Abstract

This paper argues that a disclosure-only approach provides a better means of incorporating human capital information into the financial statements. The express purpose of the financial notes is to allow an informed assessment of the company’s operations, financial position and future business strategies and prospects. We show that the current accounting framework under IFRS, specifically IAS 1, could accustom the disclosure of human capital into the notes of the financial statements. In addition, we identify the key compulsory indicators that organizations need to disclose into the notes to the financial statements. These indicators include the short and long term strategies related to human capital. In addition, organizations need to provide details on the effectiveness and performance of their human capital management policies and practices. The reporting is to be accomplished with the use of a mix of quantitative and qualitative data.

Key words: human capital, financial notes disclosure, internally generated intangible assets, disclosure framework, compulsory indicators

JEL classification: M41

1. INTRODUCTION

We are witnessing a shift in the accounting public towards developing their acceptance of the internally generated intangible assets, specifically the human capital. There are many positives due to the recent interest by researchers and practitioners on the topics of intangible assets. That is, we see more and more interest in the academia towards understanding of internally generated intangible assets. Without a doubt, the companies and countries that embrace the changes and start to accept the upcoming accounting for internally generated intangible assets would these would be able to mainly benefit from these resources. These would provide basis for competitive advantage and also bring direct investments into the specific industries that have had relied heavily on intangibles to deliver the products and services. These are steps that need to be undertaken by FASB and IASB in order to ensure that we meet the upcoming demand of our economic reality. We must note though that there are many companies that have started reporting their intangibles (specifically sports companies with their contracts). However, for complete disclosure, we need to ensure that the proper steps are undertaken. Several researchers have studied the accounting disclosures of intellectual capital made by firms [Abeysekera, 2006, 61-77, Guthrie et al., 2004, 241-251]. In recent studies [Abeysekera, I. and Guthrie, J., 2005, 151-163], human capital has gained responsiveness among the researchers as well as firms of the importance of disclosing their internally generated intangibles assets. As many researchers have shown over period of time, the difference between the market value and the book value of the firm, is attributed to the internally generated intangibles assets [Cordon, 1998, 26-81].
The scope of this paper is internally generated human capital. Therefore, other intangible assets arising from business combinations are not discussed in this paper. The separate recognition in a business combination provides users with information useful to the understanding of the cost and some of the components of goodwill [FAS 141, 2001]. However, this type of rationale is not relevant to the identification of internally generated intangible assets because internally generated goodwill is not recognized [IAS 38, 2007]. At this point of the discussion, it must be mentioned that the accounting standards used for the discussion of the human capital are IFRS, unless otherwise stated.

In section 2, this paper reviews prior research and uses it as a starting point for further analysis on the topic on the accounting of internally generated intangible assets. In section 3, we assess the current accounting framework under IFRS, specifically IAS 1, in order to determine if it could accommodate the disclosure of human capital into the notes of the financial statements. In addition, we evaluate prior research to determine if direct relationships exist between human capital and value added to the organization. For further emphasis on the topic, there is the necessary rhetoric on the limitations of these prior studies. Later, in section 4, the paper evaluates the current attempts to place a financial value on human capital. This takes the form of a synopsis of a number of methodologies that have been developed in the past. We argue that cost of labor does not necessary correlate with the value that it creates for the organizations [Pfeffer, 2001]. Further research would be necessary to prove whether acquisition costs of labor add value through incremental revenue generation. As the discussion continues, in section 5, this paper evaluates some of the alternatives approaches for presenting the human capital in the financial statements, specifically qualitative measures. As discussed in section 3, the current reporting framework, specifically IAS 1, allows disclosure of human capital into the notes of the financial statements. Also in section 3, the paper would discuss some of the variables and information that could be disclosed in the financial statements. In section 6, we identify some of the compulsory indicators needed to establish an effective and efficient guideline/framework in order to report human capital into the financial statements. The proposed guideline should be used to further develop specific reporting requirements.

2. PRIOR RESEARCH ON HUMAN CAPITAL DISCLOSURE IN THE FINANCIAL STATEMENTS

Human capital can be characterized and defined as the skills, competences, training, education, and experience of individuals [Edvinsson and Malone, 1997]. The Organization for Economic Co-operation and Development [OECD, 2007] defines “human capital” as a subset of intellectual capital, synonymous with internally generated intangible assets by a company. Intellectual capital is most commonly described as consisting 1) external structure, 2) internal structure and 3) employee competence [Sveiby, 1997], or as Edvinsson [2000] defines the intellectual capital as structural customer, structural organizational and human capital. External structure/structural customer capital consists of an organization’s relationships with customers and suppliers, brand names and reputation [Guthrie and Petty, 2000, 241-251]. On the other hand, the internal structure/structural organizational capital is described as the "embodiment, empowerment, and supportive infrastructure of human capital” [Edvinsson and Malone, 1997]. Human capital is defined as the employee competence, capabilities and brainpower [Edvinsson and Malone, 1997].

In previous accounting research on internally generated intangibles, mainly academicians have tried to put value to these assets and to assess what they bring to an organization [Pfeffer, 2001], [Grojer and Johanson, 1996] [Roslander and Dyson, 1992, 311-329], [Roslander 1997, 9-26]. However, most of the research proposals on ways to achieve...
this have not come with real solutions. There would be always researchers that would argue these resource costs should be capitalized rather than the current treatment of expensing the related costs. We must note that intangible assets are increasingly recognized as an important component in business performance. However, as with any assets or resourced, there would difficulties with identifying how to properly account for these assets. Unlike other type of assets, intangibles and mainly human generated assets are questionable as to whether they are owned by the organization or the employee [Sveiby, 1997]. In addition, human capital is not easily quantified [Pfeffer, 2001]. From an economic perspective, the intangible assets represent the equilibrium between the demand for and supply abilities to provide future resources and benefits for a company [Scarborough, 2003]. For a company’s end, the supply of human capital is dependent on the supply of the capabilities of the specific employee. In addition, companies need to properly analyze these capabilities and to aggregate them in order to achieve the ultimate goal of recognition. Some might argue that intangible capital is owned by the individuals themselves and that the formal education and work experience are owned by the workers themselves. That is, they are the real owner of the knowledge (Tomer, 2008). These are difficult concepts to prove. In a recent research, Lev (2001) notes that “intangibles are sources of value and competitive advantage, but it is clear from the above list that much of what is commonly regarded as intellectual capital and intangible value drivers would not in fact pass the accounting recognition test”.

Disclosure of internally generated intangible assets is not mandatory as per the existing accounting standards in most of the countries [IAS 38, 2007; FAS 141, 2001; FAS 142, 2001]. According to the IAS 38 [2007]:

Intangible asset is an “identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes”. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks [including brand names and publishing titles. Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

The allowed disclosure for internally generated intangible assets in voluntary. This is due to the inability to meet the accounting criteria required for inclusion in the financial reports, or they are not measured in financial terms [Van Der Meer-Kooistra and Zijlstra, 2001, 456-476]. However, we must note that there has been emphasis to incorporate external disclosure into the notes of the financial statements of companies [Petty and Guthrie, 2000, 241-251, Sveiby, 1989]. Many companies, mostly sports bases, produce an intellectual capital statement and provide information to their prospective users on their contents. Other companies use their annual report to disclose non-financial information about intellectual capital, including human capital that is considered important.

Given the controversy surrounding the recognition and measurement of human capital, specifically, we argue that a disclosure-only approach provides a better means of incorporating information into financial statements about human capital. An alternative view would be to recognize human capital on the balance sheet at its fair value, or even at
acquisition cost. Assuming that the fair value or the acquisition cost are available measures, this paper argues that it would be better to have more disclosures about human capital and the other drivers of entity value, to enable investors to better forecast future cash flows. In addition, in this paper, we present various metrics to be used for disclosing internally generated intangible assets.

There might be many who could argue that disclosure-only approach could not meet the demand by users of the financial statements. Some could argue and go further to note that these is not a real solution and that we need to even further and recognize human capital on the balance sheet of company. However, disclosure-only approach could be the initial step and if we undertake it, this could serve us later on toward full inclusion of human capital into the balance sheet of the company. In recent publications by the CFA Institute [2007] [OAASB, 2008], members have stated that:

Longer term, we believe that all intangible assets should be recognized at fair value. In the interim, however, we recommend that managers disclose the following:

- Estimates of the fair value of identifiable intangibles not recognized in the financial statements. In addition, nonfinancial indicators, such as market size and share and customer retention data, are useful disclosures.
- The principles used for recognition and measurement of intangible assets recorded in the financial statements.
- Information about intangibles that are imbedded in other tangible or financial assets, such as core deposit intangibles.
- The nature of any goodwill recognized and the key variables that would be assessed in impairment tests of the goodwill.
- The company’s business and business objectives, strategy and principal drivers of performance.
- A fair review of the development of the company’s and/or group’s business over the year and position at the end of it, including material post-year-end events, operating performance and material changes.
- The dynamics of the business – ie known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes.

These suggestions by the CFA Institute [2007] [OAASB, 2008] would seem to suggest that “human capital should be more effectively reported in the financial notes of the company”. The main premise and purpose of the financial notes is to allow an informed assessment and understanding of the company’s operations, financial position and future business strategies and prospects. The disclosure-only approach of human capital could provide such information for users of the financial statements. As with any new proposal of new reporting requirements for economic entities, there are some disadvantages, such as [OAASB, 2008]:

- potential conflicts with confidentiality
- lack of proper guidance on reporting content
- possibility of complication of current reporting rather than facilitation

3. PRESENTATION AND DISCLOSURE OF HUMAN CAPITAL IN ACCORDANCE WITH IAS 1:

The current reporting requirements in relation to assets as stated in the IAS 1 [2007] could allow the presentation of human capital as part of its reporting [as part of internally
generated intangible asset] without the need for any significant changes and modification. For example, in International Accounting Standards [IAS] paragraph 54[c] “requires the presentation of intangible assets in the statement of financial position”. In addition, in the above standard, paragraphs 55, 57 and 58 state that [OAASB, 2008]:

An entity shall present additional line items, headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity’s financial position.

It is important to note here that IAS 1 does not require or prescribe a format as to how such information can be presented. It clearly states that it could be presented. In addition [OAASB, 2008]:

[a] line items are included when the size, nature or function of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity’s financial position; and
[b] the descriptions used and the ordering of items or aggregation of similar items may be amended according to the nature of the entity and its transactions, to provide information that is relevant to an understanding of the entity’s financial position…

An entity makes the judgement about whether to present additional items separately on the basis of an assessment of:
[a] the nature and liquidity of assets;
[b] the function of assets within the entity…

In IAS 1, sub-paragraph 112[c] states that the notes to the financial statement should [OAASB, 2008]:

…provide additional information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

In addition, IAS 1 [2007] currently requires entities to disclose information in relation to the accounting policies adopted and judgments made by management that would assist users in understanding the entity’s reported financial position and financial performance. For instance, paragraph 122 of IAS 1 states that:

An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations [see paragraph 125], that management has made in the process of applying the entity’s accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

If FASB or IASB were to allow the inclusion of human capital into the notes of the financial statements, we must clearly first answer the question as to whom has control over these resources. Some could argue that these should be at the possession of the companies. After all, they are the once who investment into trainings, they are the one who teach the individuals the necessary skills to work on the job. On the other hand, some might argue that these rights are rights to the individuals, and if we take these rights from the individuals, we are taking their freedom and they become enslaved to the idea of ownership. That is, we need that prior to any such suggestions, we need to understand who is the control holder and this would mean that we need to exercise the appropriate professional judgment in the particular circumstances.

In order to determine the type of information that needs to be disclosed into the financial statements, it would be necessary to determine and “establish direct relationships
between human capital and value added to the organization” [Scarbrough, 2003]. There have been recent studies that have established methodical relationships between these human resource [HR] practices and the outcomes of businesses [Cordon, 1998, 26-81] [Scarbrough, 2003]. A recent article “The HR scorecard: linking people, strategy and performance” by Becker [2001], “it identifies a strong causal relationship between the HR system [high performance, strategically aligned policies and practices, the HR function [HR professionals with strategic competencies], and employee behaviours [strategically focused competencies, motivations and associated behaviours]” [Scarbrough, 2003].

In the “Effective People Management” [Guest, 2000] [Scarbrough, 2003] Guest finds that “HR practices influence performance through its influence on employee behavior, the increased employee skills and abilities, the promotion of positive attitudes that result in a committed workforce and finally in providing expanded responsibilities that make full use of employees’ skills and abilities”. Guest further notes that “where their effect is enhanced by operating in combination – and the importance of the effective implementation of practices” [Guest, 2000].

There many other researchers that have come with similar findings. For example in a study conducted by Wyatt “found that high scores in 30 key areas of human capital management related to about a 30 per cent gain in terms of market value or return to shareholders” [Wyatt, 2002]. This again proves that there is sufficient demand for human capital reports and therefore, we have a strong objective to ask regulators to work strong towards it achievement in the near future. As the above studies suggest [Guest, 2000; Wyatt, 2002] [Scarbrough, 2003] people and their creations do add value to the companies. The data used to determine these human resource practices currently is used only for internal purposes. In this paper, we recommend that some of the internal information used to make the HR internal decisions be modified and customized to meet the proposed framework for external reporting of human capital.

As with any arguments, there are people who have contradicted these findings. Specifically, the issues related to the arguments of framework creation. In their research for example, Scarbrough [2003] note that there are issues with “cross-sectional studies of this kind establish only correlations, not causes. A statistical correlation between the presence of a certain practice and positive outcomes in terms of productivity and profitability does not prove that the former caused the latter, only that they tend to co-exist” Further, in their research CIPD note that the “tendency to co-exist could be the result of positive outcomes feeding back into management practices – profitable firms being more likely to invest in training, for example. Alternatively, they may not be directly connected at all, their co-existence being simply the result of a deeper phenomenon that has not been measured [leadership, say] and that tends to result in both greater attention to HR and to positive outcomes” [Scarbrough, 2003].

4. FINANCIAL VALUATION METHODOLOGIES

In “Fighting the war for talent is hazardous to your organization’s health”, Pfeffer [2001] and discussed by Scarbrough [2003], some of the previous attempts by accountants to measure and/or to put value to human capital as given resource. Specifically, he presents the limitations of the following three major approaches [Scarbrough, 2003]:

• cost-based approaches – the value of human capital is determined by the costs of acquiring it [ie salaries and benefits] – amortized over expected future service
• market-based approaches – the value of employees is equated with the cost of buying in a capability from an outside supplier such as a consultant
income-based approaches – here value is related to the income that a person might generate for the firm

[Scarborough, 2003] discusses the cost-based approaches and concludes that “these approaches do not recognize the importance of the value-creation effect that is one of the major reasons for seeking greater information on human capital in the first place. If the value generated by human capital were no greater than its cost, the firm would be making a serious loss”. We could incorporate such information for internal uses. The issue here relates with the inclusion of such data and information for the purposes of external reporting. There have been many works by academics to identify or at least create a strategy towards achieving these goals. In their research, CIPD (2003) Scarborough noted the Saratoga Institute [1999] “claims that the worth of employees can be determined by dividing ‘adjusted profits’ by the number of employees. Revenue minus operating expenses for facilities, machinery, materials and supplies, and minus payroll and benefits cost is defined as adjusted profit. In the Saratoga Institute’s 1999 Human Resource Financial Report, the average adjusted profit for 891 companies in 25 industries was $110,429 per person. This varied from under $50,000 to a high of over $500,000. The Institute also advocates a measure of Human Capital Return on Investment’. This involves dividing adjusted profit by payroll and benefits. The average result in their 1999 Report was $1.82 for every $1.00 invested. Beyond these broad-brush figures, Saratoga’s selection of relevant metrics for evaluating human capital is relatively ad hoc, mixing financial valuations of human capital with norms of HR practice” [Scarborough, 2003]. For example, it highlights Saratoga Institute, 1999 [Scarborough, 2003] the following items:

- separation cost – this is said to be on average at least six months, revenue/employee
- voluntary separation rate
- training investment factor
- total labor cost as a percentage of revenue
- total compensation as percentage of revenue
- time to start – time from approval of a requisition to the start of employment
- separation cost – this is said to be on average at least six months, revenue/employee

The selected metrics for evaluating human capital, placed by the Saratoga institute [1999], have their advantages and disadvantages. Clearly, the efforts to place a financial value on human capital have the advantage that the metrics involved can be readily obtained from financial/accounting information. They could be also used by HR managers in efforts to establish and determine the company costs vs. benefits of job training, etc. However, the major disadvantage of these metrics is that these figures suffer from some of the defects of financial information. In general, these measures highlight market prices rather than value of human capital. [Scarborough, 2003].

In short, human capital is dynamic and requires multiple indicators. Thus, rather than viewing human capital as a stable stock of skills, it may be more useful to view its value as resulting from the company-level fit achieved between the flow of human resources and shifting market demands. In this view, an informed future-oriented assessment is concerned not only with what-questions, to do with the workforce skill-set etc, but also with how-questions, concerning the matching of such skills with business needs [Scarborough, 2003].

5. ALTERNATIVE [QUALITATIVE] MEASURES OF HUMAN CAPITAL

As discussed in the previous section, there are many limitations on the cost, market and income-based approaches. These limitations prevents the creation of uniform accounting standards to measure, recognize and report human capital on the face of the financial statements. Therefore, we need to look towards alternative approaches for presenting human capital, specifically qualitative measures. If we could find value creation for the users from
these measures, we could prepare a framework to disclose information that could be useful to users. In recent studies, researches have indentified range of qualitative measures of human capital [Scarbrough, 2003]. One of the most recent contributions here comes from Mayo [Mayo, 2001] [Scarbrough, 2003] who outlines a detailed framework that links the qualitative assessment of competencies to financial valuation. “In Mayo’s concept of ‘Human Asset Worth’ the value of an individual’s human capital is defined as equal to ‘Employment Cost x Individual Asset Multiplier/1,000’” [Scarbrough, 2003]. “The Individual Asset Multiplier is defined as a weighted average assessment of capability, potential, contribution to stakeholder value and alignment with organizational values” [Scarbrough, 2003]. As noted by Scarbrough [2002], “these qualitative indices are useful in that they focus on the value creation of employees”.

These recent studies performed [Pfeffer, 2001] and discussed [Scarbrough, 2003] on alternative qualitative measures of human capital would suggest that “single-point measures would be improper and misleading to users of the financial statements”. These discussions could be supplement with some of the work done in this paper. As noted in the CIPD research, “human capital represents one of the leading indicators for the future success of the company” [Scarbrough, 2003]. As noted, it also helps in the “formation of the business strategy and performance”. That is, in here, it is argued that if a company could develop proper strategy over its human capital, it would be able to properly monitor it in the future. This would ensure that once we have a level of monitoring into place, this could help the preparers with addressing this information at the decision making time. It would ensure that Company would be able to benchmark its human capital performance and improve it over time. This might sound a little bit overwhelming at first but it is believe that it could help companies in the long run. As companies have more information at their disposal to make management decision, they would have the ability to reach a level of competence that would be improved in the industry. As far as this new framework to disclose human capital into the notes of the financial statements, we must incorporate the expenses related to humans. These include training, earned skills on the job, etc. These metrics need to be incorporated into the financial statements in order to provide a level of support to potential users of the financial statements for the purposes of their decision making.

In developing such required disclosures for companies, we need to incorporate certain metrics that could be sufficient enough to encompass the necessary need for information. As we have previously suggested, the incorporation of company’s objectives regarding the use of human capital should play central role in the creation of disclosure requirements. In the provided section, regarding company’s objectives regarding the use of human capital, companies need to disclose their future plan regarding the use, training, direct investments in their employees. This would provide the necessary information for the users to make proper investment decision as time comes. In future research paper, we would further define in more detail, the necessary information that needs to be disclosed. For the purposes of this paper, we try to provide preliminary guidance as a starting point in order to develop the necessary disclosures.

6. COMPULSORY INDICATORS FOR HUMAN CAPITAL

In this section of the paper, we would try identify some of the compulsory indicators needed to establish an effective and efficient guideline/framework in order to report human capital into the financial statements. The proposed guideline should be used to further develop specific reporting requirements. This framework is not perfect by any means but
could be the starting point for further research on the topic of disclosure of human capital into the financial statement notes.

As we mentioned above, we need to identify and segregate between compulsory and discretionary indicators. This is critical that, we incorporate data that could enhance the management role of the company and therefore improve the competitive advantage of the company in the long run. That is, we need management to supplement users of the financial information with metrics that could supply information regarding internal strategies, enhance decision making of the company and ensure the internal controls are properly being tested. As part of this process, companies need to assess their plans. This would entail that companies establish internal processes to monitor and predict future performance. Usually, Companies have certain strategies in place such as budgetary reporting. They could utilize such internal processes and this could help them achieve greater understanding of their human capital. As notes in recent CIPD Reports, these includes but it is not limited to the “company's overall approach to the acquisition, development, management and performance of human capital” [Scarbrough, 2003]. Further, there are variety of methods that this information could be presented. In her, we argue that the use of narrative form would be most beneficial for the users as many would argue that quantitative information would be very difficult to achieve.

However, as with any new introduction of new accounting standards, such introduction would be difficult to implement in the short run. It would require that companies perform the necessary due diligence and ensure proper information is disclosed to potential users. In here, we believe that the information should be a mix of narrative and quantitative data. Such information should be prepared with the main premise of benefitting the users of the financial statements. It should be structured in such a way as not to be misleading. It must be mentioned here, the companies need to be proactive and force preparers to provide information that could be tested for internal control purposes. That is, the information should have a normal flaw, provide the medium to identify key controls and test their design and operating effectiveness. As such, this would ensure the data is improved over time.

7. CONCLUSIONS

In this paper, we argued that external reporting for human capital has been ignored. We noted that there have been many restrictions on external and internal reporting of human capital. We must as academicians take these problems and see them as an opportunity to emerge even stronger in the wake of the current financial crises. In this paper, we argued that the current accounting framework under IFRS, specifically IAS 1, could accustom the disclosure of human capital into the notes of the financial statements. We presented some of the major approaches and their limitation to value and reporting of human capital. Using the main existing approaches we have set out the key principles that need to be followed and have proposed information that needs to be included in the future consideration of reporting framework. It is clear that accountants should be at the front line at the creation of new accounting standards to ensure proper disclosure of human capital is achieved in the near future.

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