource value. It is a continuous cycle (Ebersberger, 1981).

Human resource accounting has been around for a long time. It has inspired much debate between accountants over whether people are assets and if they are assets how their value can be determined. The importance of human resource accounting is apparent. What is not apparent is the best method to use in human resource accounting. Many different approaches have been developed and there are bound to be many more in the future. Human resource accounting should be implemented if a company wants its financial statements to be fairly stated. Human ability and knowledge is a great asset, and it is important these assets be recorded and accounted for.
REFERENCES


