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HUMAN ASSET ACCOUNTING AND CORPORATE PROFITABILITY EVALUATION: THE NIGERIAN EXPERIENCE

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ABSTRACT

Management skepticism has been identified as the major cause of delay in the development of human resources in organizations. Though management is aware of the numerous benefits associated with human resources accounting (*HRA*), there seems to be a number of obstacles to their acceptance. The most important are that firstly, human resource accounting has to some managers seemed a hastily constructed discipline made up of recycled spare parts from other disciplines. The effects are not always pleasing and often the parts have to function satisfactorily in the original habitat. Harmony between these borrowed components is not always easy to achieve. The concept of return on investment is an enduring topic of debate with the field of finance, the paper therefore examined how *HRA* impact on corporate profitability evaluation. It also discusses the moderating influence of organisational size, technology and age on studies of *HRA*.

NATURE OF *HRA* IMPERATIVES

The reporting aspect of human resources is feared by management (account that it causes competition sensitive information to end up public domain, it leave room for information manipulation, it creates liability risks by presenting future oriented information which can't substantiated, it increases operating costs as a result of new rule bureaucracy (Seetharaman, *et al* 2002).

Skepticism for not valuing and showing human resources is because human capital values are very subjective, and unlike tangible assets it vanish overnight and thus fostering uncertainty among investor managers rather than helping them. Strassman (1998) noted that numerous attempts to measure or value intellectual capital over the last two decades, has run into the difficult problem of pricing such assets. This practice taught practitioners that the value of intellectual property is in its use, its costs. He stressed that, it is widely known that the costs of acquire knowledge and the profit generating potentials of such knowledge.

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unrelated. He concluded that this is the reason **why** attempts to include intellectual capital on the balance sheet **have** failed.

Findings from recent research **also** reveal that there seems to be more problems in capitalizing intellectual assets in the financial statements than expected. **If** intellectual assets **are** capitalized at **cost**, problems that **would** be encountered include uncertainty surrounding the possibilities to realize such assets: it **would** not be a good indication of such assets economic **value**. **Also**, knowledge is **not subject to diminution in** value, **unlike** tangible assets. **If on the other hand**, intellectual assets **are** capitalized based on economic value (future discounted cash flow), then, another set of problems **would** emerge. First is the selectiveness of the cash flow projection, which is strongly dependent on changes in interest rates, inflation or future **outlook**. Second, intellectual assets cannot be valued outside the value of **the client**. Finally, it is difficult to break down the total economic value of intellectual assets into individual intellectual assets. Seetharaman *et al* (2002) stressed that standards for measuring and reporting intellectual capital is still in its infancy, confused and unstructured, which is normal for new discipline. The problem is that today's intellectual capital management is fraught with difficulties **as** it tries to address the **issue** of **management** excellence, which is very complex, rather than focusing on intellectual capital measurement alone.

RECENT DEVELOPMENTS IN *HRA*

The intended interest in *HRA* began in earnest in the 1990s as a result of the findings on the possible cause of difference between market prices and the book prices of companies (Gebauer, 2003). Some theoretical and practical methods have been formulated and tested for human capital measurements and reporting. The new approaches try to take the problems associated with previously held notion - that human resources can not be properly accounted for in **an** organization. As it is difficult to **measure** and report **its** cost and values in the balance sheet.

As Roselender **and** Fincham (2003) observed – if it has been possible to identify some simple means of extending the established accounting calculus to incorporate intellectual capital, the (on-going) debate about accounting for intangible assets **would have** already provided clear indications on how to proceed. **It had** not, which meant that the accountancy profession was not well placed to deliver reliable information of the sort many stakeholders, might not unreasonably, expect of it. Despite this skepticism, a lot of interest in accounting for human resources in organization has increased the desire to develop reliable methods of measuring and reporting on human resources in organizations in recent times. In Edvinson (1997) the dilemma facing the accounting profession was clearly identified. The different **values** ascribed to human capital such as balance sheet value, market value and acquisition value make the

valuation methods mushrooming (Seetharaman *et al.* 2002). Underpinning the Skandia value scheme for **example** is the desire to dissolve the intellectual capital designation, thereby identifying a portfolio of elements that accountants value incrementally, hopefully building up to the difference between the organizations' **market and financial capital valuations**.

Currently, practical methods **have** been developed to measure intellectual capital. These methods range from the narrow to the broad, specific to the general. For **example**, Perrin (2000) reports that there are companies using discounted cash flow to measure intellectual capital and there are others using brand value to measure total intellectual capital. There is also a reported finding from a research carried out by Leadbeater and James in the UK which revealed that methods used to measure intellectual capital **depends** on **which** user group the report is for. The report also shows that for internal **users such** as managers who would like to have more information which allows intellectual capital to be managed more effectively (Leadbeater, 1999). **As** a result, a new range of performance measurement and internal corporate reporting which attempts to link financial performance such as cash flow to **intangible** drivers such as employee quality and morale, customer satisfaction, and so on, are already being experimented on by companies. **Examples** of such measures, which are already applied by companies in the UK to measure intellectual capital, include Economic Value Added (*EVA*), European Foundation for Quality Management Model (*EFQM*), which is used by some of the UK's largest companies among them, British Telecom, Balanced Scorecard (*BSC*) **which** is estimated by its founder Robert Kaplan and David Norton to be used by hundreds of US companies as well as by large UK based groups, especially in the financial sector such as Nat West Group and Halifax. Ethical and Social Auditing which has been used by the UK John Lewis retail chain, Camelot and UK National Lottery Operator and Unipart the car components environmental auditing adopted by both Shell and BP-Amoco and other large **companies** in environmental sensitive industries **such** as oil and chemical to report on their environmental performance (Seetharaman *et al.* 2002).

The concepts of human resources accounting are taken **up** in the Anglo-American and Scandinavian areas. Newer approaches concerning the improvement of information supply by annual reports are publicized under the designation of, but not limited to human resources accounting (Gebauer, 2003). These approaches are not only focus on human assets, but also on other values that are not included in the total assets of the balance sheet, such as the customer capital or a brand name. These approaches are termed intangible assets or intellectual capital (Bontis, 2003; Lev, 2001).

The report of the committee on accounting for human resources (1973), identify 5 main groups on which a complete research program on human resource valuation could be based, to include: (1) to develop a

theory of human resource value that explains the nature of determinants of the value of people to formal organizations: (2) to develop concepts, models and techniques for measuring the value of people in both monetary and non-monetary terms: (3) to test the empirical validity and reliability of possible principal and surrogate human resource valuation methods: (4) to test the feasibility of operationalizing human resource valuation methods in organizations and to determine the conditions under which different methods are appropriate, and (5) to study the effects of the human resource accounting paradigm and methods upon attitudes and behaviour (decisions) in actual organizations. It could be seen from the above review that most research in recent times on *HRA* focused on the problem of accounting for human resource value unlike the early work in human resource accounting that used to focus on problems of accounting for investments in people (Lev and Schwartz, 1971).

CORPORATE PROFITABILITY EVALUATION

Evaluation of profit in organisation has been influenced largely by different interpretations given to the term profit. An economist for instance views profit as the reward for entrepreneurship for risk taking. A labour leader views it as a measure of how efficiently labour has produced and that it provides a base for negotiating a wage increase. An investor views it as a gauge of the return on his money. An internal revenue agent regards it as the basis for determining income taxes. The accountant regards it as the excess of a firm's revenue over the expense of producing revenue in a given fiscal period (Lynch, 1967). Many companies adopted profit maximization objective as a primary goal of the firm. This view is taken partly because profit is regarded as the commonest measure of performance in productive organizations (Soyode, 1975).

In economic theory, profit maximization is the established objective of a firm operating in a perfect market. This is achieved by a firm producing at the output level where marginal revenue equals marginal cost ($MR = MC$). This ensures that investments are maximized and that only profitable investments are embarked upon. This will lead to efficiency in resource allocation. Though a company may pursue the profit motive, it is arguable that achieving this objective alone guarantees the satisfaction of all constituents' interest and corporate survival. Van Horne (1986) argued that a company driven exclusively by the profit motive may, in an attempt to maximize profit embark on high risk project. High risk projects have the potential for high returns but at the same time put at jeopardy the interest of the owners, especially fixed interest owner who do not often bargain for such level of risk. He stressed that profit maximization can at best be a short run objective. This implies that the firm pursues only those decisions that will lead to immediate profit and not those that will enhance the future

earning potential, It assumes **that** a firm is evaluated on the basis of current earnings alone to the exclusion of future earning stream.

Profit is required because a **company** must earn it to meet the need of the following constituencies: (1) shareholders - who expect a return on their investment which must be commensurate with the alternative **investment opportunities**, the **risk** involved and the growth in **the value of** their shareholding; (2) employees whose security may depend on the continued **existence of the** company and whose **level** of earnings may also depend on its prosperity measured by the level of profit made; (3) the community - since industry and **commerce have a** responsibility to the community in which they operate, this responsibility also extends to environmental aspects such as the prevention of pollution and the provision and supply of local amenities. It is only enhanced profit by an organization that can ensure the performance of this responsibility; (4) government through contribution of **taxes** to the national fund towards social services, defence and public investment; and (5) the company - in form of reserves for future investment.

Despite its **lofty** advantages, profit maximization as an **objective** pursued by a firm is viewed as a narrow and inadequate goal to pursue. The main criticism of this objective is that it assumes away many of the complexities of the real world (Van-Home, 1986) **for** instance, it does not **take** into consideration the risks involved in profit attainment. It assumes away timing differences of returns. The problem of **lack** of consensus on the reality of and nature of profit among accountants impact negatively **on** the reliance of profit maximization as an objective of the firm. Lynch (1967) argued that current development in accountancy principles and **concepts** is that the stated profit figures are at best only estimates in any situation. The following examples attest to the fact: (a) provision for depreciation or amortization of fixed asset; (b) valuation of **finished** goods and work in progress; (c) credit taken for profit on partly completed long-term contracts; (d) the matching of expenses with income especially where there is an element of deferred **revenue** expenditure; (e) adjustment for **changes** in the value of money; (f) the treatment of exceptional gains or losses (including unrealized losses) whether of a capital or revenue nature. In all but the simplest of businesses, the profit is an approximation figure which is very much dependent on the convention applied. The economic profit which is given as revenue less expenditure will not treat (a) - (f) as expenditure.

A distinction is usually made between profit and profitability this distinction if appreciated could assist in settling the controversy. Solomon (1963) posits that it is useful to distinguish between profits and profitability. The first is an owner-oriented concept the second is an operational concept concerned only with the production or creation of new wealth. In this more restricted sense, the potential profitability of different

courses of action provides the criterion for economizing the use of the social resources and profit maximization is simply the quest for economic efficiency. Maximization of profit is what gives rise to most of the present controversy and to much of the dissent that has been expressed.

Profitability is also viewed as the company's ability to generate earnings (Edmonds & 1111. 2000), the profit criterion could best be used as a measure of the performance of the organizations. Lynch (1967) argued that the profit criterion ensures not only a constant effort at reducing costs, but also provides the proper incentives to management to become enterprising and makes for continued efficiency.

MEASURES OF CORPORATE PROFITABILITY

Corporate profitability is often evaluated by the use of profitability ratios. These ratios are used to assess the economic condition of a firm. Profitability ratios assist in measuring the returns of a firm in relation to either sales, assets or shareholders equity and are usually given in percentages. Profitability ratios include: Gross Profit Margin, Net Profit Margin, Return on Investment and return on owners' equity (Ikoku, 1993).

Net Profit Margin

The net profit margin measures the return per unit of sales and indicates managements' efficiency in manufacturing, administering and selling its products. Net profit margin is expressed as net profit divided by sales. If the net profit margin is relatively low it may imply management's inability to manage its activities efficiently. A high ratio is more desirable.

Return on Investment (ROI)

Return on investment measures the efficiency with which a firm has utilized the total funds provided by the creditors and owners of the firm in generating profit. Here total capital or funds employed could be measured by total assets. Therefore the ratio is expressed as net profit divided by total assets. This is because the higher the ROI, the better for all capital suppliers.

Return on Owners Equity (ROE)

Return on owners equity relates return to owners capital, and it is one of the important measures in financial analysis. It indicates how efficiently a firm has used the resources of the shareholders. The ratio is computed by dividing net profit by shareholders' equity. A low ratio may imply management is not satisfying its function and main objective of maximizing the owners wealth. A high ratio is most desirable.

A close look at the three measures of corporate profitability shows that corporate profitability can be calculated in several ways. In each case a

measure of profits (or capital income) is in the numerator and the denominator varies: Dividing by sales generates profit margins dividing by shareholders equity produce return on equity. while dividing by total capital produces return on capital, Fox News Video (2004) emphasized that return on capital is the measure emphasized for several reasons, some of which are: (a) From an investors viewpoint, what matters most is how much earnings are being generated relative to invested funds -- either total capital or equity. Margins may be useful for competitive and cyclical perspective, but what investors care about is how productive their assets are (2) While an equity holder will want to know return on equity, the ability to generate return on total capital financed by both equity and debt provides the starting point (3) Changes in inflation and accounting rules have periodically distorted conventional measures.

To distinguish between return on investment and return on equity it is essential to note the following observations as espoused by Lynch (1967). The assets available to management typically derive from three sources: creditors, owners (direct investment) and retained earnings. The last two sources reflect claims by owners on the assets of the business. Capital from borrowers ordinarily is repaid with a return calculated at a contractual rate in the form of interest. Management used the assets from all sources to carry on the operations of the business; a borrowed fund buys as much as one belonging to the owners. Management must first maximize its return from its operations on all the assets used before the residual return to shareholders can be maximized. Hence, management has come to recognize that the relationship of profit from operations to the total assets used is an extremely important gauge of effectiveness of its performance in the pursuit of the ultimate economic goals.

Performance can be measured by the ability to increase the ratio of the assets returned to the amount of assets used. This measure is variously and commonly referred to as the return on investment (ROI), Return on Asset used (ROA), Return on Capital Employed (ROCE), Return on Net Assets (RONA).

Return on investment depicts the effectiveness of all the operative decisions, from the routine to the critical made by management at all levels of the organization from shop foremen to the managing director (Lynch 1967). On the other hand, return on equity concentrates on the returns due to equity shareholders only. It excludes debt capital since preferred stockholders receive a fixed return. Using ROI, the company's financial performance is assessed from the perspective of its total financial base -- liabilities plus equity or simply total assets (Wild, et al (2001)).

SOME MODERATING FACTORS IN IIRA STUDIES

A relationship is often governed by at least two variables. One must be independent variable (IV) and the other a dependent variable (DV). It is normally hypothesized that in some way the independent variable causes the dependent variable to occur. In a research a simple one-on-one relationship needs to be conditioned or revised to take other variables into account. Often one uses another type of explanatory variables of value - the moderating variable (MV). A moderating variable (or mediator variable) is the variable that has a strong contingent effect on the dependent - independent variables relationship (Ahiazu 2006). A moderating variable is a second independent variable that is included because it is believed to have a significant contributory or contingent effect on the originally stated independent variable - dependent variable relationship. Cooper and Schindler. (2001) argued that, for a given variable to be treated as all independent or as a moderating variable depends on the hypothesis. In this study, the effect of three sets of moderating (or contextual) variables are considered. These are Size, Technology and Age on our original stated independent - dependent variables of human assets accounting treatments and corporate profitability evaluation respectively,

Organization Size

Organizational size is viewed in this study as the magnitude of extent of an organization. Organizations are often referred to in dimensions such as small, medium and large. What constitutes an appropriate definition of each of these dimensions is ongoing; it is like opening a can of worms. Several definitions have been put forward by several authors. The differences in definition have been attributed to the different standpoints from which each writer approaches the issue. The management literature suggests that it is even more difficult to draw a line of divide between small and medium corporation. The small or medium is often done arbitrarily and requires value judgment (Nwakeze, 2005). It is this difficulty that gives rise to the current practice of lumping them as small and medium enterprises (SMEs).

The Companies and Allied Matters Act (CAMA), 1990 provides a definition of a company that qualifies as a small company. By section 351 of the law, a company qualifies as a small company in a year if for that year the following conditions are satisfied: (a) It is a private company having a share capital (b) the amount of its turnover for that year is not more than N2 Million or such amount as may be fixed by the commission. (c) its net asset value is not more than N1 Million or such amount as may be fixed by the commission; (d) more of its members is a government or a government corporation or agency or its nominee; and (e) The directors between them hold not less than 51 percent of its equity share capital.

At the 13th meeting of the National Council of Industries (NCI) in July 2001 the NCI offered the following definition (Nwakeze, 2005): (i) Cottage micro industry: Enterprise with total cost (including working

capital but excluding cost of land) of not more than N1.5 Million, with a labour size of not more than 10 workers. (ii) Small scale industry: enterprise with total cost (including working capital but excluding cost of land) above N1.5 Million but not more than N50 Million with a labour size of between 11 and 100 workers; (iii) the Medium Scale Industry: enterprise with total cost (including working capital but excluding cost of land) above N50 Million but not exceeding N200 Million with a labour size of between 100 and 300 workers (iv) large-Scale Industry: enterprise with total cost (including working capital but excluding cost of land) above N200 Million and a labour size of over 300 workers.

Technology

There appears to be a jungle of definitions of technology, The term technology refers to the sum total of knowledge we have of ways to do things. It includes invention. it includes techniques. and it includes the vast store of organized knowledge about everything from aerodynamic to zoology (Koontz *et al* 1980). The main influence of technology is on ways of doing things, on how we design. produce. distribute and sell goods as well as services.

Technology plays an important role in economic value measurement of human assets. Many draw backs of economic value measurements are removed through improved technology. For instance, the general problem of accurately forecasting future expectations or services potentials of assets can be properly handled by improved technology. A company that has acquired high technology in computer automation will readily adopt economic value accounting system recommended by Carper (2002). According to him, Stochastic rewards valuation mode created by Flarnholtz can be used to describe an example of human resource value accounting. All the hierarchy levels for each employee mentioned by Flarnholtz (1971) as stated in page 67 of our work can be effectively can be effectively implemented giving a condition of a high technological environment. Same can not be said of a corporate without such high technological advantage. Jaggi and Lau (1974) also justify the use of high technological advantage. They try to classify the employees in their group valuation model to different homogenous groups. With the use of a rank transition matrix, they showed typical promotions through an organization.

The suggestion by Carper (2002) on the need to include causal and intervening variables as supplement to all financial and production reports can only be possible in a corporation where adequate technology is available to handle them. The constructive treatments of human assets accounting rely greatly on adoption of new measurement for human resources accounting. These new measurements rely on improved technology to function effectively. Besides, there are various reports that

are expected at the end of the day. The more advanced a firm is in its technology, the better its chances of adopting these measurement methods.

Leadbeater and Damos investigation revealed the relevance of technology in human asset accounting treatments as they discovered that methods used to measure human assets depends on which user group the report was meant for (Lead beater, 1999). Larsen *et al* (2001) concluded that the introduction of automation of data handling as well as of mechanisms affect the productivity of an organization, the cost of products and the speed of production.

Systematic Software Engineering Ltd, one of 17 firms that participated in a large project over three years to develop a guideline for intellectual capital statements organized by the Danish Agency for trade and industry provides a new way of looking at technology (Larsen *et al*, 2001). According to them, technology used in human capital should be viewed as a three components indicator which companies of Effects, Qualifying activities and Resource. The effect part of technology refers to employee satisfaction with office premises number of hits on web site per day, bicycle index (percent of employees using a bicycle as their primary means of transportation to work). Qualifying activities involved investment in computer equipment, investment in premises and office equipment. Resources part include: PC/workstations per employee, number of servers in network M² office space. From this definition, technology required in human asset treatment is viewed from the perspective of the effects, the qualifying activities that will give the required effects and the resources required to attain the required effect.

Age of the Organization

Age of the organization is often viewed in terms of the effect on the employees. In other words, does employees' performance increase or decrease with age. Biographical characteristic of workers such as age is assessed based on the length of time the worker had actually spent in the organization. In other words the older the organization, the likely the experience of the work force.

The influence of the different treatments of human asset accounting is directly proportioned to the organization's age, Chen and Lin (2003) approach on human asset accounting treatment shows that wrong classification of human asset investment as expenses will mislead a firm to cut its human capital investments, such exercise will reduce the ability of the firm to survive and compete in the future. This is because, the older the firm, the higher the percentage of losses. On the other hand a firm that is able to undertake a right classification (where expenditures on employees (that contribute to the companies strategic goals are classified as investment), will be able to preserve investments on these classes of

personnel. The volume of such investment is definitely proportioned to the age of the organization.

Indirect investments in human capital (accommodating measures of human capital), which is considered investments rather than expenses (Chen and Lin 2003), will vary with the age of the organizations. The older organizations will have larger volume or higher value than younger organizations. Again, this depends on the type of human asset accounting treatment. The effect of employees turnover and replacements impacts greatly on the age of organizations based on the type of human assets accounting treatment applied. Companies that adopt constructive treatment would accumulate the cost of developing its personnel that contributes to the development of its goals: What Boxtall (1998) calls the inner core of the company. Such investment will definitely increase by age. If these investments deplete so fast through increased personnel turnover, the impact on the firm's ability to be more competitive in international markets will definitely be undermined. To avoid such a situation older corporations tend to protect their inner core personnel. When companies adopt **conventional human asset** accounting treatments the practice of writing off human asset development expenses on yearly basis preclude the firms to keep proper fact of actual expenditure on their inner core personnel. In period of distress, they mistakenly cut down on these set of personnel in order to reduce their cost of operations. With such treatment the age of the organisation may not make much difference in employees' development and turnover since expenditure profile on them are treated as expenses that must be written off at the end of the year.

Studies on age of the organisations have always been targeted on the age of the personnel in such organizations and their effect on variables such as job performances, absenteeism or productivity (Porter and Steers, 1973). Mobley *et al* (1979) argued that some of these researches have shown that employees productivity in organisation does not decline with age. In this study, age of the organization is considered in terms of the impact of the different human assets accounting treatments. We are interested in seeing if constructive **conventional** treatments of human asset can increase or decrease corporate profitability given the age of the organisation. Chen and Lin, (2003) study has shown that age of the organisation is directly proportional to the impact of constructive treatments of human assets accounting in organisations.

CONCLUSION AND IMPLICATIONS

Experts can perform virtual acrobatics with these tools and generate numerous results merely applying it differently or by varying certain assumptions. Good managers know this and may be skeptical when such techniques as return on investments are blindly applied to investments and people. The label human resources accounting unfortunately has an

exploitative connotation to some people. A resource is usually something that is to be used up, and accounting implies using a total that makes this exploitation process as efficient as possible. The measurement of people is decided out of fashion although the measurement of their performance is not.

It is difficult to change management's view of people from **being an expense** rather than a resource. Furthermore, the fact that people are different from most other resources (for instance they can not be owned) does not facilitate the re-training process. Capitalizing investments in people is not seen as setting up an asset in the books but as **a way** of spreading training and development costs over several financial periods.

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