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Asymmetry of Information: Recognition of Human Capital in Financial Statements

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Keywords;
Human Capital, IFRS, Professional Accountants, Financial Statements, Human Capital Accounting, Professional Accountants, Training & Development.

ABSTRACT

The underlying objective of the current study is to investigate whether Human Capital should be valued on the financial statements? This study is exploratory in nature and interviews have been conducted by professional accountants (Chartered Accountants) with at least 5 years of professional experience. The results showed that the human as capital should be valued and factors need to be considered in while valuation of human as capital in financial statements; qualification, years of experience, professional training, skills, and competencies. However, the results revealed that it is difficult to value human as capital but not impossible. International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS), doesn't allow recognition of human capital due to controllability element. Disclosure of human as capital will boost the Investors' confidence in the company and employees' motivation will also increase due to a sense of ownership. This study is food for thought for the professional accountant and corporate sector and IAS/IFRS should consider the above-mentioned factor to formulate a comprehensive framework for the valuation of human as capital in financial statements.

I. Introduction

The social and economic development of nations depends on the level of education and technology. Education creates the skillful and intellectual personnel and so they can serve the nations as better citizens (Darling, 2015; Leigh & Blakely, 2016). These transformation services required huge financial investments and services of experts to polish personnel's skills, however, reaps its return over the period. During the era of the knowledge economy, all the firms' and industries' success and failure lies or depends on the skilled employees and intellectual workforce (Rutkowski, 1996; Noe, Hollenbeck, Gerhart, & Wrig, 2006; Kwiek, 2011; Yamaguchi, 2016). In 21st Century comparative and competitive advantage of firms, industries and countries are based on the quality of workforce or even the survival of organizations is also determinant based on this key element (Karoly, 2004). As the demand for quality products with innovation and flexibility is getting higher over the period, the quality of human capital is growing, still now up to this stage we all are agreed (Dennis, 2016).

During the industrial phase, the gross domestic product (GDP) was based or largely obsessed using investments intangible assets that appear on the statement of financial position as property, plant, buildings, and equipment till the early 1980s (Kravis, 1978). During the next five years from 1980-1985, this association is reduced by 12% only 88% association between tangible assets and GDP has been observed (Auty, 1990). Since the early 20th century factor of growth in GDP has been shifted to information or knowledge and age (intangible) from tangible assets. From 2000 to 2005, 90% of GDP growth was explained by intangible assets while, only 10% growth was explained by tangible assets (Schneider, 2005).

The most common aphorism/cliché used by presidents and board of directors is "Human Capital/ employees are our most important valuable asset" in financial statements this statement is consecutively reported and documented by approximately in annual reports of all the leading corporations same the case has been observed in Pakistan; OGDCL-2016, NBP-2016 and FFC-2016 are listed corporations on Pakistan Stock Exchange (KSE 30) claims the above-mentioned statement (NBP, 2016; OGDCL, 2016; FFC, 2016).

Turning from the director's report to the statement of financial position to have a look "where is this human asset on these statements which serve as the firm's resources and earnings?" How the firm report and measured the value of "most-valuable and most-important asset"? Is there any investment and returns comparative analysis based on the most asset? Is it increasing, decreasing and constant over the period? Is the firm allocating and presenting its human assets in a way to maximize returns? Yet! Nothing is found in financial statements.

Difference of opinion has been observed between management and accountants top-level management make expenditures on skills development of workforce with the intention of investments although, accountants recorded and considered them as an expense in income statement by ignoring the future benefits or inflows (Bokhari, Qureshi, Bashir, & Hijzi, 2012; Weil, 2015; Agwagah, 2017). Accountants considered this treatment because investments in personnel considered as questionable as compared to investment in property, plant, and machines. Accountants claim that it is hard to calculate or estimate the expected future cash flows based on such expenditures currently incurred and portion need to be considered as an expense in the current financial year (Theeke & Mitchell, 2008).

International Accounting Standard Board (IASB) issued the International Accounting Standards (IAS) which are also known as International Financial Reporting Standards (IFRS). IAS standards help to provide a conceptual framework for disclosure to prepare financial statements all around the world. IAS 16, IAS 17, IAS38 and IAS 40 and IFRS 3 Goodwill deals with non-current assets. IAS 38 is about defining the criteria for recognizing intangible assets. As per IAS 38, if an asset qualifies the following conditions then it can be recognized as an intangible asset.

***Separate*:** Identifiable means that an asset should recognize independently from other assets, to rent out either in combination with the contract that is related or individually; or results from contractual or other legal rights, irrespective of whether rights are separable from the entity or transferable or other obligations or rights.

***1.1 Controllable and future financial benefit*:**

Recognition of intangible assets is only possible under IAS 38 if it is meet controllability conditions and future economic benefits from underlying resources are there. Future economic benefit means income from service or processes, products or sales. But, also involve saving cost or any other type of benefit obtained from the use of an asset. A conventional reporting framework is used to prepare financial statements, under which human resource is treated as a capital expenditure that is to be deducted from profit or loss of the current year. IAS 1 states that the matching concept should be used for the preparation of financial statements. Now a day, a human resource has become an integral part of the total wealth of an organization.

American Association of Accounting (AAA) has established the underlying valuation method of human capital. Valuation of human as capital should include "The whole process of identifying, measuring and communicating to all interested parties" (American Accounting Association, 1770). This discussion has arisen the increasing importance of human capital investment that finally leads to two important questions.

1. How to calculate the value of human capital assets to report in the head of intangible assets.
2. How improvements can be brought in the reporting framework by reporting human capital value in the financial statements of organizations.

The objective of the study

The objectives of the current study are two folds.

1. Factors need to consider while recognizing human capital in financial statements
2. To determine issues and challenges faced by the accountant while recognizing human capital in financial statements

Table 1: *Key Attributes of Human capital*

Know-how	Vocational qualification	Employee share scheme
Education	Executive compensation plan	Employee share option scheme
Training & development	employee benefits	Growth/renewal ratios: average education level
Experience	Employee numbers	Efficiency ratio: V.A/expert
Capabilities	Employee thanked	Efficiency ratio: V.A/employee
Career development	Employee featured	Stability ratio: expert seniority
Employee involvement in community	Entrepreneurial spirit, changeability	Stability ratio: the median age of the employee
Employees benefits	Employee safety	

II. Methodology

The underpinning objective of the current study is to explore the concept of HCA and implications or challenges faced by accountants to recognize it in financial statements and tries to understand the complications in implementation faced by corporations and guidelines provided by International Financial Reports Standards. Prior literature facilitates the current study in the selection of research methodology. Therefore, the current study chooses the qualitative research method for collection and data analysis based on responses. The underpinning approach being used in a current study is grounded theory to develop the framework for the recognition of human capital in financial statements. Data has been collection was conducted over a period of almost 2 months using interviews technique, average interview duration was 30 minutes from each professional (Chartered Accountants) Minimum having 5 years of experience.

Interview technique from professional accounts is the most suitable and appropriate to achieve the underpinning objectives of the current study. The first objective of the current study is to develop a framework or determine the factors for the valuation of human capital in financial statements, and the second objective is to identify the possible limitations and factors that need to control while recognizing human capital in financial statements. The sampling technique used in the current study is purposive sampling and the total number of respondents in the current study was 7 professional accountants, as information dismissal was started after 5 respondents however 2 more respondents were interviewed to ensure the saturation point is achieved. Our sample in qualitative research is enough to ensure that all the possible perceptions or important dimensions (experiences, opinions, and attributes, etc.) are covered. As all the dimensions and perceptions were covered and the repetition of results started, so the current sample size is enough (DePaulo, 2000; Onwuegbuzie, & Leech, 2007). Kuzel, (1992) suggests the sample size of 6 to 8 participants is enough in the qualitative study especially when the sample is homogeneous. The qualitative researcher should conduct the interviews of at least six participants especially when interviewees were selected based on experience to measure the construct (Morse, Field, & Estabrooks, 1994).

The approach of the current study is justified on a few counts; the sample size is sufficient, and literature suggested that qualitative and longitudinal studies are useful and authority to explore and to identify the hidden constructs (Wiseman, Gudykunst, & Hammer, 1979; Chandler, 1994). The qualitative researcher also facilitates the people in this social world to understand and their perceptions about this world and how constructs restructure their perception about their world (Wiseman, 1980).

III. Results and Findings

There is a continuous interplay between the collection and analysis of data set in qualitative research methodology (Strauss, & Corbin, 1994). The same pattern has been adapted for the current study, by analyzing data set right after conducting the first successful interview from professional accountant *Respondent 1* (Rennie, 1998). In qualitative research data analysis is recognized as intellectual craftsmanship, so there is no single and authoritative method is qualitative research for data analysis, the core objective is making sense or identifies the underpinning themes. Qualitative research is recognized as creative instead of a mechanical process (Lincoln, Denzin, & Richardson, 2000).

The current study follows the 6 steps research methodology documented by Creswell (2009) for data analysis in qualitative research. The 6 steps process is described in the logical and linear order, known as "an interactive practice," to data analysis. The process of linear order data analysis is not simple and static.

Step 1**:** Prepare and organize qualitative data set for analysis. At this stage, the researcher reviewed the interview audiotapes carefully and prepare transcripts accordingly. ***Step 2*****:** Transcripts reviewed carefully to understand the underlying constructs, "get to know your data". At this stage, the researcher tries to get familiar with data and attempts to understand the underpinning information provided by professional accountants. ***Step 3*****:** Codes are being assigned to transcripts to start the detailed analysis process. At this stage, researchers assign codes to underlying constructs or segments segregated into categories. ***Step 4*****:** Generating descriptions based on the coding process of segments and constructs for analysis. At this stage, the researcher tries to identify the small themes that lead to generate the whole or overall constructs based on the information availed from professional accountants. *Step 5*: Translate underlying themes and constructs intro narrations. At this stage, the researcher tries to translate themes identifies at step 4 into narrative passages based on the information provided by professional accounts. *Step 6*: Interpretation and findings. At this stage, the researcher tries to interpret results based on findings from step 5. However, a few researchers documented that this stage is inclined towards the researcher's background.

3.1 Recognition of Human as a Capital

Although human capital is not recognized as an intangible asset in financial statements according to International Financial Reporting Standards (IFRSs) and Generally Accepted Accounting Principles (GAAP). However, most of the professional accounts respond that human capital is most valuable in any organization. As one of respondent said;

“Any organization having the most valuable capital that is human not building, infrastructure and machinery or any other capital”

Similarly, another respondent said;

“In my opinion under some circumstances, we can recognize human as capital or can be capitalized in financial statements”

However, IAS 38 and IFRS 3 don’t allow recognition of human capital due to the controllability factor. However, it is possible to recognize the human as capital in financial statements under IAS 38 Intangible assets if any organization has any contractual agreements.

3.2 Factors to be considered while recognizing Human as Capital

Several elements and factors need to consider if any organization is going to recognize a human as capital in financial statements because parameters vary from organization to organization and from industry to industry. However; key elements need to consider while recognizing a human as capital in financial statements, experience, qualification, skills, and capabilities. However, one of respondent stated;

“How many shares of revenue is associated and carrying by an individual employee”

Similarly, another respondent said;

“We cannot simply assign one or two factors for consideration of human as capital, there are various factor their experience, qualification, skills and capabilities, attitudes towards job”

3.3 Training & Development is Investment or Expense and Firm’s Financial Performance

Investment is recognized as an asset in financial statements because future economic benefits are expected while expenses are charged in the financial statement in profit & loss accounts because economic benefits have been received from the investment. One of respondent explain this phenomenon as;

“When an organization is spending some amount of training and development ultimately the performance of employees will enhance, and the organization will receive the benefits from these training and developments over the period of time in future so it should be considered as an investment instead of expenses”.

Training & development should be considered as an investment as compared to expense because the future economic benefit is associated with training & development will benefit the organization over a period. However, literature documented that only relevant, objective-based training is considered an investment and remaining should be charged as an expense (Dichev, 2017). As another respondent said;

“It really depends on what grounds any organization is going to spend the handsome amount of training & development, without any scope or specific objectives and without proper planning then it should be considered as an expense”

Results revealed that training & development is an investment as compared to expense, however, another respondent stated

“IAS 38 provides the long list or comprehensive criteria for recognition of research expenditure and development expenditure recognition in financial statements as an asset, if any development expenditure meets the recognition criteria the associated cost will be capitalized as an asset for the period of time”

Results revealed that training & development has an impact on a firm’s financial performance (Jain & Moreno, 2015). As the results indicate that human is a most valuable asset for any organization and training & development polish their skill and enhance their competencies over the period of time which ultimately enhance firm’s financial performance (Georgiadis & Pitelis, 2016). One of respondent said

“If any organization fails to invest time in training & development of their valuable human capital then I am sure that organization or institution will not be in a position to excel their operations or even not in a position to achieve organization objectives or required level of performance”.

Like this another respondent stated;

“Training & development is an investment and benefit the organization over the period of time, if the organization have any contractual agreement with employees and staff then the organization will receive the economic benefits over the period of time”

Results of this theme are parallel to documented literature, training & development has a positive and significant impact on the firm's financial performance (Ciriaci, 2017; Lys, Naughton, & Wang, 2015). The results affirm that training & development benefit over the period of time, with the subject to a high retention ratio. If any organization has a high retention ratio and conduct training & development with proper planning or according to predefined objectives, an organization will get benefits over the period. One of interviewee said;

"It depends how effective and relevant these training and developments are, and if employee development is there and organization successfully retained the employees then yes of course organization will be benefited from this training and development over the period of time".

A similar statement has been reported by another respondent;

"If you invest through proper planning means conducting training & development based on a specific objective and the other components are securing the contracts with the employee, and proper human resource planning then it is obviously training & development will benefit the organization over the period of time".

Results show that training & development has a positive and significant impact on a firm's financial performance. The underpinning theme supports the results confirm the hypothesis, which was developed based on field notes, interviewees' responses. As one of respondent said;

"If you planned the human resource effectively, in other words, you have staff which actually has due skills and experience with the positive attitude over the period of time, obviously organization will get the due benefits from the employee's performance".

Another respondent said;

"Being a chartered accountant whenever we visit any organization the management requested to evaluate the performance of employees, same as if you make a call on call center of any organization, they request to rate the performance, whether you are satisfied or not. Because the organizations need to boost the performance of their employees which is considered the key driving force of organization financial performance".

3.4 The significance of Employees Performance

The results revealed that employees' performance is highly correlated with a firm's financial performance. Employees' performance and financial performance of any organization are highly correlated, the same evidence has been observed from the literature. Training and development enhance the employee's performance which ultimately enhances the financial performance of any organization. The underpinning theme has been established that training & development is highly correlated with employees' performance and employees' performance directly affects the firm's financial performance.

Training & development ⟶ employees' performance ⟶ firm's financial performance

Any organization doesn't matter its service providing or manufacturing sector provides satisfactory services to customers the ultimate performance of an organization will boost. As most the respondent stated

"Organizations associate employees' benefits with organizational performance currently most of the organizations doing the same thing, directors and top management bonuses and other benefits are associated with organization performance. Sometimes the organization associates these benefits with the appreciation of share in the stock market. Yes, these scenarios ensure that the performance of an employee directly affects organizational performance".

The results revealed that there is a positive and significant association between a firm's financial performances depends on employees' performance. The results affirm that there is a direct positive and significant impact on employees' performance and the firm's financial performance. However, the results of both figures infer that employees' performance is highly based on training & development, experiences, skills, competencies, and qualifications.

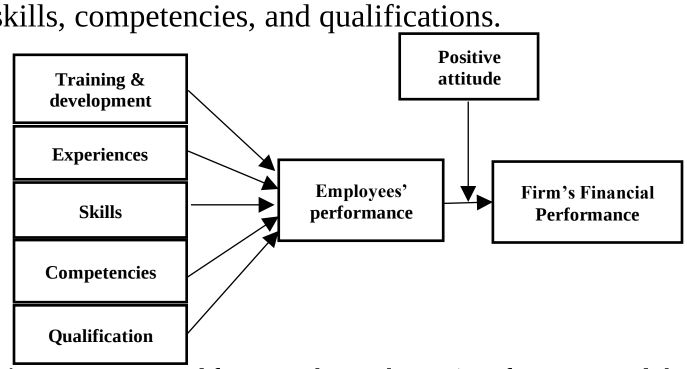

Figure 1: *Proposed framework; employees' performance and the firm's financial performance with the mediating role of positive attitude*

As one of the respondents said

"Obviously, if you planned the human resource effectively, in another word you have staff which actually has due skills, qualification, and experience

with the positive attitude over the period of time, obviously organization will get the due benefits from the employee's performance"

similarly, another respondent said

"The firm's financial performance is associated and highly correlated with employees' performance and it has been reported in previous studies and can be observed from organizations' financial reports. Qualification, experience and training and development enhance the organizational performance".

3.6 Valuation of Human Capital and Parameter to Follow

Valuation of human capital is hard but practically it's possible. Approximately all the respondents are agreed on the valuation of human capital but it's hard to value human capital in the financial statement because no such parameters are available for the valuation of human capital. It is evidenced from the previous practice and studies that if organizations do not value their human capital with upgraded packages, bonus and remunerations based on their skills and capabilities then those organizations might fail to retain human capital at that level where organizations need them (Peng, Sun, & Markóczy, 2015). As far as international financial reporting standards and financial reporting standards are concerned internally generated asset doesn't allow to be recognized in financial statements. Until unless you have secured them with some contracts and some agreements should be there to recognize that human capital in financial statements. As one of respondent said;

"I personally think it is really hard to value human capital whether Mr. A having goodwill or worth Rs.1 million or Mr. B has the goodwill of Rs. 50 million. Currently, no such parameters are available to value the human capital".

The results revealed that factors or components that need to be considered during the valuation of human capital in financial statements are; qualification, experience, training & developments. As one of respondent said;

"We can value them based on their qualifications, experience, education, and skills they have including benefits & remuneration. As the other developed economies are valuing their employees, they have their local reporting standards as well as some market factors for valuation. In Pakistan there no such market factors and local reporting standards so it is not possible to recognize human capital until it meets the recognition criteria mentioned in IAS38 intangible assets".

Another respondent said;

"One source on which we can value human capital is benefits received by employees, those are based on the employee's performance. However, it is still hard to value human capital in the financial statements. I agreed that employees' benefits are associated with or based on the employee's experience, qualification, and training & development".

3.7 Disclosure of Human Capital and its Efficiency

The results show that there is enough evidence, human capital disclosure enhances employees' efficiency. Organizations investment enough funds in training & developments of professional staff which ultimately enhance the employee's performance to achieve the organizational objectives and disclosure of human capital will ultimately enhance the efficiency of any organization. As one of the respondents said;

"Very good example when any charted accountant firms tender the corporations, firms considered how experienced and qualified staff we have, another example is university disclose the profile of faculty in the prospectus".

3.8 Effect of Human Valuation of Employees behavior

Results revealed that there will be a positive and significant impact on human behavior due to human capital disclosure in financial statements. Any organization discloses human capital in a financial statement there will be a positive and significant impact on employees' performance which ultimately has an impact on organizational performance. As one of respondent said;

"I personally think this is a most crucial or important point in our discussion if any organization conduct training & development, offer standard benefits and packages but doesn't appreciate their efforts by action or in spirit or doesn't value the human capital based on their performance then ultimately human capital will lose their motivation. Valuation of human capital will have a positive and significant impact on employees' performance in my opinion".

Another interviewee said;

"I personally think that employee performance will be boosted, due to the sense of ownership. If any employee is valued in a financial statement his/her performance will be increase which ultimately enhances the organizational performance".

3.9 Human Capital Disclosure and Investment Opportunities

The results show that there will be a positive impact on human capital disclosure on investment opportunities. The rational investor is willing to know who is out there to manage their stake and resources or investment, investors would like to know whether their investments are going to be managed by skilled, qualified and experienced personnel. One of respondent said;

"Yes, it should be a core component of the financial reports and should be disclosed properly".

Another respondent stated;

"Obviously if one firm discloses the employees they have along with their capabilities, skills, experience and professional qualification then obviously investors will be attracted towards the organization".

3.10 Disclosure of Human Capital in Financial Statement

The above themes show that human capital is the most asset in any organization. It should be reported and valued based on experience, qualification, skill & competencies and training & development. All the respondents are agreed that human capital should be disclosed in the financial statements of any organization. However; a difference of opinion has been observed, some respondents stated that human capital should be disclosed in the company's profile, while others stated that if human capital is valued properly under IAS 38 it should be disclosed in the statement of financial position under Intangible Assets. As one of respondent said;

"In my opinion information of human capital should be disclosed in company profile because International financial reporting standards don't allow to report human capital in financial statements so after that company profile is the core point at which point human capital should be disclosed. If we have an example of educational institutions, these institutes disclose the information in the prospectus and on their website to excel their businesses".

IV. Conclusion

The concept of human capital recognition in the financial statement is struggling for the acceptance in by International Financial Reporting Standards (IFRS) and International Accounting Standards (IASs) and regulatory bodies because the valuation of human capital is subjective, and parameters vary from company to company. Presently, not a single reliable valuation method is available with literature. However, researchers suggest different parameters or factors that need to be considered while human capital valuation e.g. qualification, skills, capabilities, experience, and training. The present study concludes that human capital is the most asset for any organization, in 21st century organizational financial and non-financial performance is based on the quality of human capital in any organization. The quality of human capital can be measured based on the following factors; experience, skill & competencies, professional qualification, and training. These factors are considered as antecedents to measure the quality of human capital which ultimately boosts the firm's financial performance with the mediating role of a positive attitude.

The results from the analysis indicate that the valuation of human capital is a difficult task but it's possible, the key factor which stops the recognition of human capital in financial statements is controllability. As IAS 38 intangible asset states the conditions for recognition of an intangible asset in the financial statement. However, the IAS 1 Presentation of financial statements states that the matching concept should be followed, and income and expense should be for the relevant period. Results affirm that professional accountants believe that costs associated with the employee development (Trainings & Development) benefit the organization over the period, and the results also show that an organization can control employees through contractual agreements. The concept of human capital valuation is quite new in developing nations, however; this concept was initially implemented in the United States in the 1960s and later it is recognized and implemented in other developing countries (Nimtrakoon, 2015).

This concept of human capital valuation is relatively new for developing and underdeveloped countries. The current study is qualitative in nature and data was collected using interviews from professional accountants (Chartered Accountants), the results suggest that future research should be on quantitative data set to test the underlying constructs presented in the current study. Another valuable direction for future research is the sample should include the organization's representatives from board members and from an accountant, so comprehensive results can be inferred.

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