(a) Discuss whether “human capital” is an asset of a business or an expense. Use the definitions and the recognition criteria of assets and expenses according to SAC 4, to show which of these elements “human capital” could be classified under. Provide examples to support your discussion.

The increased importance of “human capital” in the business world is undeniable. With more and more companies recognizing “human capital” as part of their intangible assets to gain higher market value. It only seems logical to better understand the definition of the term.

So what is “human capital”? Can a value be put on humans? If so, can this value be measured and included in the balance sheet of a company? Is this recognized as an asset, or is it otherwise an expense? Are there expenditures on “human capital?” If so, do we debit the asset account or the expense account?

To better equip us in the search, the Statement of Accounting Concepts SAC 4, ‘Definition and Recognition of the Elements of Financial Statements’, provides the essential information regarding the characteristics of Assets and Expenses.

The definition of assets identifies three essential characteristics.

- First, there must be a future economic benefit.
- Second, the entity must have control over the future economic benefits such that it is able to enjoy the benefits and deny or regulate the access of others to the benefits.

- Third, the transaction or the event, giving rise to the entity's control over the future economic benefits must have occurred.

Firstly the future economic benefits flowing from "human capital" may include increased revenue from sales of products or services, cost savings or other benefits resulting from the use of humans by their entity. For example, an experienced member of staff with market knowledge can make crucial decisions which may reduce future production costs rather than increase future revenues, as this is still an economic benefit to the business.

Control over "human capital" can come in the form of a legal duty on employees to maintain confidentiality. This is done by the entity to protect the knowledge and information derived from employees which has provided them with benefits.
The training of staff to provide benefits is usually uncontrollable as they may not aid the business in any way. This can be an uncontrollable event in the use of human capital, but for this reason, the company needs to be protected by legal rights. As they can use it to issue and obtain the future economic benefits expected from employees.

Was the "human capital" a result of a past transaction? Yes, there may have been a contract negotiated, or some other types of legal negotiations.
As "human capital" has qualified as an asset, it can now be tested to see whether it is recognized as one under these regulations:

- It is probable that the service potential or future economic benefits embodied in the asset will eventuate.

  - Probable is now generally recognized as a greater than 50% chance of the event occurring. As a result, it can be assumed that the training and knowledge of the employee would be at a greater then 50% capability of contributing any type of economic benefit to the business.

- The asset possesses a cost or other value that can be measured reliably.

  -The "human capital" is providing economic benefits and the price the entity will pay usually is the expectations of their future economic benefits. This price would take in for granted any directly acquired attributable costs. Such as, professional fees in training the employee up to its working condition.

Human capital has been proven to be eligible to be classified as an asset. However, there is an expenditure on "human capital which makes it eligible of being an expense.

The definition of an expense identifies three essential characteristics

- First, they are flows
- Second, they take the form of decreases in assets or increases in liabilities
- Third, they result in a decrease in equity.

"Human capital" is an expense of losses of future economic benefits in the case of labour services consumed by the business, in which the expense comes from paying the employee.

Employee's wages need to be paid, thus the cash that needs to be taken out is a result of a decrease in assets, and therefore it satisfies the second criteria.

As a result of expenses from payment of wages, they decrease assets, therefore decreasing equity, thus the third criteria is met.

The recognition criteria for expenses are the same as for assets. "Human capital" can likely occur as an expense such as wages that must be paid. And it can also be reliably measured against the employee's salary as to how much expenses will be incurred in a period.

As "human capital" can be seen to be recognized for both an expense and an asset. It is left up to the entity to debate whether which transaction they would rather use. However it is argued that choosing them as being assets is a risky operation. Like in the case of One Tel Ltd. In 1999, they chose the asset approach to recognizing "human capital" and it proved costly.

(b) Comment on Alan Salter's statement: "It's not a cash cost" it's a lower quality, inferior service to customers, lower levels of motivation and less work being done." Are these non-cash costs included directly as expenses in the financial statements?

Mr. Salter's view on downsizing is that he feels the cut will result in a loss of knowledge, motivation and productivity. The downsize will result in a sudden increase in profits, but as a result it will indirectly affect the company's status. By cutting staff it might mean they are cutting their sales. Employees of experience which once drew in customers and more importantly sales are now replaced by inexperienced and cheaper ones.

The staff could end up losing motivation by the cut, or in contrast it could eventuate in new unwanted pressures. As Mr. Salter commented, "its not a cash cost" but rather a psychological cost deriving from the employees with which the entity will be made to endure the expense. Although it is seen as an expense to the company, it does not pass the definition of an expense from which flows in actual decreases or increases can be accurately measured. Therefore, it cannot be included directly in the financial statements as a non-cash cost, but indirectly the entity can still measure the cost in the loss in sales leading to a drop in profit.