

## **Accounting for Human Capital: Is the Balance Sheet Missing Something?**

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### **Abstract**

*Human capital has become a significant factor in the success of organizations and is often regarded as one of the most valuable assets of corporations. However, traditional accounting practices do not classify human capital as an asset on the balance sheet. Society has witnessed a transition from the industrial age to the information age, and accounting has not transitioned along with it. Could the balance sheet be outdated? This paper explores the current view point on whether or not human capital should be accounted for on the balance sheet. The results revealed that 87% of the respondents hold the belief that human capital should not be accounted for and reported on balance sheets.*

**Keywords:** Human Capital, Balance Sheet, Asset

### **Introduction**

What is the difference between Lebron James and the average individual? If your answer is that he earns about \$45 million per year more than the rest of us, then you are absolutely correct. However, if your answer is that Lebron has superior athletic ability and talent, then you are also correct. Currently, in relation to basketball, Lebron's talents, skills and knowledge, or human capital, are amongst the best in the world. Could a man found walking down the street go out on the basketball court and replace Lebron? The truth is that anyone can go out there and "play" basketball. But, not everyone possesses the stock of human capital necessary to play basketball as well as Lebron does. If he were traded from one team to another, neither team would be the same anymore. The value of one team would significantly increase, while the other would decrease. The team that lost Lebron might have gained another good player, but that player does not possess the human capital that Lebron has. Lebron's human capital is a valuable asset to the team and creates value for the team. Why does the NBA pay him millions of dollars? They want him to use his wealth of talent, skills and knowledge to produce results. In essence, they just want to win. A basketball team doesn't win by possessing tangible things such as expensive uniforms or having top of the line shoes. A basketball team wins because they possess the people who contain the greatest stock of human capital.

Strangely enough, this same concept is alive and well in the business world. However, it is not as easy for fans and investors to identify which team to root for. Stat sheets, or financial statements, are compiled but don't tell the whole story. In the business world, financial statements provide the most comparable means of valuing a company. However, there is increasing discussion about the financial statements, specifically balance sheets, becoming outdated because they are missing something. How are outsiders supposed to know if a company has a Lebron James and thus, the competitive advantage necessary to win? A company's balance sheet does not reflect its greatest asset—human capital.

## **Literature Review**

The information age is upon us. Society, along with the economy, has undergone a massive transformation from an industrial age, dominated by the logic of standardized mass production and epitomized by the assembly-line to an age of information and knowledge-intensive services that are propelled by brainpower and the constant demand for innovation (Felin, Teppo, Zenger, &Tomsik 555; Peters 15). This postindustrial society has witnessed a change from a goods-producing to a service economy that is based on, “The growing power of ideas and virtual value – the turn from steel and hamburgers to software and intellectual property” (Peters 20). Production factors, such as raw materials and physical input that were used throughout the industrial age are now being outweighed by other production factors including human capital. The compilation of talents, skills and knowledge of a company’s workforce is the general definition of human capital (Wyatt and Frick 200; Schiemann 53; Wößmann 239; Berkowitz 14; Pappmehl 27). With the transition to the information age, and as the significance and reliance on intellectual capabilities grows, traditional accounting practices may need to be modernized to account for factors such as human capital.

Management and the accounting systems often have an unconscious and tacit mind-set that is colored by the values of yesterday’s industrial age (Berkowitz 14-15; Felin, Teppo, Zenger &Tomsik 555). Today, the realization that we are continuously gravitating towards a knowledge-intensive society is still catching on throughout the world. It is important for the business community to understand the effects of this transition and make adjustments to their models, assumptions and practices. Employees are now holding jobs that require the manipulation of information as skilled workers as opposed to the manipulation of material as unskilled workers (Spender & Marr 266). With the rise in significance of knowledge-intensive organizations, there has been an increasing awareness that fewer and fewer of an organization’s assets are tangible and fall neatly onto a line of the traditional balance sheet (Schiemann 53; Spender & Marr 265; Hai-Ming & Lin 470; Berkowitz 13-15; Lev & Schwartz 171; Felin, Teppo, Zenger, &Tomsik 555-556). People are often considered a company’s greatest asset. Take a look at the items that are accounted for on any company’s balance sheet and notice that you see items such as cash, inventory, land, buildings, machinery, patents, etc. However, note that neither an item nor a value exists on the balance sheet for “People.” How are financial statement users supposed to make well-informed decisions when some of the most important, and potentially most valuable, information is missing?

Not only is the value of human capital important for financial statement users, the stock of human capital embodied in people produces value for a company’s final product or service and contributes to the company’s earning power (Abdel-khalik 661). As mentioned above, human capital comprises the talents, skills and knowledge of a company’s workforce. The unique talents and knowledge found in the stock of human capital also create the competitive advantage for their company (Hai-Ming & Lin 472). If a company were to lose their workforce overnight, the value of the company would significantly decrease. The company might still possess assets like cash and land, but the ultimate driver of value, people, is gone. Adam Smith noted the value of human capital in *The Wealth of Nations*, “A man educated at the expence of much labour and time to any of those employments which require extraordinary dexterity and skill, may be compared to [an] expensive machin[e]” (Smith 1776/1976). Hence, even hundreds of years ago, Adam Smith recognized the importance of human capital. Machines are expensive assets. Likewise, humans possess dexterity and skill that are comparable to a very expensive machine and should be compared and treated as an asset.

Most companies could not achieve their missions without the pure brainpower of its workforce and yet, there is no generally accepted accounting standard for measuring or reporting the value of human capital. There are several reasons for which human capital has not made it onto the financial statements. Knowledge, skills and talents are difficult to quantify. Even when a value is conjured up, elements of the computations tend to be subjective (Lev & Schwartz 108; Spender & Marr 266). Despite the fact that there have been several proposals of reasons why human capital should be accounted for and proposals for ways to measure human capital, a consensus has not yet been reached. One of the measurement proposals often include some variation of Lev and Schwartz’s [1971] suggestion to measure the value of an employee’s future earnings potential. Even though these ideas have given some valid insight, much more research and experimentation needs to be done.

The challenge facing researchers is finding a way to consistently, accurately and objectively measure and report a value for human capital and find a place for this important factor of production on the balance sheet.

The purpose of this study is to determine if people who are currently in the accounting field believe that human capital should be valued on the balance sheet, and if so, to examine where on the balance sheet they feel it should be classified, and to explore how the results vary demographically.

### **Methodology**

We constructed a survey in Google Docs composed of eight multiple-choice questions and one free response question. The survey included questions about the demographics of the respondents and their views about reporting human capital as an asset on corporations' balance sheets. The survey was distributed through email by providing potential respondents a URL link. Data was collected via Google Docs in an Excel Spreadsheet. The survey was sent to approximately five hundred individuals in the accounting field. These individuals work for corporations and certified public accounting (CPA) firms. Of the approximately five hundred surveys distributed, 180 people responded.

### **Results**

As mentioned previously, 180 of the approximately 500 individuals surveyed responded. This represents a 36% response rate. Of the 180 responses, only 13% said that human capital should be accounted for on the balance sheet. Twenty-eight percent of the respondents were females and 72% were males. The data was analyzed, and is divided into two sections below, that show the differences between the responses of those who believe human capital should be accounted for and reported on balance sheets and those who believe human capital should not be accounted for and reported on balance sheets.

#### **Human Capital Should be Accounted for and Reported on Balance Sheets**

Thirteen percent of the respondents agreed that human capital should be accounted for on balance sheets. Of the 13% of individuals that said yes, 4% said that it should be classified as a current asset, 71% agreed it should be classified as an intangible asset, 12% thought it should be classified as an investment, and 13% agreed it should be classified as other assets. Additionally, 50% of those who said yes were male and 50% were female. CPAs comprised 50% of those who said yes and 83% currently work for an accounting firm. In addition, 56% of yes respondents have graduate degrees and 44% have only an undergraduate degree. Democrats made up 42% of yes respondents, 13% were Independent, and 46% were Republican. Interestingly, 58% of the males who responded yes were Republicans. With regards to age, 38% were between 18-25, 25% between 26-35, 17% between 35-45, 8% between 46-55, and 13% were 55 or older. This means that approximately 63% of the yes respondents were 18-35 years old.

#### **Human Capital Should NOT be Accounted for and Reported on Balance Sheets**

Of the respondents, 87% agreed that human capital should not be accounted for on balance sheets. Results revealed that only 19% of those who responded No were under the age of 35. As far as political affiliation, the majority of 51%, were Republican, 30% Independent, and 13% Democrat. In regards to education, 65% had an undergraduate degree as their highest degree obtained, and 35% had graduate degrees. Results also revealed that 25% of the respondents who answered that human capital should not be accounted for on the balance sheet were females. Of the females who responded no, 55% of them were Republicans, 18% were Democrats, and 21% were Independents. In addition, 63% of the females who said no had an undergraduate degree as their highest level of education. Males comprised 75% of the No respondents. The age differences amongst the males were that 6% of the males were aged 18-25, 9% were 26-35, 20% were 36-45, 33% were 46-55, and 32% were 55 and over. Thus, 65% of the males who said no were over age 46. Additionally, 50% of the men were Republican, 35% were Independent. Male respondents with graduate degrees were 34%.

The respondents who did not believe that human capital should be accounted for also submitted their thoughts as to why human capital should not be included. The reasons varied but the general comments submitted were that it would be impossible to measure, very difficult to maintain consistency, too subjective and there would be no conformity among companies. Respondents also stated that it might not be a good idea because human capital as a line item on the balance sheet could be easily manipulated and thus, distort the balance sheet. Even if you could determine a way to value the information that each individual human brings to the table, humans are too mobile. A person could easily switch jobs. In addition, the financial performance of a company already represents the inherent value of the human capital. It is inherent that a successful company would have the best qualified personnel for their positions.

However, some people have certifications but they don't know a lot about the business or may not be great workers. Other people don't have certifications but know a lot about the business and are great workers. Other people have certifications and know a lot about the business and are great workers. It's hard to determine on a case by case basis. So, what is value? I.e. a janitor who keeps the place spotless or the receptionist who knows every client's name may have more value than the PHD that knows the answers but turns people off. The computation would be redundant because wage expense and salary payable account balances represent the value of a firm's human capital. However, aside from all of the concerns about accounting for human capital, there were some positive comments as well. Some respondents expressed the concern that the income statement and balance sheet reporting mechanisms are long standing and are in need to develop similar tools for equally important elements of operating performance, particularly for human capital and for quality. These additional elements however, should not be integrated in a financial tool. That does not reflect their importance and it will be lost in the financial focus of the balance sheet documents.

### **Conclusion**

The results of our study indicate that the majority opinion among individuals in the field of accounting hold the belief that human capital should not be included on balance sheets. These opinions arise from the concerns that it would be very difficult to measure human capital and the value of human capital is very subjective. This would lead to incomparability and opportunities to inflate a company's assets. If there were a consistent way to measure human capital, we believe that the results of this study would change. We believe that if there were a way to consistently and accurately measure human capital, there would be a strong shift of opinion.

For now, however, because there is no consistent way to measure human capital, individuals in the accounting field do not want this value on the balance sheet. There are some opinions that human capital should be valued, but perhaps the financial statements are not the proper place for such a number. It might be a good idea to have a separate human capital report that would provide statistics and other facts about a company's stock of human capital.

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