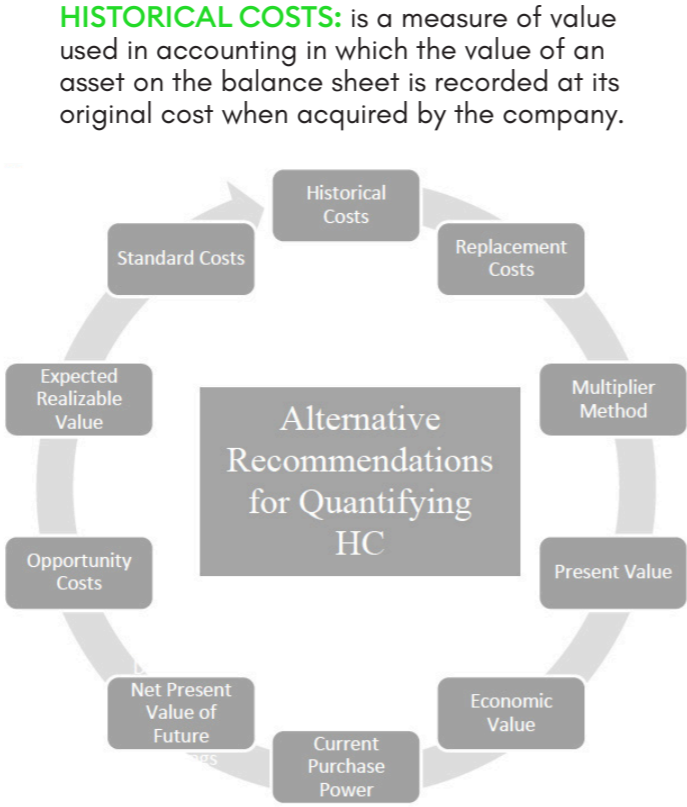


# MEASURING Human Capital Part 3

Why do we need to consider a valuation for Human Capital?

**PREVIOUSLY ATTEMPTED METHODOLOGIES**  
 Everything seemed to change in 2013 when the IASB published a discussion paper proposing radical changes to its Conceptual Framework. This paper acknowledged that the conservative bias of traditional accounting had led to incomplete balance sheets. The traditional requirement that the value of the asset be “reliably measurable” would be removed so that, going forward, balance sheets could provide a more complete account of the economic resources available to a company. The IASB then gave a list of some economic resources that might qualify for the balance sheet, including expertise, customer lists, supplier relationships, and an existing workforce. The following summarizes a litany of alternative methods that have been explored as a means of quantifying the HC of an enterprise:



**HISTORICAL COSTS:** is a measure of value used in accounting in which the value of an asset on the balance sheet is recorded at its original cost when acquired by the company.

**REPLACEMENT COST METHOD:** Under this method, the replacement cost of existing personnel is estimated. Replacement cost includes the cost of recruitment, training, and opportunity cost for the intervening period. The difficulty in this method is that the value differs from person to person, making it difficult to find identical replacement of the present human assets.

**ECONOMIC VALUE METHOD:** Under this method, human asset is valued based on the contribution they are likely to make to the organization until their retirement. The payments made to them in the form of pay, allowances, benefits, etc., are estimated and then discounted appropriately to arrive at the present economic value of the individuals.

**EXPECTED REALIZABLE VALUE:** The elements of expected realizable value of employee are measured through behavioral measures. For

example, the productivity of an employee can be measured by using objective indices and managerial assessment. Psychometric tests and subjective evaluations can be used to measure the promotability and transferability of employees. Similarly, attitude surveys can be used to measure employee satisfaction and motivation.

**DISCOUNTED NET PRESENT VALUE OF FUTURE EARNINGS:** This method is based on three variables— casual, intermediate, and output. The effectiveness of HC can be measured by using these three variables.

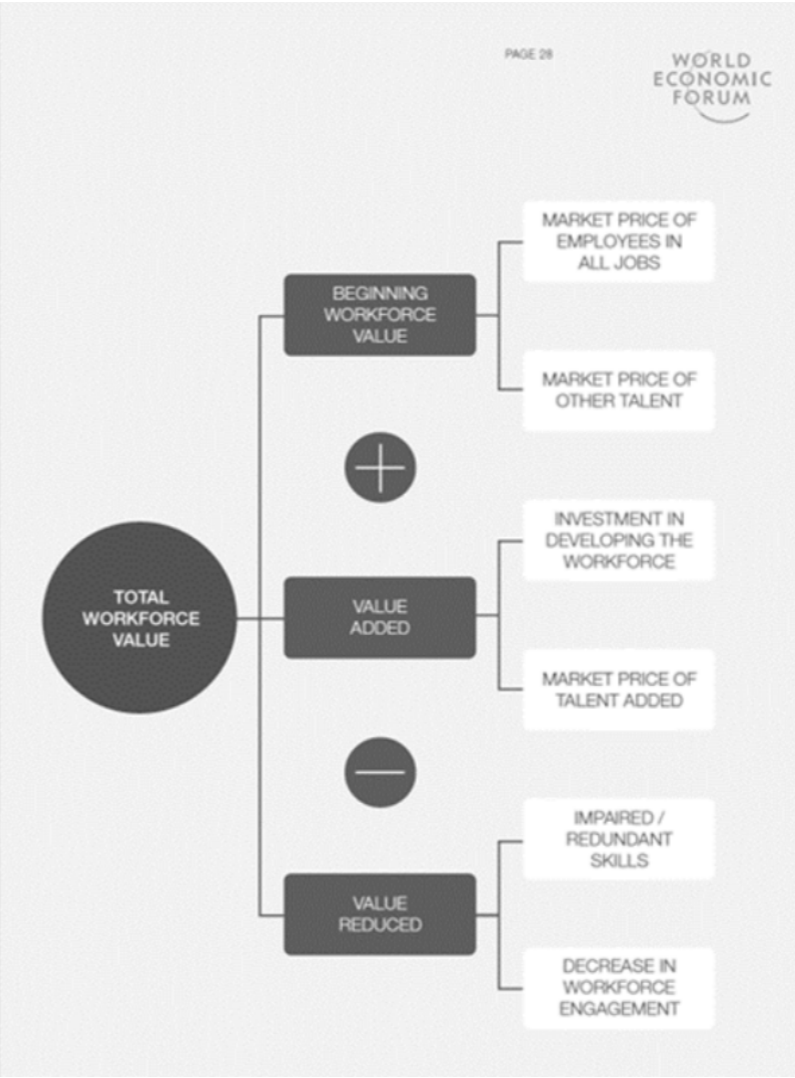
Casual variables such as leadership style and behavior affect intermediate variables such as morale and motivation, which in turn affect output variables such as sales and profit.

**STANDARD COST METHOD:** This method is an improvement from replacement cost method. Under this method, the standard costs of recruitment, training, and development are developed and established every year to overcome complications in calculations.

**PRESENT VALUE METHOD:** Under this method, the net contributions of employees to the earnings of the organization are discounted to include present value of human resources.

**ASSET MULTIPLIER METHOD:** This method assumes that there is no direct relationship between cost incurred on an employee and his value for the enterprise. This is because the value of an employee depends on factors like motivation, working conditions, and their attitude toward work and organization. In this method, all employees working in an organization are broadly classified into four categories: top management, middle management, supervisory management, and operative and clerical staff. The salary bill of each category is multiplied with appropriate multiplier to ascertain the total value of each category for the organization at a given point of time. Here, multiplier is an instrument that relates the personal worth of employees with the total asset values of the organization.

**CURRENT PURCHASE POWER METHOD:** In this method, the historical costs are converted into current purchasing power of money with the help of index numbers.



FROM THE US



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**OPPORTUNITY COST METHOD:** Under this method, the value of human asset is determined in their alternative use or the next best alternative use. This value forms the basis for valuation of human asset of organization.

acceptability to be recorded on the balance sheet as an asset.

Our recommendation that the derived value of the human capital should not be placed on the balance sheet as a line item. The quantification of the human capital is too subjective, and the nebulous assumptions would dilute the results

The following table subjectively analyzes the strengths (+) and weakness (-) of each method.

Method	Degree of Subjectivity	Accounts for Team (1+1 >2)	Future Benefit Stream	Ease of Implementation & Reporting	Verifiability
Replacement Cost		-	-		
Economic Value	-	-	+	<b>Limited</b>	-
Asset Multiplier	+	+	<b>Some</b>	-	+
Economic Value					
Present Value	-	+	+	-	-
Expected Realizable Value	-	-	<b>Some</b>	-	-
Current Purchase Power	+	<b>Some</b>	<b>Limited</b>	+	+
Discounted Net Present Value of Future Earnings	-	-	+	-	-
Standard Cost					
Opportunity Costs	+	-	-	-	-

**RECOMMENDED SOLUTIONS**  
**THE VALUE OF HC AS A DISCLOSURE IN THE BALANCE SHEET**

The value of human capital is a critical component of the overall enterprise valuation. Accordingly, the determination of this human capital subset may be required for a host of reasons. Overall, the value of the human capital is “baked into” the value of the overall enterprise. The more complicated scenario is when the valuator is required to value the specific asset – human capital – as a stand-alone asset. An option for this specific valuation is outlined below.

The Conceptual Framework from the IASB provides the theory behind accounting rules; however, it has not formalized a consistent, verifiable, practical method that is rallied as the “solution” for the measurement of human capital – at least not to the degree of

generated. Rather, the human capital value should be placed in the financial statements as a note disclosure. At a minimum, this disclosure should include the number of employees, average duration of employment, total costs of each employee for the past 3 years, a set of schedules illustrating on how management has opted to quantify the human capital, and the underlying assumptions.

With the aforementioned approach, the balance sheet has become less subjective – however, within the body of the financial footnotes, the value of the human capital can be outlined, providing the reader with essential information. Recall that the notes accompanying the financial statements are an integral component of the financial statements, so that investors and other stakeholders have a more accurate picture of the true value created by the enterprise. For valuing the human capital as a



component of the enterprise, this approach is the most practical, realistic, and implementable solution.

**ENGAGEMENT TO DETERMINE THE VALUE OF HUMAN CAPITAL**

Our recommendation for such an engagement in which one must determine the value of the HC as a stand-alone asset is as follows:

- i. Determine the overall value of the enterprise as a whole
- ii. Value all the tangible assets and adjust for the liabilities/obligations
- iii. The result i. less ii. would be the total intangible assets
- iv. Identify those intangible assets that have a “quantified value” (e.g. patterns, brand, copyrights, etc.)

**MEASURING HUMAN CAPITAL**

- v. The remaining value is the set of intangible assets that are not assigned a quantified value
- vi. For the remaining assets in Step v., allocate a percentage of the value based upon the enterprise and its characteristics.

This is an indirect means of deriving the HC, but it has more of the characteristics of valuation methodology than many of the methods summarized above. Human Capital is a major asset for virtually

all enterprises. It needs to be measured and properly recorded in the financial statements of the enterprise. The challenge is finding a practical solution that is consistent with the accounting methodologies (either GAAP or IFAS) and the measurement of other assets. Extrapolating future benefits on such a “soft asset” needs to be verified, replicable, relatively consistent with accounting principles, requires a degree of objectivity, auditability, acceptable to all audiences, meaningful between life cycle of the enterprise, and addresses the nuances between the industries is a complex set of prerequisites. For these very stated reasons, there is simply not a viable methodology that would add meaning to the financial statements if human capital were placed within statements itself. Rather, the human capital value should be placed in the financial statements as a note disclosure. ■

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