Reporting Human Capital

Accounting for Human Resources

Professor Chris Higson, London Business School

About the author:

Chris Higson is a professor in accounting practice at London Business School, where he was Chair of the Accounting Group and director of the School's Financial Seminar for Senior Managers. He has degrees in philosophy and in economics from University College, London, and has a doctorate in finance from London Business School; he is a chartered accountant and worked for Deloitte and Touche.

During his career he has given advice on financial performance to senior managers in around 120 organisations, including many of the world's leading industrial and financial companies. His current research examines financial performance in recessions, the value of information to organisations, and the performance of the private equity industry. His areas of expertise are in financial statement analysis, financial performance and valuation, taxation, governance and regulation. He serves as an expert witness in the areas of accounting practice, corporate finance and taxation.

In a highly competitive and rapidly changing knowledge economy the success and even the survival of an organisation depends on the quality of its people. With increasing demand for flexibility and innovation, and for the production of knowledge assets, the importance of human capital can only grow. This much we can all agree on.

So the old corporate mantra about people being the most important asset has never been truer. From that, it surely follows that people should be in the balance sheet. The U.K.'s CIPD has recently argued that case with some passion, 'the onus is now on the IASB to explain why the value of human resources cannot now appear on the balance sheet as an asset in its own right.'

Balance sheet recognition has always been the gold standard in accounting. The concern is that if an asset is not in the balance sheet it will not get proper attention – outside stakeholders, and particularly investors, will not understand its true value and will not hold managers to account for it. Inside the organisation, managers may not exercise proper stewardship over their assets and may underinvest in them.

In this paper I see what insight finance can bring to the measurement and management of people. I explain why human capital is unlikely to find its way into the balance sheet and why the HR profession, if it was in charge of accounting, would reach the same conclusion. Putting a number on the value added by the people in an organisation is just too difficult.

Instead the focus should be on developing reliable metrics to signal the health of the organisation's human resources – that is, we need to focus on building the human capital scorecard. The accounting debate forces us to be clear exactly what we mean by human capital and what a scorecard needs to look like.

When we are accounting for human capital we have two potential audiences in mind – the internal audience, and investors and other stakeholders outside the business. 'What we should tell the investors' has received a lot of attention in this debate. But because the value added by human capital is complex and context specific, the narrative is sure to be discretionary. Experience tells us that voluntary disclosure to an external audience contains inherent conflicts and limitations. Rather, I argue that the preoccupation should be with how best to measure and report the health of the human resource inside the organisation.

The main accounting acronyms I use in this paper are as follows – the IASB is the International Accounting Standards Board that is in charge of IFRS, which are International Financial Reporting Standards. GAAP, Generally Accepted Accounting Practice, is shorthand for the prevailing accounting rules. IFRS and US GAAP are the two main systems of GAAP internationally.

In the report 'Valuing Your Talent', published in 2014 by the CIPD in collaboration with the UKCES, CIMA and CMI.

Human capital as an asset

Human capital sits in a diverse group of assets, including organizational culture and competences, intellectual property and know-how, alliances and networks, and brand and reputation that form the 'intangible assets' of the organisation. Intangibles meet the most basic definition of an asset – they are resources that we control and that we expect to provide benefits in the future.

The intangibles are what differentiate a business and sustain its competitive advantage, so they are frequently the most valuable resources that an organisation has. Intangibles provide the vocabulary of value creation, the vocabulary of economic success. When we ask why this or that organisation is successful, the answer is invariably couched in terms of intangibles.

To recognise something in a balance sheet you have to put a number on it – you need to be able to clearly identify it and reliably value it. GAAP just does not believe you can do this for most intangibles. Intangibles are typically unique and differentiated assets. This is what makes them valuable, but from a valuation point of view that is also their downfall. With no active market in intangible assets and no market price, valuation has to be an estimate based on uncertain future events.

But if intangibles are bought in a transaction then there is an identifiable cost and GAAP is much more relaxed about putting them in the balance sheet. In fact, there is quite a long list of intangible assets that GAAP is happy to see recorded after a takeover; that list includes brands but – strikingly – still does not include human capital!

Everything seemed to change in mid-2013 when the IASB published a discussion paper proposing radical changes to its 'Conceptual Framework'. It acknowledged that the conservative bias of traditional accounting had led to incomplete balance sheets. But the IASB now proposed some changes. The traditional requirement that the value of the asset be 'reliably measurable' would be removed so that, going forward, balance sheets could give a more complete account of the 'economic resources' available to a company. It then gave a list of some economic resources that might qualify for the balance sheet, including know-how, customer lists, supplier relationships, and *an existing workforce* [my emphasis]. This clearly influenced the writing of the CIPD's Valuing Your Talent discussion paper.

Unfortunately, I think the excitement is misplaced. The IASB would probably say that in the case of human capital the discussion paper actually intended something much more limited – perhaps adding the workforce to the list of intangibles recognized after a takeover. Anyhow, though the Conceptual Framework provides the philosophy behind the accounting rules it is not an accounting standard itself. When the actual rules come to be rewritten, I doubt that GAAP's position on human capital will have changed much.

The problem is that if you are going to put an asset in a balance sheet you must to be able to measure it, or put a number on it. This is unavoidable. So in its discussion paper the IASB also said that an asset or a liability would only be recognized if the benefit exceeded the cost of measuring it, and it would not be recognized if no measure would give a 'faithful representation'. To all intents and purposes, this is the old 'reliable measurement' requirement under another guise.

What do we mean by human capital, exactly?

For the purpose of this discussion I am going to use two definitions of human capital, one narrower and one broader:

- Narrower. Human capital is the knowledge, skills and abilities that reside in individuals. This is the capital that humans take with them when they leave. The word 'talent' is shorthand for this.
- Broader. Frequently, we want to broaden the human capital construct to include the social capital of the organisation, that is, the shared skills and knowledge of employees as a group. This includes the culture of the organisation, its norms and values, and the tacit understanding of 'how we do things here'.

Arguably, you can define human capital more broadly still. Intangible assets are all in some shape or form 'knowledge' assets – they reflect knowledge or skill, attitudes and beliefs, and the fruits of past intellectual activity. So we need to be alive to the fact that all intangible assets are produced by human capital, or are a joint product with human capital.

It sometimes feels as though, of all the intangible assets, GAAP has been most resistant to recognising human capital in the balance sheet. There is a reason for this. It follows from the observation that an employment contract is an 'executory contract' – a contract that creates both a right and an obligation.

Under an employment contract, employees commit to deliver services in the future – that is the asset. But in exchange the organisation commits to pay them – that is a liability. GAAP's assumption is that a company pays a full and fair price under executory contracts. As a result, the asset equals the liability so that nothing needs be recognised in the balance sheet.

When an executory contract has become 'onerous', because the cost exceeds the benefit, then the shortfall does have to be recognized right away as a liability. Companies regularly do this. A nice human-capital example is observed in the balance sheets of football clubs that have players or managers who are no longer performing, but whom the club is committed to pay for the remainder of their contracts.

In the same way, to put talent in the balance sheet as an asset you would have to argue that the employment contracts are the opposite of onerous, and that the employees are worth more to you than you are paying them. Then, following the executory-contract logic, the asset you would put in the balance sheet is the surplus, the value added by your employees over and above their remuneration.

Now it is just about always true that employees are worth more than you pay them, and often by a wide margin. Otherwise, there is no point employing them. A profitable business cannot survive without its employees, and the significant costs that organisations incur in replacing and training employees is testimony to their value added. So GAAP is probably too conservative in the way it applies the executory-contract logic to human capital.

But the executory-contract idea is helpful in clarifying that, in the case of human capital, the asset is not the talent itself but the value added by the talent. Putting a number on that value added – 'reliably measuring' it or providing a 'faithful representation' – is clearly a challenge . And if we take the broader definition of human capital, in addition to the value added by the talent, we need to put a value on the culture of the organisation, its norms and values, ways of working, and so forth.

The value that employees add typically comes from them being employed in combination with each other and with other intangible resources the organisation possesses, particularly its organizational knowledge and social capital. The complexity of these systems and relationships means that in most organisations it would be difficult and probably impossible to quantify the value added of human capital.

Building a scorecard

A series of important economic questions follow from treating something as an asset. What is the value of the asset and how does that value grow or decay through time? What is the life of the asset? How much expenditure is required each period, to maintain the asset, and enhance it so as to achieve its productive potential?

Without balance sheet accounting, we need to find some other way of ensuring that these questions stay in view and get regularly addressed. The solution is to step down a level and use a scorecarding approach to identify factors that can be reliably measured and that reliably indicate the health and the value of the organisation's intangible assets. A useful way of thinking about this is in terms of the valuation model we might build to value an intangible asset.

Take brands as an example. Compared to human capital, brands have attractive 'asset' qualities and are probably a lot easier to value! They have some protection in law, and they can potentially be separated from the other assets and traded between companies.

If there is a transaction, then there is an observable price and you can put the asset in the balance sheet. Football clubs are unique in putting human capital in the balance sheet. They show player transfer fees as an asset then 'amortise' the asset over the duration of the player contracts and charge it against profit in addition to the players' wages. Effectively, the transfer fee is a prepayment to secure the surplus that the club hopes the employee will generate over and above his wage. So even in this case, there is no attempt to measure the value added by the players, over and above the transfer fees and the wages. In fact, famously, many football clubs make losses because they overpay for their players, with the result that the value added by human capital is often negative in that industry.

When one company sells a brand to another, each side sits down and builds a valuation model, which means putting a value on the stream of income that the brand is expected to generate in the future. The model will need assumptions about the factors that determine what income the brand will generate: market share, customer loyalty/customer churn, the advertising expenditure required to maintain and grow the brand, the competitive environment, macroeconomic conditions, and so forth. We could call these factors the 'value drivers' of the brand. They are the factors you would put into a scorecard to track the health of the brand.

Clearly, all of these assumptions are uncertain in their measurement and they are contingent on future events, so when you are analysing the value of a brand you would probably think in terms of a range of scenarios. This inherent uncertainty is what makes brands unsuitable for the balance sheet in GAAP's view.

In summary, when a scorecard is used to monitor the health of an intangible asset like human capital the dashboard or factors in the scorecard are best seen as the variables that would contribute to a model of the asset's value, if we had that model. These are the features of a good scorecard:

- All of the factors in a scorecard should have a clear empirical link to the health or value of the human capital asset, and thus to the overall goal of the organisation.
- The scorecard factors need to be parsimonious; as few as possible to adequately account for the health of the human capital asset.
- Some of the factors will be qualitative rather than quantitative. Either way, they should be capable of being clearly described so that they can be evaluated.
- The factors in the scorecard will depend entirely on context and different settings may require different scorecards. This needs to be driven by empirical research.

Who is the audience?

Brands also provide a salutary lesson for human capital. The debate about whether brands should be recognized in the balance sheet goes back at least 25 years. Because the complete omission of home-grown brands from the financial statements seemed unsatisfactory, there was a parallel effort to identify some brand performance metrics or 'value drivers' that companies would report and that investors could use to assess the brand asset. This was a similar exercise to the one now contemplated for human capital – guidelines for reporting the health, and therefore implicitly the value, of the intangible asset. The attempt to do this for brands has not been successful, and there are two strands to this.

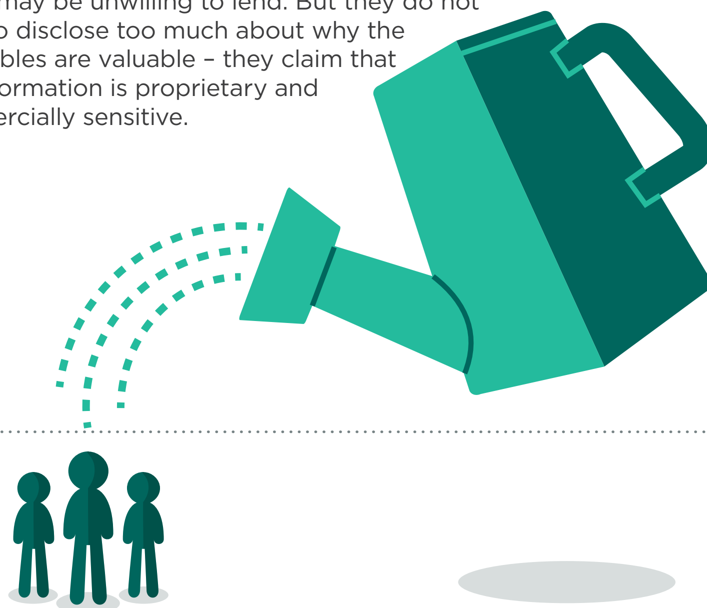
A mandatory accounting disclosure requirement needs to be simple and generalisable.

Marketing experts pointed out that brands are complex and come in many shapes and sizes, so that the performance metrics are context specific and the list of potential metrics would be potentially long. Disclosure would need to be case-by-case and therefore discretionary. In consequence, there is still no required disclosure in financial statements about the health of a company's brand assets.

But companies are reluctant to disclose the necessary data voluntarily.

It is notable that when some companies did actually publish a value for their brands, they rarely backed it up with the assumptions they were making – on market share, growth, profit margin and so forth – to get to the brand valuation. But the brand value number on its own was of little use to outsiders without the underlying model or the supporting explanation. It was recognition without disclosure.

The ostensible reason for this reluctance to disclose is intangibles' key role in value-creation. Companies want the world to know just how valuable their intangibles are – otherwise they worry that equity investors may undervalue the company and banks may be unwilling to lend. But they do not want to disclose too much about why the intangibles are valuable – they claim that this information is proprietary and commercially sensitive.



A more fundamental obstacle to voluntary disclosure is the natural reluctance to disclose bad news. Even if a company currently has a good story to tell, the worry is that by telling it the company may be riding for a fall later on. For this reason, the narrative that companies voluntarily provide in their financial statements has a tendency to regress to boilerplate.

In discussions about human capital reporting there can be a Polyanna-ish belief that such disclosure would always contain positive news. But if disclosure is to be economically meaningful that cannot be the case. Sometimes the news will be good, and other times less so. This reality is corrosive to voluntary disclosure.

For these reasons, investors display less interest than might be expected in corporate disclosure about intangible assets. Investors doubt the objectivity of voluntary disclosures. And, more fundamentally, since companies themselves struggle to value their intangibles internally, it is hardly surprising that outsiders struggle to do so.

In summary, when we are accounting for human capital, there are two audiences. Voluntary disclosure to the external audience contains inherent conflicts and limitations and does not provide a useful template for reporting to the internal audience. The key question is how to report the health of human capital to that internal audience.

Conclusion

The traditional preoccupation with putting human capital in the balance sheet is grounded in the reasonable view that what gets measured, gets managed. But the logic of accounting provides useful insights when we are thinking about human capital as an asset. It turns out to be simply too difficult to value human capital, and to put a single number on it.

Instead we need to step down a level and use a scorecarding approach, to identify factors that can be reliably measured and that indicate the health and the value of an organisation's human capital. Because that scorecard is likely to look different for different types of human capital and in different economic settings it is not an area where accounting rules are going to work. Instead we need to develop guidelines for best practice.

The most important focus for those guidelines is internal decision-making and making sure that managers exercise good stewardship over human capital and make the right investment decisions for this key resource. The external audience is more challenging. A good scorecard needs to be balanced and objective, but no one has yet figured out how to get organisations to voluntarily disclose bad news to outsiders.

About Valuing your Talent

Valuing your Talent is a partnership between CIMA and the CIPD; designed to help organisations better measure and report on their human capital data. For more information visit www.valuingyourtalent.com