

SHOULD HUMAN RESOURCES BE CAPITALIZED?

An Honors Thesis (ID 499)

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C O N T E N T S

	Page
I. THE PROBLEM . . . . .	1
II. DEFINITION OF TERMS . . . . .	3
III. REVIEW OF RELATED LITERATURE . . . . .	5
IV. DISTINGUISHING ELEMENTS . . . . .	7
V. DESIRED EFFECTS . . . . .	8
VI. METHODS OF CAPITALIZATION	
A. Discounted Wages . . . . .	.10
B. Historical Acquisition Cost . . . . .	.14
C. Replacement Cost . . . . .	.15
D. Adjusted (Present) Value . . . . .	.17
E. Goodwill . . . . .	.19
VII. THE R. G. BARRY CASE . . . . .	.22
VIII. OVERSELLING THE ADVANTAGES . . . . .	.25
IX. AN ALTERNATIVE . . . . .	.27
X. SUMMARY AND CONCLUSION . . . . .	.30
XI. BIBLIOGRAPHY . . . . .	.23

## THE PROBLEM

In recent years, accounting for human resources has taken on increasing importance, in part because data have indicated that expenditures on human capital have risen faster than those for non-human capital. As the financial emphasis has shifted, so has interest.<sup>1</sup>

A fundamental question about management's good stewardship of the human resources of a business was propounded in 1967 by Rensis Likert, in his book The Human Organization: Its Management And Value. Likert is a professor of psychology and sociology at the University of Michigan. He studied the effects of a cost-reduction program in industry and concluded that the savings realized had been offset by deterioration in personnel morale.

Several months after the cost-reduction program starts...lower levels of management and the nonsupervisory employees are apt to begin developing hostile reactions...and a very important change begins. Productivity starts to drop back... absence and turnover increase...the quality of the product and services decreases.... It often requires years for even an extremely competent manager to bring about any substantial improvement.<sup>2</sup>

Likert contended that proper human resource measurement could have avoided the errors.

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<sup>1</sup>William C. Pyle, "Human Resource Accounting," Financial Analysts Journal, September-October, 1970, p. 69.

<sup>2</sup>The Human Organization, pp. 86-88.

To prevent mis-management of the human resources within an organization, proper measuring systems must be devised and adopted so that information can be gathered and the best decisions can be made.

Such systems do not now exist. Techniques for human resource measurement have not been developed as rapidly as the measurements used for non-human resources.

One proposed answer to this problem is the capitalization of human resource values. Once the values are determined, they would be put into the accounts by debiting an asset account such as "Goodwill" and crediting an equity account such as "Human Resource Equity." The accounts thus created would appear on the company's financial statements. Accountants, economists, sociologists, and business people are interested in knowing if this method is practical and feasible.

The purpose of this investigation was to assess the utility of capitalization, for utility is the only logic for implementing new procedures.

## DEFINITION OF TERMS

A research project is being conducted jointly by the Institute for Social Research and the Graduate School of Business Administration of the University of Michigan.<sup>1</sup> Its purpose is to develop human resource accounting in industry. The director of the Institute is Rensis Likert; assistant project directors are William C. Pyle and Eric G. Flamholtz; research associate is R. Lee Brummet.<sup>2</sup>

Because of their objective and prominence in the subject, the term "sociologists" will be used to represent these people and their school of thought, although others within accounting, economics, etc., may share their views.

The sociologists and others have chosen to use the terms human "resources" and human "assets" interchangeably. Some accountants would question this license, and perhaps legitimately so. Gilbert argued that:

...the justification for assigning asset status to human resources is based on the economic concept that an asset is capable of providing some future service...economists equate assets, resources, expected future services, and factors of production, which clearly justifies human resources being

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<sup>1</sup>William C. Pyle, "Human Resource Accounting," Financial Analysts Journal, September-October, 1970, p. 69.

<sup>2</sup>William C. Pyle, "Monitoring Human Resources--On Line," Michigan Business Review, July, 1970, p. 19.

considered as assets.<sup>1</sup>

To counter, accounting is not economics. Accountants measure and economists value. Accounting is a record from which others make judgements and which judgements determine values.

However, in accord with the spirit of C. West Churchman's invocation to accountants to "...join (other) professional associations in looking at today's problems...with all the humility, humor and purposefulness possible,"<sup>2</sup> the new propositions should be investigated only on their merits as to practicability and without regard to the issue of semantic ritual.

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<sup>1</sup>Michael H. Gilbert, "The Asset Value of the Human Organization," Management Accounting, July, 1970, p. 26.

<sup>2</sup>"On the Facility, Felicity and Morality of Measuring Social Change," The Accounting Review, January, 1971, p. 35.

## REVIEW OF RELATED LITERATURE

Likert said, "In human asset accounting we are concerned with developing and attaching explicit dollar values to a firm's human organization."<sup>1</sup> The idea proposed is that these dollar values should be made a part of external business reporting.

The title of a magazine article, "Put People On Your Balance Sheet,"<sup>2</sup> puts the idea squarely. Accounting for human resources from this point of view, then, means capitalizing them. Alternate methods are available, and one will be reviewed later.

In his book, The Foundations of Accounting Measurement, Ijiri noted that:

We have seen the appearance of numerous books, articles, and speeches dealing with contemporary challenges to accounting from those who make growing use of...behavioral science theories, etc. in dealing with business and economic problems. In fact, accounting has now come to a critical turning point which is at least as important as the one it came to in the early 1930's. (Response should come) only after careful study...it is crucial to perceive whether the need for a change in accounting theories and practices lies in the essentials or the peripherals from the viewpoint of the structure of accounting measurement.<sup>3</sup>

Barbatelli observed that in attempting to refine their tools

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<sup>1</sup>The Human Organization, p. 148.

<sup>2</sup>James S. Hekimian and Curtis H. Jones, Harvard Business Review, January-February, 1967, p. 56.

<sup>3</sup>Yuji Ijiri, preface, pp. ix, x.

of analysis, accountants have been frustrated by an inability to quantify the human element. He asked "How do you put a price tag on human endeavor? And what are the effects?"<sup>1</sup> These are the questions to which this inquiry is addressed. Looking ahead, Barbatelli foresaw that "the attempt to place value on present and potential contributions of employees can have far-reaching implications...."<sup>2</sup>

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<sup>1</sup>Ettore Barbatelli, "Accounting for People," Management Accounting, June, 1971, p. 1.

<sup>2</sup>Ibid.

## DISTINGUISHING ELEMENTS

Human resources can be separated into three classes, according to the benefits rendered to a business which engages an employee: 1) present services, 2) future services, 3) favorable/unfavorable attitudes. Examples of these kinds of costs, respectively, are: the weekly wages paid for operating a truck, a training program undertaken to create new skills in employees, and attitudes and motivation appearing as company loyalty or absenteeism.

Under presently accepted accounting principles, the costs of all these benefits (or non-benefits, as it may eventuate) do find their way onto the income statement and balance sheet whether immediately, via "expensing," or by temporarily holding and "capitalizing" them for periodic application. The only variable is the timing. (Attitudes and motives not found on the statements per se are also present in the economic results of operation.)

This division of expenditures based on the kind of benefit received is a distinction the proponents of capitalization have not made. They view all human resource costs as assets, i.e. as being beneficial to the future, and would capitalize past and/or anticipated costs accordingly.

## DESIRED EFFECTS

The sociologists desire to make the value of the human element in an organization ascertainable by way of the financial statements.

They stated:

A favorite cliché for the president's letter in corporation reports is "our employees are our most important--our most valuable asset." Turning from the president's letter and looking to the remainder of the report, one might ask, "where is this human asset on these statements which serve as reports of the firm's resources and earnings? What is the value of this most important or most valuable asset? Is it increasing, decreasing, or remaining unchanged?"<sup>1</sup>

The sociologists regard people as so important to a business that they believe proper recognition and safeguarding of the value will occur only if it appears on the balance sheet.

Protection from abuse was another goal, illustrated by Gilbert:

Without human asset accounting a "pressure artist" may be able to achieve high earnings over a few years while causing unmeasured deterioration of the loyalties, favorable attitudes, and motivations of the personnel.<sup>2</sup>

Another reason was offered by Caplan. "In order to develop a more dynamic management accounting system there must be a recognition

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<sup>1</sup>Brummet, Flamholtz and Pyle, "Human Resource Measurement," The Accounting Review, April, 1968, p. 217.

<sup>2</sup>Michael H. Gilbert, "The Asset Value of the Human Organization," Management Accounting, July, 1970, p. 114.

of behavioral science concepts which will bring to management's attention the importance of the firm's investment in its human assets."<sup>1</sup>

It is also thought that such an accounting would bring about better decisions regarding the allocation of human resources, which is a prime concern of economists.

Unfortunately, management at present lacks the tools to measure all the effects of its decisions. However, it should be noted that financial information which is collectible for balance sheet reporting is collectible for management purposes, and that qualitative values will appear on statements only insofar as they are reducible to dollar amounts.

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<sup>1</sup>Edwin H. Caplan, "Behavioral Assumptions of Management Accounting," The Accounting Review, July, 1966, p. 509.

## METHODS OF CAPITALIZATION

Discounted Wages

Lev and Schwartz regarded the worth of human capital as "the present value of future income discounted by a rate specific to the owner of the source."<sup>1</sup> The income they used was wages to be paid to an individual in the future, discounted to a present value.

Citing the U. S. census profile, these authors would adopt census figures for average earnings in several classes of workers, e. g., average earnings of industrial engineers 25 years of age. Each year the figure would be multiplied by the number of people employed in that category, and it would be discounted and capitalized as the firm's human resource asset.

Two question can be raised as to the profile's applicability. It declines from about forty-five to sixty-five years, attributable to a decline in productivity, said the authors. This profile includes all American males, but an industry employs only a selective number of males, presumably capable and productive. There would be no adjustment for health deterioration, disability, under-employment, early retirement, etc., all of which are reflected in a census profile.

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<sup>1</sup>Baruch Lev and Aba Schwartz, "On the Use of the Economic Concept of Human Capital in Financial Statements," The Accounting Review, January, 1971, p. 110.

Also, those on the payroll will likely make higher wages with age because of seniority and classification--not lower as the profile indicated. A current General Motors publication stated that "each employee will...reach the maximum in his grade."<sup>1</sup> The decline is therefore an average, composite figure which cannot be validly transposed to any particular industry.

Since wages are determined mostly by market conditions and union contracts, to anticipate, discount and capitalize any projected amount would be arbitrary, with a consequent loss of significance. More important, it is not demonstrated how management could avoid or alter the amount and/or incurrence of this expenditure. As a matter of fact, capitalizing could cause serious oversights if a predetermined amount were to cause the possibilities of automation to be overlooked.

From the investor's viewpoint, the actual amount of expenses are not relevant as long as he has reason to believe that they are in line with the market. His interest is in the difference between income and expenses, profit. Wages discounted offers no further help in making his investment decision.

Gilbert made another point:

...this approach is limited in usefulness because of the lack of a direct relationship between salary and an employee's value to the firm. Personnel receiving the same salary rarely contribute the same value to the firm."<sup>2</sup>

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<sup>1</sup>General Motors Corporation 1973 Report on Progress in Areas Of Public Concern, GM Technical Center, Warren, Michigan, February 8, 1973, p. 78.

<sup>2</sup>Gilbert, "The Asset Value of the Human Organization," Management Accounting, July, 1970, p. 26.

Lev and Schwartz stated several benefits for wage capitalization. One was that new ratios of human/non-human capital may be revealed, and economists study such trends to try to relate them to return on investment. Such a study probably produced the information which was cited earlier, viz., that human capital expenditures are rising faster than non-human. This information has utility for a very limited number of financial statement readers. The costs of implementing such a measuring program must be offset by the benefits, and unless information can increase profits or decrease costs, a business would be unwise to go to the expense of gathering it.

Since particular benefits for any one business are not shown by this method, it is an unjustified expenditure for the purposes of allowing economists to make studies.

A second benefit cited was that the "skill (scientific) intensity" of industry and its relation to the rate of return and growth is a currently debated issue. Capitalization of future wages discounted shown on the statements would supposedly aid in resolving the debate.

This benefit does not have a relationship to the objective of any one business--to make a profit. No suggestion was made to the effect that, in possessing this information, a manager could adjust his amount of future wages discounted and improve the profits of his company. It is doubtful that a business has the responsibility to supply third persons with such expensive information

because it happens to be a current "issue."

It was asserted in Lev and Schwartz's article that investors could learn by reading the discounted wage amount that management was hiring low quality employees to maximize profits in the short run.<sup>1</sup>

This statement was typical of the ideas and ideals of the proponents of capitalization. Throughout the literature it was noted that they always assumed that the statement reader would reach the proper conclusion, an unrealistic expectation.

There are many ways to interpret a lower discounted wage amount, e. g., a reader might conclude that management has made mechanical innovations, allowing them to hire fewer employees. Or he might conclude that there was more turnover and beginning-rate employees were in the majority (avoiding what some have termed the "aging firm"). Or he might conclude that better labor planning was being done, e. g., work schedules were rearranged to tap a new and lower priced (but not necessarily lower quality) labor market, like split shifts of four hours for housewives with idle time. The result in all cases would be a lower human capital figure.

This was the one common fallacy in the proponents' arguments for capitalization. They always believed that financial statement figures had one interpretation--the correct one, a fact which accountants simply cannot take for granted, especially in the current legal

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<sup>1</sup>Ibid., p. 108.

environment with its increased levels of accountant responsibility and liability.

#### Historical Acquisition Cost

This method had the most objectively verifiable basis for capitalizing, even though it would contain estimates. It would include the costs of hiring and training a human resource.

Capitalized historical costs do not, however, tell more for having appeared on the balance sheet individually than for having been incorporated in the expenses on the income statement. Once an employee is brought to the point of rendering services and costs have been incurred which do not significantly affect future performance, it is questionable if there is any value to be capitalized and spread over future periods. A distinction should be recognized here between outright expenses, and costs invested in special skills of an employee which are expected to change future profits.

Flamholtz established his criterion for capitalizing:

If an object is not capable of rendering future economic services it has no value... objects which do not possess expected future benefits can not, by definition, be "resources."<sup>1</sup>

Amounts of historical costs carried as values on financial statements could mislead readers to believe that more skills which are convertible to future profits are present than those which actually are.

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<sup>1</sup>Flamholtz, "Toward a Theory of Human Resource Value in Formal Organizations," The Accounting Review, October, 1972, pp. 667-668.

When historical costs are once communicated, the information has served its maximum utility without being carried any longer.

Likert proposed something similar in his start-up costs, in which he would include the time and effort required to familiarize a new employee and for him to establish a working relationship within the organization.<sup>1</sup> This is a more sophisticated and comprehensive idea but, as he acknowledged, very expensive and difficult, if not impossible, to measure.

An important consideration for capitalization of historical costs would be the impact it would have on tax liability, since these costs are now customarily expensed and tax deductible. Capitalization would result in a tax disadvantage, especially if competitors do otherwise. The forgone deduction and increased tax liability would have to be added in as another cost of the human resource measurement program.

#### Replacement Cost

By this method a human resource would be valued at the amount it would cost to recruit, train and maintain another equivalent individual. It would necessitate the keeping of market prices on a wide range of indices. A serious handicap in utilizing this approach is that it is not consistent with the current methods of valuing other company assets.

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<sup>1</sup>Likert, The Human Organization, p. 147.

It is also subject to market fluctuations and unpredictable variables which could render it meaningless for long-range decision-making. A recent example serves to illustrate. When the space program was cut back, engineers were plentiful and probably accepted under-average salaries in order to work, while at other times engineers have been expensive to gain, if they were available at all, because of Congress's budgetary moods about space exploration.

If replacement costs were used, conceivably, the asset carrying value would have to be adjusted with every economic and/or employment change affecting the labor market. With many classes of employees and many variables to consider, it would become a very costly program and, as always, the benefits must outweigh the costs.

As a springboard for discussion of the concept of replacement cost capitalization, Likert and Pyle asked executives across the country:

Suppose that tomorrow your firm had all of its present facilities--everything, but no personnel except the president; and he had to rebuild the human organization back to its present effectiveness. How much would this cost?<sup>1</sup>

This was a highly unlikely eventuality and an irrelevant question, for, even providing that an accurate answer could be given, the questioners failed to show what kind of beneficial

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<sup>1</sup>"Human Resource Measurement," The Accounting Review, April, 1968, p. 217.

action could be taken. This is an aggregative quantification of no practical use.

On a more tractable basis, a manager might well be interested in this kind of information because it could be used to plan, and to influence future conditions. For example, if a manager had access to data which showed that to replace one chemical engineer in a certain department, the cost would consist of interviewing thirty engineers, transporting eight of them to the home offices for negotiations and appraisals, hiring and moving two to the locality, training, and, after time, keeping one good and productive engineer, a different policy might be adopted for keeping the engineer contented and productive. But even this use implies that management is not already making such adjustments without replacement cost information. Individualized data carries managerial potential; capitalization of an aggregate does not.

Given that replacement cost information in the proper scale is valuable, the question still to be answered is whether or not assistance would be given to a decision maker by capitalization of the replacement costs ascertained. The answer is that there would not. Therefore, the costs of aggregating these values is unwarranted, balanced against the utilizable value.

#### Adjusted (Present) Value

Roger Hermanson advanced this method. The value base would be the next five years' salary of the human resource. This amount

would be discounted to a present value using the rate of return the business earned on its other assets for the current year. The discounted value would then be multiplied by a human efficiency ratio computed by comparing the return of the current year with the return experienced by others in the industry. (If the business were more profitable than its competitors the ratio would be above one; if less, under one.)

An entry would be made by debiting human resources, and crediting future wages payable and excess worth. (If the business operated at a ratio under one, a reserve for future inefficiencies would be debited instead of excess worth increasing.) The question to be answered is, what utility has this information? Would managers or investors discover more by observing these account balances on the financial statements than they could learn by looking at the return on investment? No. But investors could be deceived as a result of the capitalization because this approach presupposes that similar industries should make similar returns.

In their report, the Committee on Non-Financial Measures of Effectiveness observed:

Seldom, if ever, are competitive conditions fully realized in any industry. Interdependence and indivisibility of production factors force analysts to seek alternative means of evaluating effectiveness.<sup>1</sup>

Comparability of financial statements, and hence firms,

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<sup>1</sup>Robert E. Jensen, et al., "Report of the Committee on Non-Financial Measures of Effectiveness," The Accounting Review, Supplement to Volume XLVI, 1971, p. 165.

which many capitalization proponents expect, rests on a supposition which is not always valid.

A question also arises here as to the psychological aspects of recording expected "inefficiencies." This could have a deleterious impact on the human resources so devalued, bringing about discouragement and destroying motivation. The financial results could thus be a result of the financial reporting.

The adjusted value figure may be a poor approximation under this method, because the probability of obtaining a true figure is a function of the number and quality of the factors which are used in constructing the figure and because the product for several probabilities decreases rapidly.

For example, the three factors cited above might each have a high probability, say .8. If the probability of ascertaining the accurate wages for five years is .8, the probability of the relevant discount rate remaining unchanged is .8, and the probability of the excess earnings being caused by inordinate human efficiency is .8, then the best estimate of adjusted value which can be made has only a .51 probability of being correct, since the three factors,  $.8 \times .8 \times .8$ , yield .51. It is not reasonable to interject information of this caliber into the accounts when there is little evidence that it can be used to favorably alter the course of future events, which it was not demonstrated to do.

#### Goodwill Method

When a company makes returns on its investment which are

above the average of the industry, some proponents of capitalization would infer that unstated human resources are present within the business and that they are responsible for the excess earnings. Hermanson would capitalize the earnings in excess as goodwill.<sup>1</sup>

In discussing goodwill, Paton disagreed.

The conditions leading to success are exceedingly complex. Managerial ability, methods and processes, territorial location... numerous other factors may contribute to financial success. Further, purely external and fortuitous circumstances...may be the dominant conditions....<sup>2</sup>

For the sake of investigation, however, it may be said that two sample industries have human resources responsible for the excess earnings, and that they have been capitalized. Chambers illustrated such a case.

Suppose that 100 units invested in a firm gives a return of 8 units and that the normal return...is 5 units. The present value of 5 units is 100 and of 8 units is 160. The value of the goodwill is, therefore, 60 units. If this is added to the 100 units invested, the return on the resulting 160 units is 8 units, and the same rate as the normal expectation.<sup>3</sup>

As Chambers concluded, "All opportunities would seem to be alike...the process is circular and self-defeating."<sup>4</sup>

Since the amount of excess earnings is readily obtainable under present practices, it is not necessary to capitalize it for

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<sup>1</sup>Roger H. Hermanson, Accounting For Human Assets, 1964, p. 9.

<sup>2</sup>William A. Paton, Accounting Theory, (Chicago: Accounting Studies Press, Ltd., 1962) p. 313.

<sup>3</sup>Raymond J. Chambers, Accounting, Evaluation and Economic Behavior, (Englewood Cliffs, New Jersey, Prentice-Hall, Inc., 1966) p. 211. <sup>4</sup>Ibid.

managers' and investors' purposes. Return on investment and stock market values have equated opportunity and cost for a long time, and capitalization of excess earnings would erase the distinction which now causes attraction of capital to the most efficient organizations, a primary objective according to Hermanson.

Brummet suggested a slightly different goodwill method. The excess earnings would be allocated among the human resources of the firm in the ratio of human to non-human resources present.<sup>2</sup> He did not explain, however, how the human assets would be valued in the first place, and whether inferior earnings would be treated in the same manner.

Circuitous results, questionable assumptions, and the possibility that funds will tend to flow to less efficient organizations, render this procedure worthless, if not dangerous.

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<sup>1</sup>Ibid.

<sup>2</sup>Brummet, Flamholtz and Pyle, "Human Resource Measurement," The Accounting Review, April, 1968, p. 219.

## THE R. G. BARRY CASE

In conjunction with the Institute for Social Research, the first human asset accounting system has been adopted by the R. G. Barry Company of Columbus, Ohio, a manufacturer of leisure footwear.

Along with the annual financial statements Barry published a pro-forma balance sheet showing "conventional and human resources."<sup>1</sup> Their stated aim was to "develop a method of measuring in dollar terms the changes that occur in the human resources of a business that conventional accounting does not currently consider,"<sup>2</sup> and to "improve the effectiveness of management decision-making...."<sup>3</sup>

Development of people is the theme of Barry's reports on their human resource accounting system,<sup>4</sup> but there have been other benefits operative, too. They have pleased their work force by designing and incorporating an accounting process unique to the business world and directed at recognizing their employees' value. One of their spokesmen stated:

As personnel see the real care that is being taken to try to monitor this asset as well as the physical tangible assets...they have actually

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<sup>1</sup>R. G. Barry Corporation Annual Report, 1970, Columbus, Ohio, p. 13.

<sup>2</sup>R. G. Barry Corporation Annual Report, 1969, Columbus, Ohio, p. 14.

<sup>3</sup>R. G. Barry Corporation Annual Report, 1970, p. 12.

<sup>4</sup>R. G. Barry Corporation Annual Report, 1969, pp. 14-15; 1970, pp. 8-9.

taken a good deal of pride in the fact that as a group...they are participating in something new...."<sup>1</sup>

The company has also attracted capital, no small consideration for a growing firm. Edward Stan, their treasurer, stated that they have been able to "attract more borrowing power than our 'cold figures' would justify on the surface...the human factor was surely considered."<sup>2</sup>

Barry has also gained the publicity benefit of being the first company to publish statements with capitalized human resources. The publicity thus gained is valuable, and almost free (for the cost of keeping extra accounts, etc.) compared to the cost of similar publicity through regular advertising channels. It also gives the company the aura of being a progressive leader.

A fact not mentioned in the Barry literature was that carrying values for individual employees provides an effective means for identifying and "weeding out" under par personnel. Barry's annual reports imply that they have exceptional people working for them. Surely the thought has occurred to them that human resource measurement could aid them in building an organization composed of superior performers only.

The unstated objectives of this firm may be to attract capital

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<sup>1</sup>Thomas J. Burns, Editor, The Behavioral Aspects of Accounting Data For Performance Evaluation, (Columbus, Ohio: College of Administrative Science, The Ohio State University, 1970) p. 41.

<sup>2</sup>William C. Pyle, "Human Resource Accounting," Financial Analysts Journal, September-October, 1970, p. 71.

<sup>3</sup>R. G. Barry Corporation Annual Report, 1969, p. 12.

and attention, and to improve the level of employee quality and morale, all of which translates into higher profits. That is good thinking, but the effects may be different for businesses who do not enjoy Barry's unique position. Barry now has the best of two worlds because the expenditures made are tax deductible, yet carried as assets "pro-forma" for other benefits.

Nearly one half million dollars was shown as deferred taxes in Barry's 1970 annual report, because the human resource costs were expensed. If capitalization should become a widespread practice, it would be unrealistic to believe that the Internal Revenue Service would not insist that enterprises recognize their tax liabilities in accordance with their financial reports, and one significant advantage of the present system would be lost. Notably, the sociologists have not discussed the tax question.

Adverse development here would add to the cost of a human resource accounting system, and the benefits of capitalization would be greatly reduced, if not erased.

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<sup>1</sup>R. G. Barry Corporation, 1970, p. 13.

## OVERSELLING THE ADVANTAGES

It is possible that the sociologists and other capitalization proponents are overselling the benefits of human resource accounting.

In discussing System Four, Likert's model for proper human resource management, he wrote:

The highest productivity, best performance, and highest earnings appear at present to be achieved by System Four organizations, i. e., organizations with an interaction-influence or participative management system.<sup>1</sup>

Lippert disagreed, saying, "the evidence is not so conclusive. Studies of attempts to introduce this concept have shown that success is dependent on a whole host of variables, of which each must be present in just the right quantity."<sup>2</sup>

Lippert went on to say something relevant to the whole human resource measurement effort.

It should be remembered that many of these concepts and applications were spawned and tested during the prosperous years following World War II. Companies could afford to experiment. "If competitor Jones, down the street is trying it, why shouldn't we? After all, the try-out costs are a deductible business expense. And we can't let Jones gain that competitive advantage, in the event that it does work."<sup>3</sup>

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<sup>1</sup>Frederick G. Lippert, "Whither HRM in the Seventies?" Michigan Business Review, March, 1972, p. 16.

<sup>2</sup>Ibid., p. 14.    <sup>3</sup>Ibid., p. 16.

Today, Lippert said, the pendulum has swung.

Expenses must be pared. Aftertax dollars are a scarce resource. And among the first of the "nice but not essentials" to be lopped off are the "better HRM" projects and programs.<sup>1</sup>

The sociologists have not always been right in the past, and well qualified people like Mr. Lippert are not so optimistic about the proposed benefits of measuring and "writing up" human resources.

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<sup>1</sup>Ibid., p. 16.

## AN ALTERNATIVE

Proponents of capitalization want management to develop better ways of accounting for human resources, and they want financial statement readers to be able to pass judgement on the allocation and conservation of these resources.

As an alternative to capitalization for attaining these goals, a kind of measuring which has received less publicity, but which holds more promise, is operational auditing.

The objective of operational auditing is to appraise management's organization, techniques and performance with a view toward improvement.<sup>1</sup> This work should very naturally include the management of and accounting for human resources.

Operational auditing takes into account the fact that there is an interrelationship between all business functions. Buckley stated that "there is a need for the specialist who examines one problem in particular, (but) there is an equal need for the analyst who can review the whole business systematically and examine the efficiency of functional interaction."<sup>1</sup> Human resources are not isolated. They, too, should be managed by methods compatible with the particular circumstances of all segments of a business operation.

The qualitative and quantitative factors of human resources are so intertwined that attempts to report them in money terms only

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<sup>1</sup>Ibid., p. 71.

may be confusing and dangerous. Attitudes, e. g., are legitimate interests of business owners and managers, but such characteristics are not economic factors. They are conditions, and one cannot measure in dollars the time, place and circumstance which make human conditions what they are. Operational auditors could report conditions such as employee morale, whereas financial auditors could not.

This is the fallacy in the capitalization method of accounting for human resources: in finding a common base by which to measure, detail must be sacrificed because common denominators lose the ability to impart specific information. This is not to say that even qualities cannot or should not be measured on numerical scales. Measurement systems should be developed for these purposes. An opportunity exists here for the sociologists to provide the complement necessary to the accounting function for an all-over organizational temperature-taking. They can teach accountants how to convert human resource qualitative data to measurable, reportable standards. Accountants can say how much was spent; behaviorists can provide methods to tell whether or not the money decision resulted in a better (non-financial) condition of the organization.

Human resource data can thus be transformed into constructs for planning. The results of such measures then belong to the operational auditors because it is their job to match the overall condition of things to the performance of management, and to make an assessment. Also, they are the best qualified to show management

better ways of utilizing these resources, given the restraints that the operational auditors, and perhaps uniquely they, recognize as the limits within which management can act. Their report should serve as the matrix for improvement as well as a summation of past results.

With the increasing importance of a multitude of environmental factors such as pollution, the writer envisions the annual financial audit and the operational audit as inseparable and equally important parts of a firm's "health" report. Certainly the condition of labor is as important as the condition of the business environment--governmental, customer, supplier, etc.--and none of these is a part of present financial reporting.

## SUMMARY AND CONCLUSION

The philosophy which is behind the current inquiry into human resource accounting has potential, if properly developed. New kinds of measurements should be available so that better decisions can be made. It is important, however, that the surrogate measurements of effectiveness not become objectives in themselves. Measuring for the sake of measurement has no virtue.

The methods proposed for capitalization of human resources up to this time do not appear to offer the benefits which would justify them.

A word of caution came from Iiri:

isolate the dollars invested in human resources; it would reveal what opportunities management had to utilize these resources, and whether their decisions were superior or inferior, given the circumstances.

Just as financial auditors measure the flow of money through an organization in order to assess the financial opportunities management had, so could operational auditors make a critical examination of the human resource decisions, in the light of the conditions prevailing at the time the decisions were made. This function would satisfy the safeguarding goal by identifying intentional mismanagement decisions and/or policies. In a sense, it is the negative function of the audit.

The positive function emerges as auditors discover non-optimum performance because of unintentional human resource errors. Specific areas of difficulty, question, or confusion, would be brought to light, and specifically-designed human resource measurements could be implemented by management, with the aid of the operational auditors. The measurements thus decided upon would help in problem solving. The greatest benefits from human resource measurements are to be realized from such focusing, contrasting strongly to the en masse measurements currently proposed, like capitalization, which is an unwieldy aggregate not amenable to use as a corrective device.

Through the positive and negative influences inherent in operational auditing, management could expect to be critically scrutinized, fairly judged, and aided in making improvements. Such

a balance of discouragement and encouragement should bring out the best managerial talents possible, and result in better business organizations. Operational auditing would thus provide a more fully rounded solution to the human resource measurement problem.

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