So tell me again . . . just why would you want to account for people?

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Abstract

Purpose – The paper sets out to identify the key role that Jan-Erik Grojer's work on human resource costing and accounting played in linking initial developments in accounting for people with the more recent advances associated with the emergence of the intellectual capital concept.

Design/methodology/approach – The paper is in the form of an essay that briefly considers the history of approaches to the challenge of accounting for people.

Findings – The recent developments associated with intellectual capital highlight the importance and value of adopting a rather wider conception of accounting for people.

Originality/value – The paper provides a provocative introduction to the topic of accounting for people and as such may be of value to both newcomers to the field and those who are simply intrigued by the idea itself.

Keywords Human resource accounting, Human capital, Accounting research

Paper type General review

Jan-Erik Grojer played a pivotal role in continuing a focus on the necessity of identifying how it might be possible to account for people. Together, with his colleague and fellow contributor to this collection, Ulf Johanson, Jan-Erik advocated the development of human resource costing and accounting, a contribution that provides the critical link between human resource accounting, the principal approach to accounting for people in the 1970s, and intellectual capital, the development that has galvanised renewed interest in this topic as well as identifying the ultimate reason why people should be taken into account. This contribution is clearly evident in their seminal 1998 paper entitled: "Current development in human resource costing and accounting: reality present, researchers absent", published in the *Accounting, Auditing & Accountability Journal*. On a personal level I am greatly indebted to Jan-Erik for persuading me that I should make something of a U-turn in my own journey within accounting research. Having written a couple of papers on human worth accounting, and accepted an invitation to join the founding editorial board of the *Journal of Human Resource Costing and Accounting*, I had begun to explore the relationship between management accounting and marketing management via the notion of strategic management accounting. An invitation from Jan-Erik to participate in a memorable symposium in Brussels in autumn 1998 resulted in me having two exciting avenues to traverse in the next decade, and indeed for the foreseeable future, something for which I am deeply appreciative.

The following essay is conceived of as a very personal, brief introduction to the topic of accounting for people, a project which Jan-Erik did so much to promote throughout his own career. It draws on elements of a previous contribution written with Guy Ahonen and Gunnar Rimmell and published in 2007. In some part it is also

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the script to my Public Professorial Lecture at Heriot-Watt University of the same name presented in January 2009, which was itself dedicated to Jan-Erik's memory.

Human asset accounting

The necessity to take people into account was recognised in the 1920s by Paton, one of the founding fathers of accounting theory who acknowledged that:

> In the business enterprise, a well-organized and loyal personnel may be a more important "asset" than a stock of merchandise [. . .] At present, there seems to be no way of measuring such factors in terms of the dollar; hence, they cannot be recognized as specific economic assets. But let us, accordingly, admit the serious limitation of the conventional balance sheet as a statement of financial condition (Paton, 1922, pp. 486-7).

It was several decades later, however, before Hermanson (1963, 1964) identified the human asset accounting approach to accounting for people. At that time the merits of the historical cost convention, the traditional foundation for financial accounting and reporting, was being widely debated. This was to have a significant impact on Hermanson's own ideas about accounting for people, which was largely envisaged as a balance sheet issue. Although not responsible for identifying accounting for people with "putting people on the balance sheet" (Hekimian and Jones, 1967), it was more or less inevitable that Hermanson focused significant attention on the issue of human asset valuation. He was very aware of the need to provide a robust valuation methodology in order to persuade both practitioners and many academics alike that it was possible to account for people in the absence of historical costs. He offered two possible alternatives in the form of the unpurchased goodwill method and the adjusted present value method, both of which had established credibility in the economics and finance fields, respectively. In so doing, Hermanson was the first in a long line of contributors to accounting for people who explored the potential of increasing arcane "hard number" approaches to the central task of valuation. A third, sometimes overlooked contribution to human asset accounting can be found in Likert (1967). Interestingly, Likert links the challenge of accounting for people with accounting for customers, something strategic management accounting has only recently begun to consider. In the final analysis, and despite his expertise as a management academic, Likert is also seduced by the lure of the sort of "accurate facts" widely associated with the traditions of financial accounting and reporting.

Human resource accounting

This is the broad approach to accounting for people that accounting academics and practitioners are most familiar with, and which dominated this field during the heady days of the 1970s when it was one of the hottest accounting research topics. The principal advocate for human resource accounting was, and remains, Eric G. Flamholtz, whose contributions, including three editions of a research monograph, remain key reading for anyone interested in accounting for people (Flamholtz, 1974a, 1985, 1999).

From the outset it was evident that Flamholtz sought to position accounting for people within the traditions of managerial accounting rather than financial accounting and reporting (Brummet *et al.*, 1968). And within the managerial accounting designation, Flamholtz's inclinations were rather more skewed towards management than accounting:

> Although familiar accounting concepts and terminology are being used, human resource accounting is not being designed for use in published financial statements. It is intended as a managerial tool. It is designed to satisfy information needs presently faced by operating management. It aims to provide management with relevant, timely, quantifiable, and verifiable information about human resources to encourage informed judgements and decisions. It is future oriented, and thus deals not only with transactions data as conventional accounting, but also with measurements of replacement cost and economic value. Since human resource accounting is intended as a managerial tool, it need not be constrained by accounting conventions, legal restrictions, or tax laws (Brummet *et al,* 1968, p. 224).

In the light of these observations, it is hardly surprising that human resource accounting also became part of the amorphous branch of managerial accounting known as management control as well as its close relation, behavioural accounting. On the other hand, Flamholtz showed himself equally adept at engaging with the (financial) valuation paradigm, including advancing his own model of human resource valuation based on identifying individual careers as a succession of service states conceived of as a stochastic process (Flamholtz, 1971; see also Flamholtz *et al.*, 2003) and providing a critique of Lev and Schwartz's, 1971 approach in Flamholtz (1972).

A 1974 paper in the *Journal of Management Studies* provided Flamholtz with the opportunity to review the progress of human resource accounting. He identifies the literal meaning for human resource accounting as:

> [A]ccounting for people as organizational resources. It means the measurement of the cost and value of people to organizations. More formally, "human resource accounting" can be defined as the process of identifying, measuring, and communicating information about human resources to decision-makers (Flamholtz, 1974b, p. 44).

Any doubts that Flamholtz views human resource accounting as other than a managerial accounting development are dispelled as he continues:

> The term "human resource accounting" ought to be viewed as a metaphor. Human resource accounting is not only a system of accounting for the cost and value of people to organizations, it is also a way of thinking about the management of people in formal organizations (Flamholtz, 1974b, p. 45).

Flamholtz identifies three objectives or purposes for human resource accounting. The first objective is to develop methods of measuring human resource cost and value designed to provide a quantitative basis for decision making by managers and investors. The second objective is to develop methods for measuring human resource cost and value necessary to monitor the effectiveness of management's utilisation of human resources. The third objective identified by Flamholtz affirms the managerial emphases of human resource accounting:

> Another ultimate objective of human resource accounting is to develop a theory explaining the nature and determinants of the value of people to formal organizations. This theory would serve a dual purpose. First, it would identify the variables which must be considered in developing measures (both monetary and non-monetary) of human resource value. Second, the theory might ultimately become the basis for a new paradigm for human resource management (Flamholtz, 1974b, p. 45).

In the same year Flamholtz published the first edition of his *Human Resource Accounting* text. This provided the opportunity to assemble a comprehensive overview of an expanding literature from one of accounting's then most researched topics. Affirming human resource accounting as primarily a managerial accounting development, Flamholtz identifies its primary purpose as being "to help management plan and control the use of human resources effectively and efficiently" (Flamholtz, 1974b, p. 3). Its financial reporting potentialities are viewed as being rather limited, Flamholtz commenting that such information "may also be reported in financial statements for use by investors and others outside the organization". An input-output model is used to illustrate the operation of a human resource management system [a term not yet in wide currency at that time], reinforcing the management control affinities of human resource accounting. Flamholtz also repeats his assertion that human resource accounting is a way of thinking about or "paradigm" for the management of an organisation's human resources.

When the second edition of *Human Resource Accounting* was published in 1985, research interest in human resource accounting had declined from the heady days of the mid 1970s. The text included new chapters on second generation accounting systems for human resource costing and value, respectively, while part IV focuses on more practical issues associated with applications and implementation. Part I discusses the uses of human resource accounting for managers and human resource professionals and for corporate financial reporting, respectively. In the former case, Flamholtz offers a succinct statement of the three major functions of human resource accounting:

> It serves as a framework to facilitate human resource decision making; it provides numerical information about the cost and value of people as organizational resources; and it can motivate line management to adopt a human resource perspective in their decisions involving people (Flamholtz, 1985, p. 10).

It is in these ways that human resource accounting helps management to plan and control their use of human resources effectively and efficiently. More specifically, human resource accounting provides information needed to "acquire, develop, allocate, conserve, utilize, evaluate, and reward human resources" via "measures of the cost and value of people to an organization" (Flamholtz, 1985, p. 25). The terminology on display was now increasingly familiar, suggesting that human resource accounting was no longer generating new ideas. In retrospect it is apparent that this was not the case with the generality of managerial accounting, which soon to move into an exciting new era in the form of the new management accounting.

Human resource costing and accounting

In retrospect it is extremely fortunate that some accounting and management researchers, including Jan-Erik, did not follow fashion and abandon human resource accounting in the 1980s. Together, with colleagues at the University of Stockholm, he began to explore the potential of what was originally termed *Personalekonomie*, later to be redesignated human resource costing and accounting, which in turn was incorporated into the title of this journal, founded in 1996 and based in the Personnel Economics Institute, created in 1988 by the group. Largely unknown beyond Scandinavia until the mid 1990s, the work involved in quietly developing a human resource costing and accounting approach ensured that a highly talented and motivated group of researchers existed, capable of responding rapidly to the identification of the intellectual capital phenomenon within the popular management literature (Brooking, 1996; Edvinsson and Malone, 1997; Stewart, 1997; Sveiby, 1997).

At base, human resource costing and accounting was created by marrying together two well established sets of ideas: human resource accounting and utility analysis. In the case of human resource accounting it was the underlying principles that were most appealing, the people-focused approach to human resource issues. Such an enlightened managerialism was consistent with the Swedish social settlement underpinned by a social democratic philosophy that had resulted in it becoming one of the most progressive societies during the post war era. The tradition of Scandinavian accounting (Jonsson and Mouritsen, 2005) played its part too. More closely intertwined with business administration than its Northern American counterpart, the managerial emphases of human resource accounting were less disconcerting to accounting practitioners and academics. As Grojer and Johanson (1998, p. 498) note: "The balance sheet has not been in the foreground in Sweden", one consequence of which was there were examples of a human resource costing and accounting informed profit and loss statement being used in Swedish organisations (Grojer and Johanson, 1996).

It would be wrong, however, to suggest that human resource costing and accounting simply exchanged a "putting people on the profit and loss account" for "putting people on the balance sheet" approach to accounting for people. Utility analysis provided a novel (in accounting terms at least) means of providing the sort of information that Flamholtz had identified as being central to the human resource accounting approach. Utility analysis originally emerged in the mid 1960s, more or less in parallel to human asset accounting, in the industrial/organisational psychology literature, with Cronbach and Glaser (1965) and Naylor and Shine (1965) providing models for estimating the financial utility of personnel selection. In contrast to human resource accounting, utility analysis' impact was modest in succeeding years. However, it experienced a renaissance in the late 1970s, one consequence of which was that by the mid 1980s it had become firmly embedded within labour economics in Sweden, itself a further constituent of human resource costing and accounting.

The principal focus of utility analysis is on investments in human resources: the costs of selection; recruitment; placement; training and performance measurement, rather than their value to the organisation, as in human resource accounting. While the latter seeks to represent the value of human resources using the metrics normally associated with financial accounting and reporting, utility analysis is concerned with determining the return on investments in human resources, by analysing the benefits resulting from the incurrence of human resource expenditures. Such a "finance" as opposed to an "accounting" perspective on human resources reflects the economics lineage of utility analysis. This said, it was the industrial/organisational psychologists Schmidt and Hunter who devised a means of placing a cash value on people doing jobs, regardless of their complexity or indefinability of end product (Cook, 1998). Their rational estimate technique was based on the assertion that it is supervisors who are the best source of information on employee productivity. This allowed Schmidt and Hunter to calculate a standard deviation of operator productivity, SD_y, which indicates to employers how much the worker's work varies in value. In principle, SD_y provides a means of estimating the returns to any investment in human resources. Where it is high, there is much that can be gained from ensuring that such investments are made on an informed basis.

One of the attractions of utility analysis is that it promises to put some of the relatively "softer" aspects of human resource management, i.e. selection, recruitment, training, etc. onto a sounder or "harder" footing. Boudreau *et al.* (1997) begin their paper on utility analysis by making this point:

> Suppose we could calculate for a manager the return on investments in human resource management (HRM) programs, such as testing, training, compensation, and performance appraisal. Further, what if such calculations were based on accepted scientific research about the effects of such programs, and could be expressed in terms of financial and economic considerations [...] to make them comparable to calculations routinely carried out by analysts in such areas as marketing, finance, and manufacturing operations? (Boudreau *et al,* 1997, p. 303).

As such utility analysis complements human resource accounting, sharing the same belief in the value of quantitative information for better management decision making in relation to human resources. The critical advantage that utility analysis has over human resource accounting is that it is not constrained by the requirements of a specific, broader measurement and reporting regime. Utility analysis provides stand alone information in a way that human resource accounting was never able to. In this way, there is a strong case for identifying utility analysis as an example of a managerial accounting tradition that is informed at least as much by the needs of management as it is by the demands of accountants, something that Flamholtz's human resource accounting is not.

The impact of human resource costing and accounting in Sweden or Scandinavia should not be overstated, however. Although well received in some sectors of their economies, and in many instances by a human resource management function conscious of its potential to strengthen its position in the managerial hierarchy *vis a vis* their accounting and finance colleagues, Grojer and Johanson (1998) intimate only a measured uptake (Johanson, 1999). In retrospect, the importance of a human resource costing and accounting approach to the challenge of accounting for people lies more in its theoretical excursions than its practical accomplishments. The exploration of the potential of human resource costing and accounting reinforces the suggestion that it is desirable to interpret accounting in a much broader way than is usual, something that neither human asset accounting nor human resource accounting had seriously done. It encourages interested parties to look beyond the narrow confines of the cost and value paradigm when seeking useful accounting and managerial insights. It also demonstrates the value of adopting an interdisciplinary approach to the task of accounting for people, one which moves beyond the confines of the managerial disciplines into the more fundamental realms of the social sciences, an attribute that the human resource costing and accounting approach shares with human worth accounting, a further approach to accounting for people identified in the early 1990s by Roslender and Dyson (1992), see also Roslender (1997).

More significantly, however, and as a direct result of the continuing interest of Jan-Erik and his colleagues in seeking to account for people in during the 1980s and early 1990s, an invisible college of academic researchers and some practitioners was readily mobilised to exploit the intellectual capital concept.

Intellectual capital

Intellectual capital was identified in the mid 1990s as being increasingly the most important type of capital within the value creation and delivery process within business enterprises and beyond. It was superseding physical capital, the traditional foundation for wealth creation, and financial capital whose importance had itself increased massively in the previous decades. While both the latter forms of capital remained highly important, relative to intellectual capital they were in decline, particularly in many leading edge, hi-tech enterprises that were heralded as the model for the future. Intellectual capital had many constituent elements, although what was claimed to unite them was their "intellectual" nature, which in turn was identified using equally broad terms such as "knowledge" or "information". This linkage was exemplified in the assertion that intellectual capital was characteristic of the current Information Age or Knowledge Economy (or some variant thereof).

One of the pressing tasks confronting those interested in intellectual capital was to develop useful taxonomies of intellectual capital's constituent parts. A working consensus was not too long in emerging, with three components being identified: human capital; relational or customer capital and organisational or structural capital (Lynn, 1998; Mouritsen, 1998). Further refinements have subsequently emerged but for the past decade this taxonomy has proved very useful. What it confirms is that many, if not all, forms of intellectual capital possess an intangible character and for this reason some researchers have embraced the term "intangibles" to designate them, and used it interchangeably with intellectual capital. Unfortunately, this has led to some in the field confusing intellectual capital with intangible assets. While it is reasonable to observe that very many of those assets that in pre-intellectual capital days financial accounting and reporting referred to as intangible assets, there are many new examples. To further complicate matters, many of the former intangible assets, e.g. trademarks, copyrights, patents, brands, etc. now have reasonably established accounting and reporting treatments associated with them, based in the tradition valuation model, this is not the case, and indeed is unlikely to be the case for the greater proportion of intellectual capital constituents.

The failure to be able to account for the greater part of a business enterprise's intellectual capital resulted in what was designated the hidden value problem facing financial accounting and reporting. In some leading edge organisations current market values were many multiples of book value, emphasising that organisations and their accounting and finance staff were having to deal with something of significantly greater magnitude than internally generated goodwill, another problem from the pre-intellectual capital era. The accountancy profession's first inclination was, perhaps understandably, to suggest an incremental valuation approach to the problem of hidden value, identifying the various constituents of a stock of intellectual capital, then engaging in a wide-reaching robust valuation exercise. This was soon recognised to be both massively resource intensive and unlikely to deliver credible results. In truth it was the outcome that Hermanson had identified 35 years previously, and only now a much, much greater scale.

During the next years great strides were made in measuring and reporting the growth of organisations' stocks of intellectual capital, initially making use of the scoreboard approach to the task, as in the Skandia Navigator, Balanced Scorecard and Intangible Assets Monitor, and thereafter the development of narrative-based approaches. Naturally, Jan-Erik, Ulf Johanson and a group of their colleagues were heavily involved in this exercise as the Swedish participants in the Meritum project (2002), which also resulted in the publication of a set of papers on intangibles published in *Accounting, Organizations and Society* in 2001, which included Jan-Erik's paper entitled: "Intangibles and accounting classifications: in search of a classification strategy".

Why we must continue to account for people

A colleague engaged in research within the human research management field recently commented to me that although he had long recognised human resource accounting as an interesting solution, he was still not clear as to what the problem actually is! With the emergence of the intellectual capital concept, the possibilities for accounting for people in ways far removed from what most people would recognise as accounting have suddenly become much more evident. It has nothing to do with costs or values, two of the central precepts of the financial accounting and reporting calculus. The key performance indicators or metrics that might be incorporated into some form of intellectual capital scorecard or narrative now have much more to do with people than with accounting. In this respect human capital accounting, as a component of intellectual capital, probably provides an even better solution. But my colleague's question still remains: to what problem?

For both Paton and Hermanson the problem was that a balance sheet that did not take people into account was incomplete. Accounting for people was therefore principally a technical exercise. Flamholtz's intervention was motivated by a belief that people were a scarce resource that management could better deploy if in receipt of appropriate accounting information. In both instances, any resultant improvement in the lot of people within the organisation was of essentially secondary importance. Without doubt, some of the motivations informing the development of human resource costing and accounting were of a more humanistic nature than either of the approaches that preceded it. At best, however, they were little advance on the thinking that underpinned the iconic Kalmar work redesign experiments a decade or so previously, namely the attempt make employment increasingly less unattractive (Fincham and Rhodes, 1999), the underlying problem being the need to ameliorate the prevailing social organisation of work.

Identifying people as capital marks a significant advance on viewing them as either assets or resources. In the same context the term capital is usually associated with those inhabit the upper echelons of the organisation, including owners, managers and accounting and finance professionals, rather than lower level participants, i.e. employees. Accepting that in the twenty first century the structure of the organisation is much more complex than in previous eras, designating employees of all types as capital, as in the intellectual capital literature, accords them a much enhanced importance. Nor is it only the intellectual capital literature that recognises the increasingly critical role played by employees. Similar sentiments are evident within the quality literature, customer relationship marketing and both strategic human resource management and knowledge management. In this regard, the emergence of the intellectual capital concept indicates an acknowledgement that people's contribution to the organisation is now recognised for what it always has been – fundamental.

The evolving intellectual capital accounting literature has generally not explicitly privileged accounting for human capital (people) over its other components, i.e. relational capital and organisational capital. This to be applauded since many contributors are clearly sympathetic to the advancement of people within the organisation. Edvinsson's founding 1997 paper makes use of a dichotomy between human capital and structural capital that strongly implies the primacy of the former over the latter. This is reinforced by identifying the human focus within the Skandia Navigator as the soul of the house employed to visualise this intellectual capital reporting framework. "Our people" are similarly the principal focus within Sveiby's Intangible Assets Monitor (Sveiby, 1997). And even allowing for the actant status of knowledge within any organisation, it is difficult to avoid recognising the critical role played by people in the context of the knowledge narrative, management challenges and initiatives components of an intellectual capital statement (Mouritsen *et al.*, 2001; DMSTI, 2003).

An intellectual capital based approach to accounting for people identifies employees as the critical source of value creation and delivery in all organisations. It is for this reason that I have previously identified human capital as primary intellectual capital to be distinguished from secondary intellectual capital, i.e. relational and organisational capital (Roslender and Fincham, 2001, 2004). As the source of all creativity, people deserve to be privileged over the infinite range of manifestations of that creativity. Without people and the creativity they gift to organisations, and thereby to the broader society, there would be no such thing as the comfortable, civilised life that many of us enjoy on a day to day basis, and which we are challenged to extend to the rest of humanity.

Against this backcloth, it should be clear that the purpose of endeavouring to account for people does not simply extend to taking people into account in ways that will result in them becoming more effectively controlled, or significantly emasculated, i.e. denied the opportunities to exercise their creativity. Accounting for people has always held out the promise of providing provides a means of demonstrating the enduring potential that people have to deliver advance, progress and betterment for the whole society. And in order to do so, it is necessary that people should not be subject to the prevailing social organisation of work and, in this context, to those accountings designed to secure its continued reproduction.

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