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Human Value Inclusion in Financial Statements: Concern for Standard Setters

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ABSTRACT

Notably, the Human Capital (HC) development and connected index (Human Capital Development Index) becomes vital for all economies. Also, it is observed that all the factors of production except the labour (i.e., HC) are accounted for and reported by entities. The major reason for non-reporting the HC in financial statements is argued to be the ignorance of this domain by standard setters. This paper sheds light on this fact through content and theoretical thematic analysis of relevant international and national accounting standards employing critique research method. The paper concludes the significance of the inclusion of Human Capital Reporting (HCR) in the standard setting and financial statements.

Introduction

The HC and Financial Accounting (FA) are two important domains in management literature. Economics, on the other hand, fuels the basics for these two domains *viz.* the factors of production (land, labour, capital, and entrepreneurship) and the reporting aspects of them (revenue and cost). The main concern of this paper is the labour and its exposure to financial reporting. The FA has given prominence for accounting for land (land and building), capital (plant and equipment), and entrepreneurship (profit or loss). However, the inclusion of the value of labour in financial statements is debatable (Akintoye *et al.*, 2018; Christian, 2014). The labour is considered as an expense (salary and wages) but not reported as an asset in the financial disclosures. Further, the assets are made up of current and non-current assets. Even though the HC is the significant player of the operations of the company or the nation it has not been included in either of the asset categories. Therefore, this paper discusses the need for fair presentation as fundamental for the HC value inclusion in financial reporting. Moreover, it considers the HCR and its international experiences as a vital aspect to the study, and analyses the institutional capacity requirements for the change. It also examines the important gaps found in the literature on this issue.

Problem Statement

The FA has grown faster and reached its age of 525 from the double entry inception by father of accounting Luca Pacioli. Though remarkable developments were observed in this field especially in the standard setting for relevant areas of accounting and financial reporting, it is argued that there was two fundamental negligence: one being the negligence of public sector and the next was the negligence of HC at work. The first has been given consideration by standard setters where the next continued to be ignored without proper attention.

Purpose of the study

The purpose of this study is to explore the negligence of the standard setters on HC Accounting (HCA) and explain the need for HC value inclusion as an asset in financial reporting.

Methodology of the study

The study falls into the qualitative paradigm and employs content analysis as the technique for analysing the data available in the International Accounting Standards (IASs), International Financial Reporting Standards (IFRSs), International Public Sector Accounting Standards (IPSASs), Sri Lanka Accounting Standards (LKSs), Sri Lanka Financial reporting Standards (SLFRSs), and Sri Lanka Public Sector Accounting Standards (SLPSASs). This study adopted the directed approach of content analysis since it starts with economic, HC, and accounting theories as direction for initial codes (Hsieh and Shannon, 2005). Also, this study engaged the theoretical thematic analysis technique (Braun &Clarke, 2006) in analysing the major theoretical themes of HC and the human value inclusion in the financial statements based on the definition of Accounting by Nagendrakumar (2017). Furthermore, it embraced the critique research method (Ryan *et al.,* 2007) in analysing the results found through the content and theoretical thematic analysis.

Significance of the study

The study supports the recent works of Akintoye, et al. 2018, Yadav and Singh (2017), Christian (2014), Saha (2011), Agarwal *et al.* (2009), and Gibson and Oxley (2003) in explaining the fact that the standard setters have to realize that the HCA is vital, eloquent and precarious to the enduring development of the firm in particular and nation as a whole. All the professional studies and pronouncements in the field of HCA not withstanding accounting reforms will not take hold unless the standards setters of accounting invest their resources in better HCA practices. Furthermore, this study highlights the need to recognize not only the suitable accounting ideologies that are necessary for flawless disclosure but also adherence to evocative accounting principles which would enhance the HCA discipline. It is posited that HCA would facilitate more germane information for improved choices, systems efficiencies, and effective disclosures.

Literature Review

This section brings to the light the FA and its relevance to the HCA focusing on the eminence of financial reporting, the importance of conceptual framework and accounting standards for HCR,standard setting for HC, financial accounting and reporting as a social reality, need for the regulatory mechanism, and gaps in HCR.

Quality and financial reporting

The drive of an accounting system is to provide germane financial information to concerned parties (Christensen, 2010). The interest on financial information might arise in two different situations; one is to make investment decisions (decision-making demand), and the next is to control the resources entrusted to the management by the owners (stewardship demand) (Gjesdal, 1981). Thus, two types of demand for information have implications on the quality of financial reporting. The decision-making demand comes from external users (*i.e.,* for General Purpose Financial Statements (GPFS)) while the stewardship demand comes from the internal users (*i.e.,* for Specific Purpose financial Statements (SPFS)). As a consequence, stewardship demand for information is highly relevant for HCA since the objective is to report on the control and use of the human resources entrusted to those who are accountable by shareholders.This is true in the public sector context as well where the people entrust the overall management of human resources of a nation to the elected members of the Parliament. The Parliament by constitution and laws entrust the management of the nation's human resources to different ministries and departments. As a result, the general public becomes the ultimate owners of the nation's human resources, and therefore, the elected Governments have the stewardship demand for information. So, whether private or public entities, they need to report the HC in their respective financial statements.

The importance of regulation for HCR

The legal framework, conceptual framework, and accounting standards are positively and significantly associated with the quality of financial reporting (Nkundabanyanga *et al.,* 2013). The idea of the frameworks and standards are to deliver a set of constant principles to regulate financial reporting as part of the political decision-making process (Christensen, 2010). As a result, it harmonizes the accounting and financial reporting practices across a wide variety of practices, organizations, industries, sectors, and the world as a whole.

In recent past different countries have experienced the transformation towards the development, introduction, and adaptation of comprehensive international accounting standards (*i.e.,*International Accounting Standards (IASs), International Financial Reporting Standards (IFRS), and International Public Sector Accounting Standards (IPSAS)) in the private and public sectors (Bewley, 2008). However, there had been no unique and separate accounting standards for the HCA rather than including the HC as one of the elements under integrated reporting in the annual reports.

Thus, it has become the common phenomenon that an acceptable design has not yet been recognised and adopted with respect to the HCA. Mayston (1992) argues that the ignorance of well-defined conceptual framework by the accounting profession is defensively comparable to a house built ignorance of principles of Newtonian physics. The absence of a sound conceptual framework for HCR might cause many complications. Therefore, attention to the conceptual framework would empower the standards setters to be in a better position in responding to them effectively.

The above claim necessitates the need for a conceptual framework for HCA. One way of doing it is that the direct involvement of Government administrators or politicians and the other way is delegating it to the external expertise in the field (Bewley, 2008) such as Chartered Institute of Personal Management of Sri Lanka and Institute of Chartered Accountants of Sri Lanka (CASL) in Sri Lankan context. The literature implicitly posits that the experts who have developed the rules and regulations, concepts, systems, and standards for accounting and financial reporting are first for the private sector (Nagendrakumar et al., 2015a; Nagendrakumar et al., 2015b). When it comes to the public sector though it is being introduced IPSASs, it has not yet come to the normative and practical conclusions on the best model for a specific public sector accounting environment.

When it comes to the case of HCA, it is worse than the public sector accounting since it has not been given even basic consideration by the standard setters. Another point is that the weaknesses in accounting practices ascend because regulators are notably dependent upon political reform promoters. The process of setting standards vary for different jurisdictions, and thus, has given rise to differences in GAAPs (Chua and Sinclair, 1994). But then again indeed, it is argued that HCR becomes significance for both the sectors even though the significance of them have not been recognized by either standard setters.

When setting standards for HCA, one may emphasize the stewardship of HC and the need for budget compliance (*i.e.*, 'accountability driven' ideology); some other may emphasize the HC aspects of financial performance, and the financial position (*i.e.*, 'managerialism-driven' ideology); another may emphasize the mixed approach in modelling the HCA. Nevertheless, the present move of HC inclusion in financial statements should focus on both'accountabilism driven' to 'managerialism-driven' ideology. Apart from this, experts from all the sectors should urge the standard setters to play a key role in bringing the trade-off in this regard which would set framework and standards widely interpreted as being fair.

Financial accounting and reporting: A social reality

Tavares and Dias (2018) claim that: *"Accounting is not a mere daily sustained and due practice, a result of years of habits and self-indulgence, but that it also involves and brings about social and institutional pressures that lead entities to take certain measures and decisions in behalf of those institutions' legitimacy, which originates constant shifts and changes, not only at the accounts level but also at the technological and social levels"*.Ohlson and Zhang (1998) claim that: *"Accounting data summarizes the primitive transactions or events through accounting policies and standards with the purpose of preserving value-relevant information about the firm"*. Further, Hoskin, (1994) claims that: *"Financial accounting is an important technology of valuing, objectifying, organizing and reporting business and economic phenomena"*. As a consequence, Hopwood, (1984) argues that the above claims help to infuse and profile organizational agendas, concerns, and choices. Also, accounting figures out accountability, transparency, and good governance and shreds of evidence organizational activities (Broadbent and Guthrie, 2008). Therefore, Tower (1993) argues that accounting has a causal relationship with societal welfare because it endorses organizational sustainability through the endowment of transparency by the way of financial and non-financial reports. Accordingly, HCA should focus on classifying, recording, and briefing the numerous aspects of HC transactions which an organization regularly executes. Then, it refers to how the HCA information disclosed as part of the comprehensive annual financial reports of the organization. Four basic accounting principles; matching, accrual, going concern and reporting cycle correspond perfectly with the human life cycles, the act and reward of such lives, and "balancing" the pains and gains of individuals and society (Saliya, 2012). Also, it is good to note that the inventor of financial accounting is a person who is related to the religion (*i.e.,* a monk; Luca Pacioli). Similarly, representations of the past records of financial accounting research, too, classically divulge that the accounting leans towards social science (Beattie, 2005).

Regulatory mechanism

Regulatory mechanism refers to the regulatory arrangements of the Government and standard setters about a subject matter. The regulatory arrangements may be from the law enforcement in the legislature to the institutional arrangements in designing, implementing and controlling the domain and the inclusion of the related organizational field (in this case the HC) in the relevant documents (in this case the financial statements presented by the entities). Puxty et al. (1987) as cited in Ryan et al. (1999) argue that the regulatory mechanism could be designed based on liberalism, legalism, associatism, and corporatism. Liberalism exclusively relies on market mechanisms. Legalism exclusively relies on the legislative and coercive powers of the state. Associatism involves a basic reliance on the market augmented with professional self-regulation. Finally, corporatism involves a strategy where the state incorporates organized interest groups into their system of regulations, often using them to achieve the public interest goals. For example, Miller (1996) argues that the Australian Accounting Standards setting process was corporatism based since it had the blessings from the legislature. Further, Ryan (1997) supports this argument stating that the Government regulators and political commitment are indeed very important for accounting profession regulators to regulate the financial reporting of the sector effectively. However, this has not been true as far as the HCA standard-setting process is concerned, and still, standard setters stand in isolation without giving due concerns for HCA.

Human Capital Development Index

This is the instrument which identifies the developments in HC. There are several initiatives to improve the HC but the reporting is given less significance. It is further argued that many studies (Yadav & Singh, 2017; Christian, 2014; Saha, 2011; Agarwal *et al.,* 2009) have focused on the measurement of HC and they have come out with many methods by which the HC could be quantified. It was the criticism during the early age of the accounting that inability of identifying and calculating the human value.

This criticism has been now well answered and many methods are proposed. The application and adoption of human value in the financial statements certainly would reflect in net assets of the organizations. Overall, this would lead to the disclosure of human value in the nation's financial statements as well. Provided all the above fact it is a dilemma why accounting standard setters are ignorance of paying their attention in announcing a standard for HC.

Discussion of findings

It was found that the International Accounting Standards Board originally developed the IASs which is now being migrating to IFRSs. It was observed that there are approximately 24 IASs and 17 IFRSs. It is argued that almost all of them have been mimicked in Sri Lankan context *viz.* LKASs and SLFRSs respectively (Nagendrakumar *etal.*, 2015a; Nagendrakumar *et al.*, 2015b). It was further found that the standards of both jurisdictions (international and local) have not given recognition for HCA.

Financial accounting refers to the economic information system, measurement methodology, and communication system designed to produce selected quantitative financial data in a pre-disposed structure about an entity which engaged in any economic activity during a particular period (Nagendrakumar, 2017). The definitions cover five theoretical themes (Braun & Clarke, 2006) *viz.*economic information system, measurement methodology, communication system, pre-disposed structure, and quantitative vs. qualitative nature of accounting which posit distinct relationship to the study. These themes underpin the necessity of inclusion of HC in the financial statements.

The economic information system consists of three basic concepts *viz.* Economics, Information, and System: Economics deals with the production, consumption, and transfer of wealth among a societal in a particular jurisdiction; Information is the processed and learned data meaningful for decision making, and System is a mechanism or process in which elements are interconnected in performing a specific task. Thus, taken as a whole, the economic information system of HCA is a mechanism or a process which deals withthe processed and learned data meaningful for decision making with regard to the production, consumption, and transfer of human wealth in a society in a particular jurisdiction. Accounting and financial reporting have been always subject to measurement methodology- i.e., historical cost, current cost, realizable value, replacement cost, and present value (CASL, 2018). Communication is referred to as imparting or exchanging of information by speaking, writing, or using some other medium. The language of accounting is debit and credit. Furthermore, the reporting style of accounting is written. So, the HCA becomes a system of communication where organizations report the value of the HC to its stakeholders.Pre-disposed structure is the GAAPs and accounting standards which govern the disclosure of HC value in the financial statements. The world of accounting so far does not experience the existence of such predisposed structure for HCA. Therefore, it is vital to focus the HCA accounting also to be taken into such predisposed structure. One of the key features of the definition of accounting is that the presentation of quantifiable information in money terms (money measurement concept). The quantifiability of the HC values in money terms is argued to be difficult but possible. So HC inclusion and developing a unique standard for the mega theme (HC inclusion) is possible nonetheless it is portrayed by standard setters difficult. Yet, it seems not prevalent a standard (international or otherwise) which is specifically designated to the HCA and HCR. However, integrated reporting recommends the inclusion of HCR. Overall, it was found that the HCA and HCR have not penetrated into the standard setting and the disclosure requirement.

The above research problem could be solved only when the HCA is accepted as one element in the financial statement so that the HC is recognised as an asset in addition to physical and financial assets. This argument leads to the need for the discussion of HCA approaches in the literature and inclusion of human value in financial statements.Accordingly, HC and its inclusion in financial statements have to be officially announced as designated standard(s) by the standard setters failing which would allow organizations to continue the ignorance of HC in reporting. Also, it was found that the standard setting for HCA could only possible within the scope of the IAS and IFRS.As a result, the HCA approaches are possible under the measurement methods available under the IFRS. The historical cost measurement method, according to CASL (2018) posits *that "it is the amount of cash or cash equivalents paid or fair value of the consideration given to acquire them at the time of their acquisition"*. Under this method, the cost associated with acquiring the human resource to the organisation (recruitment, selection, induction, etc.) needed to be considered as the historical cost of the human resource. The current cost method, according to CASL (2018) posits that *"it is the amount of cash or cash equivalents that would have to be paid if the same or equivalent was acquired currently"*. Under this method, the cost of acquiring and replacing the HC of the same calibre (selection, recruitment, induction, etc.) must have to be revisited based on the current cost of the market conditions. The Realizable value method, according to CASL (2018) posits that *"the assets that are carried at the amount* *of cash or cash equivalents that could currently be obtained by selling the assets in orderly disposal"*). This is simply the Industry Premier League (IPL) method in which the human resource is valued by its selling price. As such the industry may have to have the open market competition and auction in having the particular human resource and the rate must have to be decided accordingly. Present value method, according to CASL (2018) posits that *"assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of the business"*. Therefore, businesses are expected to estimate the future economic inflow from the HC and to calculate the present value based on the acceptable industry average. So, the industry average is the matter to be decided by the relevant chambers.

LKAS 1 and SLPSAS 1 which deal with the presentation of financial statements categorises the assets into current and non-current assets (CASL, 2018). It is argued that the HC is meant for consumption by the organization for short term and long term. The consumption may be in the capacity of different positions in the organization. As a result, the HC could also be divided into current and non-current assets. A current asset, according to CASL (2018) *"is the asset which is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle, it is held primarily for the purpose of being traded, it is expected to be realized within twelve months after the balance sheet date, and it is cash or a cash equivalent"*. The HC could be current in nature when it is intended for short term consumption in an entity's normal operating cycle. For example, employees on the contract (less than one year), and on a casual basis could be valued and recorded under current assets. This standard uses the term 'non-current' to include all the assets excluding the current assets (*e.g.*, tangible, intangible and long-term financial instruments). The HC could be noncurrent in nature when it is intended for consumption for long term particularly more than one year. For example, permanent employees, workers with more than one year contract, and the other position long term in nature.

Conclusion

The study concludes that the international standard setters have given no attention so far to the HC and have not come out with a unique standard to deal particularly with HC. It also concludes that the local standard setter (i.e., CASL) also has not given importance to this segment of accounting. This becomes a gap in interdisciplinary recognition and inclusion of economic transactions (labour – i.e., HC inclusion) of an organization in the financial reporting.

Recommendation

The fundamental change required is to move the reporting system to HC based. As a consequence, the financial information on aspects not previously included in the disclosures of financial statements necessarily become available to the stakeholders and the general public (Ryan *et al.*, 1999). This standardization process should be led by the IFAC and there should be a separate sub-board formed for this purpose. The objective of this board should be to serve the purpose by developing HC accounting standard(s) for use by all sectors in presenting the GPFS.

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