

# Interface of Human Resource Accounting with Accounting and Finance and Performance Evaluation

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**Abstract:** *The purpose of this study is to report a link between the three disciplines of human resource accounting, accounting and finance and performance evaluation through a conceptual framework highlighting the interfaces between them. The term interface here refers to the points of interaction, connection or overlap between these three disciplines, highlighting how these disciplines interact, intersect or work together within the conceptual framework. The conceptual framework is designed based on a previous literature review. The final outcome of this study is a conceptual framework which reports the interface areas between human resource accounting and accounting and finance and between human resource accounting and performance evaluation, along with the individual roles of accounting and finance, human resource accounting, and performance evaluation disciplines in the interface development. This study contributes to the existing body of accounting literature by showing how accounting and finance lays down the foundation for the valuation and reporting of human resources in an organization, which in turn, facilitates in performance evaluation.*

**Keywords:** Human resources, Human resource accounting, Human resource management, Accounting and finance, Performance evaluation, Interface

## I. INTRODUCTION

Human Resource Accounting (HRA) acts as a connecting link between the disciplines of accounting and finance and performance evaluation. Purcell (1995, p. 84) stated that “the challenge of human resource management is to show a link between policy, practice, and organizational outcomes that is meaningful to the corporate board”. This is where the role of management accounting comes. It is one way of reporting the human resource-organizational performance link (Kouhy et al., 2009).

The term interface in general refers to the points of interaction, connection or overlap between two or more subjects, functions, technologies, or disciplines among others. In the context of this study, the term interface refers to the points of interaction, connection, or overlap between the three disciplines of human resource accounting, accounting and finance, and performance evaluation. It highlights how these disciplines interact, intersect or work together within the conceptual framework leading to a more integrated understanding essential for developing strategies that align human capital management, accounting practices, and performance measurement.

Accordingly, this paper shall analyze the links between human resource accounting, accounting and finance and performance evaluation through a conceptual framework representing the interface amongst them. The framework shall report the interface areas between human resource accounting and accounting and finance and between human resource accounting and performance evaluation, along with the individual roles of accounting and finance, human resource accounting, and performance evaluation disciplines in interface development.

## II. LITERATURE REVIEW

### 2.1 Human resource accounting

The term Human Resource (HR) refers to the set of individuals who form the workforce of an organization or a business entity (Bansal & Sharma, 2019). According to Syed (2009), human resources encompasses the energies, skills, talents and knowledge of people which are, or which may potentially be applied to the production of goods or for rendering services.

The Human Resources Accounting Committee of the American Accounting Association (AAA) defined human resource accounting as "the process of identifying and measuring data related to human resources and then communicating that information to the concerned authorities"(Report of the committee on human resource accounting, 1973; 169).

Human resource accounting is the measurement of the cost and value of an organization's workforce (Flamholtz et al., 2002). It involves identifying and measuring data about human resources and conveying this information to the interested parties (Enofe et al., 2013). It is a management tool intended to help senior management in understanding the long term cost and benefit implication of their HR decision so that better business decisions can be taken (Rani, 2016).

### 2.2 Need for human resource accounting over conventional accounting

Bullen and Eyler (2010) stated a need for organization to focus more on the skills, knowledge, competence and intellect of employees rather than on the company's physical assets. Determining the value of human resources is a complex process as it cannot be evaluated like other organizational resources (Kumar & Awasthi, 2018).

Under conventional accounting, no information is provided about the human resources employed in an organization, which in turn affects the operational effectiveness of financial and physical resources (Anil et al., 2022). The expenses related to the human organization are charged to current revenue rather than being treated as investments, which in turn cause a significant distortion in the reported net income. Amount on recruitment, training, etc. are categorized as expenses and written off against revenue under conventional accounting. However such amounts should be treated as investments, as their benefits accrue over a period of time (Anil et al., 2022).

When the expenditure incurred on recruitment, training and development of human resources is charged to current period's profit and loss account, profit during that period gets understated or losses gets overstated. By not capitalizing expenses relating to human resource, the assets gets concealed and net worth gets understated. Traditional financial accounting reports for only the fixed assets and current assets as assets in the balance sheet of companies' annual reports, but the real asset, that is, the human assets are not taken into consideration (Bansal & Sharma, 2019).

But the contemporary perspective is that the cost incurred on human resources shall be capitalized as it offers benefits that can be quantified in monetary terms (Bansal & Sharma, 2019). While many companies acknowledge that their most valuable assets are their employees, yet these companies often remain unaware of how to incorporate human resources into their financial statements through appropriate accounting practices (Ali, 2020).

### 2.3 Need for human resource accounting in financial statements

Reporting of human capital can be defined as a company reporting system that offers insights on the knowledge, skills, abilities and motivation of employees (Flamholtz et al., 2002).

Fajana (2002) stated that companies rely on skilled and committed employees for optimum performance yet this importance is often belittled by a sketchy one-sentence remark mentioned at the end of the board chairman or company president's statement in most annual reports. Many organizations assert in their annual report that their employees are their greatest assets but they are not treated as such in the books of accounts. Rather all amount spent on human resources is expensed (Micah et al., 2012).

Bullen and Eyler (2010) stated that such expenses like amount spent on recruitment, selection, hiring, placement, promotion, training and development shall be reported in asset account rather than as expenses as these generate benefits far exceeding the current accounting period.

Akindehinde et al. (2015) stated that the prevailing accounting practice of treating all expenditures on human assets as expenses do not reflect the true and fair view of an organization's balance sheet. Rather there is a need to value and

capitalize this asset like other intangible assets, such as goodwill which are included on an organization's balance sheet or statement of financial position (Envi & Akindehinde, 2014).

The substantial investments made by corporate entities on human resources and the impact of such investments on employee productivity justify their classification, recognition and treatment as assets rather than as expenses (Hossain et al., 2014).

Accounting for human resources constitutes an explicit acknowledgement of the premise that people are valuable resources for any organization and an integral part of the overall resource mix. The organization processes are operated by human resources, so valuation of this resource is pertinent and information about such valuation should be given to the investors, the management and others through financial statements (Bansal & Sharma, 2019).

#### **2.4 Role of human resource accounting in interface development**

Hendry and Pettigrew (1986, p. 6) stated that "HRM has a role in creating *competitive advantage* in which the skills and motivation of a company's people and the way they are deployed can be a major source of competitive advantage". Bassey and Tapang (2012) highlighted that human resources are recognised as a key source of competitive advantage by many organizations in today's economy.

Schuler and Macmillan (1984, p. 242) asserted that "effective management of human resources gives benefits which include *greater profitability*". Ichniowski et al. (1995) observed that the implementation of progressive HRM practices result in both *high productivity* and *high financial performance*. Batra (1996) found that human resource valuation and audit activity could be beneficial in *improving the efficiency of human resources* in the evolving business environment. Accordingly, human resource accounting contributes in interface development by offering: competitive advantage, greater profitability, high productivity, high financial performance and by improving the efficiency of HR.

#### **2.5 Role of accounting and finance in interface development**

Management accountants play a crucial role in providing *detailed competitive analysis* and both *financial and non-financial analysis* in relation to HRM at the senior management level (Vedd & Kouhy, 2005). They also *provide analytical information for decision making, coordinate HR budgeting process, help HR managers to prepare business cases for large projects, helps to set HR targets, provides information to take investment decisions, assist the divisional HR planning process* as well as *conduct cost/benefit analysis for major projects* Management accountants also *helpset up HR guidelines and policies*, and serve as a foundation for the formulation of organization's HR strategic plan (Vedd & Kouhy, 2005).

They make sure that the financial figures are right before any contract or quotation is sent to a customer, *conduct 'what if' analysis, renders information on performance variances, serves in an advisory role, provides inputs into policies and decisions, monitors HR performance and prepare, present and communicate information on HR performance measures.* The role of management accountants in the future will be even more of a *partnership role* with HR managers (Vedd & Kouhy, 2005).

Accordingly, accounting and finance contributes in interface development by offering: detailed competitive analysis, financial and non-financial analysis, analytical information for decision-making, coordination in HR budgeting process, preparation of business cases for large projects, assistance in setting HR targets, information to take investment decisions, assistance in HR planning process, cost-benefit analysis for major projects, setting of HR guidelines and policies, performing 'what if' analysis, information on performance variances, advisory and partnership role.

#### **2.6 Interface between human resource accounting and accounting and finance**

Kumar and Awasthi (2018) described HRA as the art of systematically valuing, recording and presenting the contribution of human resources in an organization's financial statements. It is an accounting analysis system (Rani, 2016). Human resource accounting can be defined as an integrated accounting system that delivers accounting information about investments in human resources. This information is utilized by management for decision-making and by external stakeholders for assessing the company's performance and making investment decisions (Ali, 2020).

Human resource accounting serves as a *vehicle for improvement of management as well as measurement of HR* (Flamholtz et al., 2002). Avazzadehfath and Raiashekar (2011) examined the impact of human resource accounting

information on the investment decisions and explored the factors that might interfere in this effect. Their findings indicated that the disclosure of human resource accounting information in financial statements is relevant and influence *optimal investment decisions*.

Some Japanese organizations demonstrated a more direct link between corporate strategies and management accounting compared than their Western counterparts (Kouhy et al., 2009). Hiromoto (1988) contented that Japanese organizations used their accounting system to motivate employees, serving in more of an “*influencing role*” than an “*information role*” in the managerial process.

Armstrong (1989, p. 164) observed that the decisions regarding organizational structures and employee management are as much influenced by accounting logic as by the human resource strategy, to the extent that “the treatment of human resources becomes an instrument for the *achievement of accounting targets*”. Roslender et al. (1998) proposed that for management accounting to retain its significance in business organizations, it needed to adopt a more strategic focus.

The role of accounting over human resources is to supply information to assist the management in analyzing their decisions, particularly those concerning employees. Failure to measure investment costs in human resources and report them in the financial statements leads to unclear results in the company's *performance appraisal* process (Ali, 2020).

Accordingly, the interface areas between human resource accounting and accounting and finance includes: vehicle for improvement of management, vehicle for measurement of HR, optimal investment decisions, influencing role in managerial process, achievement of accounting targets and performance appraisal.

### **2.7 Role of performance evaluation in interface development**

The term performance evaluation refers to a systematic analysis and measurement of the performance and achievements of human resources in such a way so as to detect deviations (if any) by comparing it against the targets, define steps to correct such deviations and provide feedback to the concerned authorities in order to refine new levels of work for the next period.

Saffar and Qasim (2006) stated the importance of evaluating performance in the form of *detection of deviations, remediation of deviations, achieving goals specified in the plans*, and as a *measure for incentives*. Organizational financial performance is dependent upon the performance of its workforce, with decision making theory serving as a guiding principle (Babalola & Kolawole, 2022).

Performance evaluation plays a central role in the effective management of the human resource of an organization which in turn assists in workforce development and improving the overall organizational performance (Ahmed et al., 2013).

Accordingly, performance evaluation contributes in interface development by offering: detection of deviations, remediation of deviations, goal achievement specified in the plans and measure for incentives.

### **2.8 Interface between human resource accounting and performance evaluation**

Linking the effects of different HR policies to organizational performance is challenging due to the twin problems of the number of other factors affecting organizational performance and the time lags between the introduction of a new HR policy and its effect on organizational performance (Kouhy et al., 2009).

Several studies linked human resource accounting with organizational performance. For instance, Nkomo (1987) linked HR planning with business performance but found no correlation between them. Similarly, Delaney et al. (1989) reported no association between HR practices and financial performance. Micah et al. (2012) in their study identified the existence of an inverse relationship between the performance metrics (ROA) of a firm and the extent of its human resource accounting disclosures. The outcome is expected, as return on assets (ROA) reflects a company's overall profitability and when investments on human capital development are recoded as expenses, both assets and earnings tend to be understated.

In contrast, Ulrich et al. (1984) observed positive relationships between specific HR practices and business outcomes. A study conducted by Huselid (1995) provided evidence that the implementation of high performance work practices (such as *comprehensive recruitment and selection procedures, incentive compensation, performance management systems, extensive employee involvement and training*) resulted in better organizational performance. Research by the

Chartered Institute of Personnel and Development (CIPD) (2003) suggested that a correlation existed between the performance of companies and the methods used for developing and managing their employees.

Srivastava (2014); Ifurueze, Odesa and Ifurueze (2014) in their studies found a positive association between human resource accounting and the performance of organization. Viewing employees as assets rather than costs may lead to increased expenditure in the short-term but positively influences an organization's long-term performance. Additionally, employee recruitment decisions play a crucial role in shaping an organization's future performance (Kouhy et al., 2009).

"*Job for life*" policy encourages employees to take a long-term view in decision making, increase their motivation level, enhance their organizational loyalty and holds a positive effect on the long-term performance of the organization. *Teamwork* also creates a great positive impact on the organization's performance apart from the "job for life" policy. *Organizational culture* and a good *pensionscheme* can have a major impact on organizational performance. (Kouhy et al., 2009).

In his exploratory study, Liao (2006, p. 716) reported that "empirical results from 93 firms reveal that the appropriate use of HRM control systems was a contributing factor to firm performance". Katou and Budhwar (2006, p. 1248) in their research investigated the relationship between human resource management policies and organizational performance based on a sample of 178 organizations operating in the Greek manufacturing sector. The study concluded that "managers should recognise that *changes in employee skills, attitudes and behaviour* that are caused by HRM policies precede changes in organizational performance".

Valuing human resources contributes to *organizational development, job involvement, job satisfaction, motivation, high morale and sense of belongings* to the organization. These factors help improve an organizations' performance (Kumar & Awasthi, 2018).

Accordingly, the interface areas between human resource accounting and performance evaluation includes: comprehensive selection and recruitment procedures, incentive compensation, performance management system, extensive employee involvement and training, job for life policy, teamwork, organisational culture, sound pension scheme, changes in employees skills, attitudes, and behavior, organisational development, job involvement, job satisfaction, motivation, high morale and sense of belongings.

### III. RESEARCH METHODOLOGY

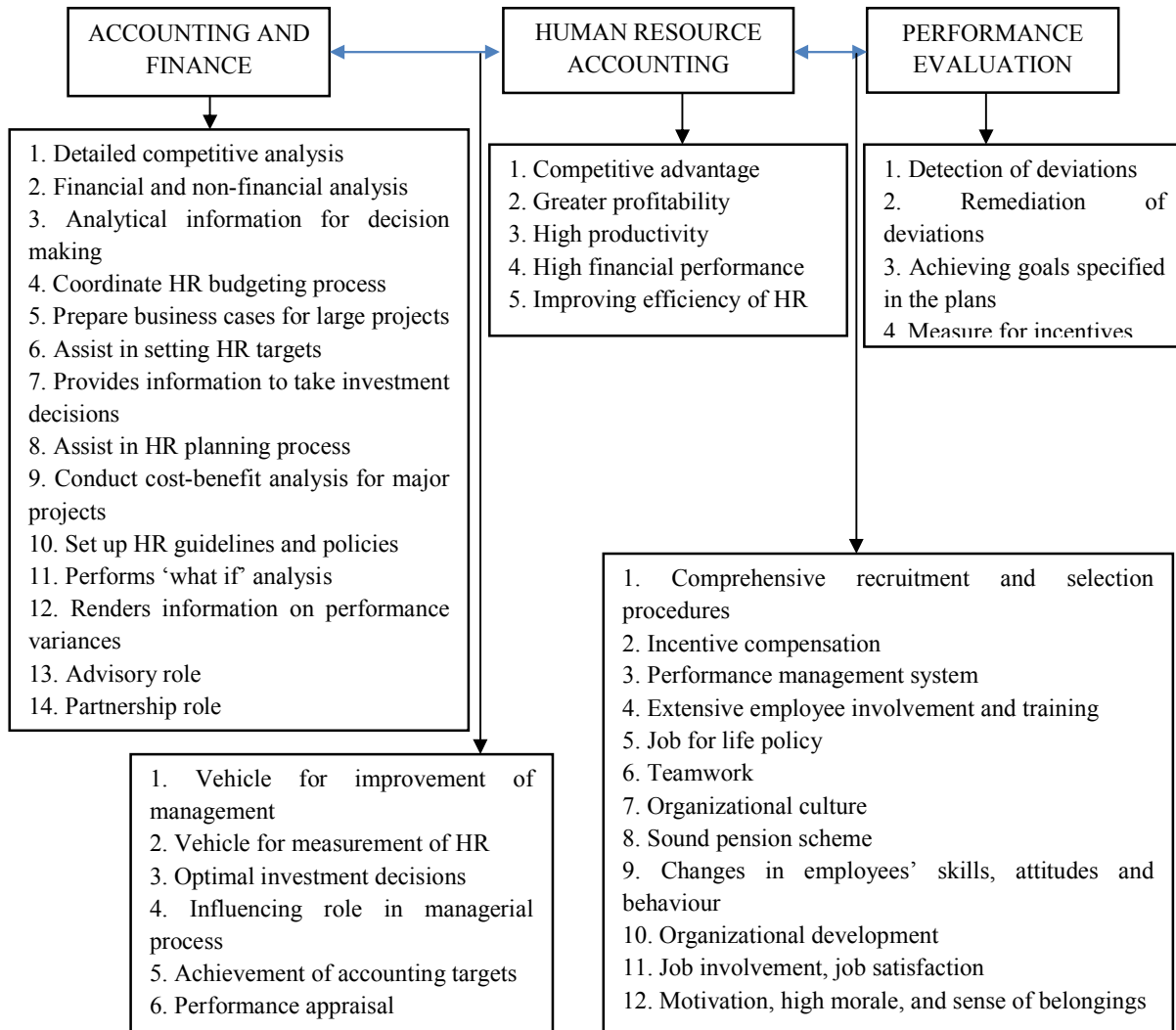
#### 3.1 Need of study

The study aims to analyze the interface between the three disciplines of human resource accounting, accounting and finance and performance evaluation through a single study, and generate a conceptual model, based on the results. The conceptual model shall highlight how these disciplines interact, intersect or work together leading to a more integrated understanding essential for developing strategies that align human capital management, accounting practices, and performance measurement.

#### 3.2 Conceptual framework

The study based on the literature review of interface of human resource accounting with accounting and finance and performance evaluation resulted in the development of a conceptual framework by integrating the findings of different researchers in a single framework. The framework shows the interface areas between human resource accounting and accounting and finance and between human resource accounting and performance evaluation, along with the individual roles of accounting and finance, human resource accounting, and performance evaluation disciplines in interface development.

Fig 1. Interface of human resource accounting with accounting and finance and performance evaluation



Source: Author's own work

**IV. CONCLUSION**

Accounting and finance lays down the foundation for the valuation and reporting of human resources in an organization, which in turn, facilitates in the performance evaluation and performance improvement. While individually these disciplines do serve their own purposes, but in an interface situation where these disciplines interact, intersect or work together, they act as a connecting link with each other, thereby performing inter-disciplinary roles in the organization, leading to a more integrated understanding of organizational performance. It creates a need on the part of accounting bodies, regulatory bodies and government agencies for issuance of clear cut guidelines for human resource accounting in financial statements to make the disclosures more objective and user worthy. It also creates a need on part of the organizations to understand the significance of human resource management and accounting in terms of the interface development contributing towards improved organizational performance, and thereby implement the needed changes in their financial statements.

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