

# **THE ETHICAL IMPLICATIONS OF HUMAN RESOURCE ACCOUNTING**

**O. Scott Stovall**

**Abilene Christian University**

**John D. Neill**

**Abilene Christian University**

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## **Abstract**

This paper has two objectives. Our first aim is to critically analyze the ethical implications of current accounting principles relating to human resources. Our second purpose is to propose three alternatives to the current accounting treatment of human resource costs as an expense of doing business. We utilize institutional economic analysis in our investigation of the ethical implications of current human resource accounting. Through the use of institutional economics, we conclude that the language that accountants use to describe human resource costs as expenses must change before the accounting system can change. We conclude that the current accounting treatment of human resources lessens the dignity and even the inherent humanness of a company's labor force, and clearly does not match common rhetoric from management that refers to employees as an "important" asset or resource. In addition, we contend that current accounting for human resources serves as an

institutional impediment to pursuing a multiple stakeholder corporate governance model. This paper contributes to the human resource accounting literature by proposing three alternatives to current practice, each of which is superior to current practice from an ethical perspective. Our third alternative represents a significant change to current accounting practice since it employs a multiple stakeholder perspective and treats a firm's labor force as a source of "intellectual capital."

## INTRODUCTION

We suggest that accounting should, at the most fundamental level, be considered an ethical or moral endeavor. Dolfsma (2006) argues that accounting should be taught as an example of applied ethics. That is, he posits that ethical principles are constitutive of accounting theory and practice. Further, Mayper *et al.* (2005) maintain that the hegemonic corporate pursuit of pecuniary profits has been enabled by accounting calculus. They assert that accounting, including education of the discipline, has essentially become devoid of necessary ethical discourse. In the present work, we point to the accounting for human resource costs as a prime example of how accounting has become oriented exclusively on, and perhaps dominated by, the pursuit of short-term profits for shareholders.

Human resource accounting is the term commonly used to describe how a firm accounts for the costs of recruiting, supporting, growing, and maintaining its labor force. Examples of such costs include training, employee retention, recruiting, and paying above average wages and benefits. Current generally accepted accounting principles in the United States classify human resource costs as an expense of doing business, rather than as an investment. This treatment is typically justified on objectivity grounds. In other words, proponents of maintaining the *status quo* for accounting for human resources maintain that the capitalizing of human resource costs as assets would require highly subjective

measures of the future economic benefits attributable to a company's workforce. However, we argue in this paper that the current accounting treatment (1) "commodifies" human resources, (2) serves as an institutional impediment to pursuing a multiple stakeholder perspective of corporate governance, and (3) may lead to suboptimal decisions that focus on short-term profits rather than long-term profitability.

Current U.S. accounting principles treat virtually all labor costs, including wages, benefits, recruiting, and training, as expenses. This treatment is similar to how a firm accounts for commodities such as materials or supplies. The practice of "commodifying" labor developed primarily during the Industrial Revolution. Baird (1992, p. 9) notes that labor "was viewed as a commodity to be bought, used and then discarded. . . ." The commodification of labor developed along with the shareholder-dominant view of the firm and does not view employees as a valuable source of corporate capital. The shareholder-dominant perspective is the view that stockholders are the only constituency requiring the accountability of managers for the effects of managerial decisions.

The remainder of the paper is organized as follows. We first describe the ethical problems inherent in the current accounting treatment of human resource costs. We then propose that institutional economics can be used as a means to (1) identify the current accounting treatment of human resource costs as an institutional impediment to pursuing a multiple stakeholder view of corporate governance, and (2) change the current accounting treatment through the changing of the language used by accountants to describe human resource costs. We then conclude our analysis by providing three alternative accounting treatments, each which provide a greater emphasis on the importance of firm's labor force than is provided by the current accounting system.

### **ETHICAL PROBLEMS INHERENT IN CURRENT HUMAN RESOURCE ACCOUNTING**

The direct write-off of employee costs leads to at least two problems. First, in a traditional sense, accounting understates assets when it expenses such costs immediately. Training costs, whether general or specific, usually provide benefits to the firm for multiple periods and therefore satisfy the Financial Accounting Standard Board's (FASB) current definition of an asset (FASB, 2008; Flamholtz, 1985).

Accountants' insistence on providing "objective" measures (often at the expense of a reduction in relevance of the measures) has led to the present accounting model's inability to capture important information about investments in intangible resources, such as human resources. In spite of the drastic change in the nature of economic activity over the last several decades, financial reporting remains largely unchanged. Merino (1993) suggests that the private property rights paradigm has dominated accounting theory, specifically represented by the residual equity, historical cost accounting model. Under the residual equity view, managers view human resources as costs they should control for the benefit of shareholders. Best (1990) contends that the accounting treatment of labor as a cost of doing business (i.e., an expense) creates incentives for management to make jobs routine and to turn workers into interchangeable parts. That model may have worked well during the industrial age, but in today's high tech, knowledge intensive environment, an accounting system is needed that creates incentives for management to foster "knowledge workers" and invest in employees.

While accounting theory accepts the long-term nature of capital assets and natural resource reserves, the current accounting system masks labor's long-term contributions to firms. While accounting methodology has addressed current trends in the economy regarding noncapital assets, with a general change toward a "mark-to-market" approach, it has not examined the adequacy of the current model to measure intellectually-based economic activity.

A second problem with current accounting for human resource costs is that the direct write-off of employee costs as expenses encourages managers and stockholders to take a short-term perspective in decisions regarding the firm's labor force. Managers often lay off employees, freeze or cut pay, and cut training programs to enhance short-term profit (Downs, 1996). Since labor cost is usually substantial, these cuts usually increase net income in the short term. Downsizing may be, in part, the result of pursuing short-term profits inflated by labor cuts. Downs (1996) contends that this short-term focus ignores long-term issues. Steven Roach, an economist for Morgan Stanley, says:

Plant closings, layoffs and other forms of downsizing have certainly had the effect of providing a short-term boost to earnings. However, whether . . . [they] will also drive lasting productivity enhancement is highly debatable... Labor can't be squeezed forever, and Corporate America can't rely on the 'hollowing' tactics of downsizing to maintain market share in an expanding global economy... I'm now having second thoughts as to whether we have reached the promised land. (Koretz, 1997)

Current accounting for human resource costs clearly contains many ethical issues. The commodification of labor that results from the current accounting treatment serves to lessen the dignity and even the inherent humanness of the company's labor force, and clearly does not match common rhetoric from management of referring to employees as an "important" asset or resource. When managers experience pressure to report increased profits, they often respond by first cutting the "investment" that is required to adequately maintain the workforce. This response often includes reducing the workforce itself. While this strategy immediately increases cash flows and accounting earnings, it may hinder the ability of companies to generate positive cash flows and earnings in the long-term, and almost certainly places the workers themselves at economic peril.

## **INSTITUTIONAL ECONOMICS AND THE POWER OF LANGUAGE**

Institutionalism suggests that social and economic norms both shape and are shaped by language (Hodgson, 1988). Further, institutionalism points to language as a potential impediment to change in actors' worldviews and in their behavior. Hodgson (1988, p. 128) states:

The habitual use of particular concepts and modes of thought may mask the hidden assumptions and axioms that are being employed.... Scientific researchers may habitually employ categorizations or techniques without questioning whether their use is legitimate.

Hodgson explains that economists use terms and concepts similarly without questioning the legitimacy of their application in a given context. We maintain that the current accounting model, in its routine reference to human resource costs as expenses, is an important example of how the habitual use of a concept masks or inhibits managers, shareholders, and others from viewing employees as, and making decisions as though employees are, an important stakeholder group. We therefore contend that current accounting language serves as an impediment to pursuing a multiple stakeholder corporate governance model.

According to stakeholder theory, a stakeholder is defined as "any group or individual who can affect or is affected by the achievement of the organization's objectives" (Freeman, 1984, p. 46). When offering examples of important stakeholder groups, most descriptions of stakeholder theory include employees prominently (Parmar *et al.*, 2010; Freeman, 1984). Multiple stakeholder perspectives generally conceptualize employees as constituents of a firm since their interests are fundamentally affected by management decisions. Since employees are stakeholders in this sense, stakeholder theory generally suggests that managers should be held accountable for how their decisions affect employees. While the salience, importance, or power of employees as a corporate constituency as compared to other groups

remains an open issue (Freeman, 1984; Mitchell *et al.*, 1997; Neill and Stovall, 2005), virtually all stakeholder models include them in the list of stakeholders to whom management should be held accountable.

However, accounting language is inconsistent with the view that employees are an important stakeholder group. As previously described, the current accounting model commodifies labor since the model treats virtually all labor costs as expenses. Why is this the case? We propose at least two answers to this question. First, we suggest that accounting language (habit) is shaped by “the hidden assumptions and axioms that are being employed” (Hodgson, 1988, p. 128) in defining accounting concepts. As stated earlier, accounting is built upon a proprietary, exchange-based, shareholder as dominant stakeholder view. Under such a framework, employees are relegated to a mere input in the production process, rather than a long-term economic resource or supplier of capital that is worthy of managerial consideration. This exchange-based, proprietary (shareholder/legal owner) view of governance, rather than a more inclusive stakeholder model, thus serves to inform accounting theoretical development and language with respect to the firm’s relationship with its workforce.

Second, in a reflexive manner, accounting serves to promote the shareholder-dominant view of the firm, rather than a more inclusive governance model such as stakeholder theory. In assessing the performance of management, the traditional convention in business is to calculate net income as an important performance measure. In the net income calculation, payments made to enhance the performance of a workforce such as training expenditures, recruitment costs, and other costs incurred with the intent to improve the productive capacity of a workforce are expenses, deducted from revenue in the same manner as utility costs, sold inventory, or expended supplies. In fact, the resulting residual, or income, can be increased by the managerial decision to reduce payments for workforce enhancements. Firms that cut such employee-related costs are often referred to as “lean” or “efficient.” In other words, managers are motivated to reduce

workforce enhancement efforts, everything else being equal, because doing so increases income, thereby increasing one important measure of their performance (i.e., net income).

Some economists (e.g., Penrose, 1959; Best, 1990; Reich, 1992) argue that the income producing capacity of the typical business enterprise today lies principally with human capital rather than tangible capital. While accounting does value certain aspects of intellectual capital like goodwill, patents, and trademarks, Reich (1992) says that these “legal legacies of past successes” may lose their value very quickly in an intellectually-based economy.

Accountants, such as Elliott (1994, 1991) and Wallman (1996) concur with these economists’ assessments about the importance of knowledge assets. They maintain that the current accounting model risks becoming irrelevant in the information age. Specifically, Wallman (1996) suggests that proponents of the current accounting model preoccupy themselves with reliability as the key recognition criterion for financial statement concepts. He suggests that relevance is often pushed aside as a recognition criterion. Few would deny that investments in intellectual capital such as training a workforce or engaging in research and development meet the relevance criteria present in the FASB’s definition of assets (i.e., providing future economic benefit to the firm). However, since a firm cannot own or control an individual or an intellect, some reject calling such investments assets on subjectivity grounds (lack of reliability). Interestingly, Flamholtz (1985), Sackman *et al.* (1989), and Lev (1997) all suggest that failing to describe human resource investments as assets results in valuing the future benefit of such investments at zero, which is perhaps the most subjective measure of all.

We contend that accounting for human resource costs will not change until the language that accountants use regarding human resources changes. Institutional economics can be used as a vehicle for such change. For example, Luker *et al.* (1998) propose that inquiry in all social sciences should attempt to modify the language used within a discipline toward providing useful social advancements. In addition, D’Agostino (1988) maintains

that questions and inquiry in the sciences change incrementally as language changes.

### **PROPOSED CHANGES TO THE CURRENT ACCOUNTING MODEL**

We propose three changes that could be made to the existing accounting model for human resource costs. By extending the idea of the “usefulness” of academic inquiry in Luker *et al.* (1998), and D’Agostino (1988), these proposed changes in accounting’s description (language) of firm assets, expenses, and resources might prove useful to investors and employees. Investors may gain insight into how firm management fosters and nourishes human capital in a rapidly changing business environment in which human intellect increasingly drives economic activity. Employees may also benefit by this change in language if it causes management to consider the long-term impacts of reductions in training and/or downsizing the labor force.

The three proposed changes range from merely increasing required disclosures about human resource costs in the footnotes to the financial statements to a complete overhaul of how human resources costs are measured in the financial statements themselves. We contend that if employees are to be treated as a valuable stakeholder group, then accounting must refer to them as such.

Our first proposed alternative involves increasing disclosure requirements without changing the traditional accounting treatment of classifying human resource costs as expenses. Expanded disclosures relating to corporate support for employees and the contribution of employees to meeting the objectives of a firm would be mandated under this proposal. Examples include disclosures regarding (1) the costs incurred to recruit, train, retain, and improve productivity of employees, (2) the turnover rates for various types of employees, and (3) working conditions, which would include reporting the results of employee satisfaction surveys.

A second way that the current accounting model could be changed would involve capitalization of costs that are incurred to benefit employee productivity. This would require that the costs of recruiting, maintaining, and improving a firm's workforce would initially be recorded as a long-term asset. Then, like other capitalized intangible assets, it would be necessary to allocate those costs to expense over the estimated useful life of the asset through the amortization process. We would suggest that the proper costs to capitalize would be support costs rather than actual wages/salaries. However, if a firm paid above (below) average wages, the portion that exceeds (is less than) the industry average could be capitalized as an asset (liability) using a present value of future earnings approach such as models that have been suggested historically (see Lev and Schwartz, 1971).

The capitalization of human resource costs has been proposed by accounting theoreticians for many years because it is obvious that many of these costs provide companies economic benefits over a number of years. For example, companies would not invest in employee training programs and send employees to conferences and seminars unless they believed that having a trained workforce would benefit the company in the future. The expensing of such costs, which is currently mandated by generally accepted accounting principles, is clearly incorrect from an accounting theory perspective. Costs that provide future economic benefits should be capitalized as assets and then systematically allocated to expense over the useful life of the asset. As stated earlier, the objections to this more theoretically correct accounting treatment stem from the fact that subjective judgments about how to measure the amount of future economic benefits must be made. Accounting theorists may also oppose such capitalization models because presumably management cannot control people in the same sense as they can control the use of other capital assets. Furthermore, ethicists may object to the capitalization of human resource costs as an asset since people cannot and should not be "owned" or controlled as other capital assets.

Our third proposed accounting treatment would represent a radical departure from the current accounting system. This alternative would involve treating employees as a supplier of intellectual capital, in much the same manner that stockholders are treated as suppliers of capital under the current system. This accounting treatment would require accountants to maintain both asset and equity accounts representing the long-term contributions of employees. As a first step, we would start with only certain types of employees, such as knowledge workers. These workers typically have more mobility and their contribution to the value of a firm might be easier to measure than that of other types of workers.

These new asset and equity accounts could either be incorporated into the present financial statements, or we could create a separate financial statement or section of the annual report for such disclosures. These new measures could be audited through a social audit methodology. This third alternative, while a radical departure from the current system, has the benefit of employing a multiple stakeholder perspective. Alternatively, both the current accounting treatment and the alternative of capitalizing human resource costs are consistent with the shareholder view of the firm, namely that shareholders are the only important stakeholder group because of their capital investment in the firm.

If one adopts the stakeholder view of the firm (Freeman, 1984), employees are viewed as a valuable stakeholder group along with stockholders, customers, suppliers, etc. Under such a viewpoint, a firm's human resources can be seen as an important source of capital. Under traditional accounting, the only sources of capital are investments by stockholders and the proceeds of borrowings. This proposed accounting treatment would add a third source of capital, namely the intellectual capital provided by a firm's labor force. If today's employees are indeed "knowledge workers," as proposed by Stewart (1998), then viewing the labor force as intellectual capital is appropriate. This treatment is also consistent with Kelly's (2003) view in *The Divine Right of Capital*

that knowledge workers represent a valuable source of corporate capital.

Treating human resources as a source of capital would require a major shift in current accounting practice. Such a treatment would involve more than simply capitalizing the actual human resource costs incurred. It would require the firm to estimate the future economic benefits accruing to the company because of their workforce. In other words, a determination of the amount of the firm's "intellectual capital" would be required. Once determined, the intellectual capital would be recorded on the balance sheet as an equity account. This treatment views employees as a source of corporate capital and not merely as an expense of doing business or as the property of shareholders and management.

We acknowledge that some, perhaps many, accounting theorists and practitioners will initially object to our suggestions, particularly the second and third proposals, as being too "subjective." Such objections are nothing new. We agree that either (1) capitalizing human resources using historical costs or some sort of future discounted cash flow model, or (2) accounting for human resources as a supplier of capital, is indeed subjective.

We respond to this "subjectivity" argument with three related observations. First, as noted in this paper earlier, and by other HRA proponents before us (e.g., Flamholtz, 1985), while any capitalization of human resource costs is subjective, it is no more subjective than placing no value on such resources at all (i.e. assigning a value of zero to such resources by not recognizing them as assets). Of course, this response employs the assumption that companies often allocate resources in order to enhance the future productivity/profitability of human capital, and/or rely on employees to create future earnings capacity.

Second, as social constructionist critics of accounting such as Hines (1988) have noted, accounting language used to "report" reality actually constructs social reality. Such critics argue that accounting objectivity is really a myth; accounting language is created and maintained by consensus within the profession. The

accounting profession typically accepts change to this language when enough outside pressure is brought to bear to modify it. We would suggest that this may be the time to acknowledge the growing notion in both business and society at large that people are assets and/or that they supply capital to the organizations within which they work.

Further, we note that the “objectivity” argument to human resource accounting is consistent with Porter’s (1995) observation that the accounting profession is somewhat “insecure” in that it attempts to avoid influence from powerful outside interests by appearing to be “objective” by measuring and reporting accounting elements by following complex rules. It seems plausible that a proposal to modify such rules might be met with resistance from those within the profession who want to avoid criticisms from outside groups that might not want human resources to be accounted for as we propose. Such interests could, among others, include (1) managers who would not want to classify human resources as assets due to the enhanced accountability to manage employees more effectively that doing so might signal, or (2) corporate constituents other than employees, such as investors or creditors, who already enjoy recognition status on the financial statements as suppliers of capital.

## **CONCLUSION**

In this paper, we demonstrate that current accounting for human resource costs in the United States is fraught with ethical concerns. Current accounting language classifies costs related to a firm’s labor force as an expense of doing business, rather than as a long-term investment in intellectual capital. This treatment tends to commodify human resources and often leads to suboptimal decisions that disregard the long-term impact of the decisions. We conclude that the current accounting treatment serves to lessen the dignity and even the inherent humanness of a company’s workforce. It also clearly does not match common rhetoric from management that refers to employees as an important corporate resource. In addition, we contend that current accounting for

human resources serves as an institutional impediment to pursuing a multiple stakeholder corporate governance model.

Through the vehicle of institutional economic analysis, we assert that the language that accountants use to describe human resource costs must change before the accounting model will change. We propose three alternatives to the current accounting treatment of human resource costs. These proposals all place a greater value on a firm's labor force than the current accounting model. The third alternative represents a radical departure from the current accounting model since it employs a multiple stakeholder perspective and treats a firm's labor force as a source of "intellectual capital."

We believe that a change in accounting language is a necessary first step in the process of employees being viewed as a valuable stakeholder group and as an important source of corporate capital. We see two potential benefits of a shift in accounting language toward a multiple stakeholder perspective. First, current and potential investors may gain insight into how a company's management promotes and cultivates its human capital in a rapidly changing business environment in which human intellect increasingly drives economic activity. Second, employees may benefit by a change in accounting language relating to human resources if the change causes management to carefully consider the long-term impacts of downsizing the workforce and/or reducing employee training costs.

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