

# Preface

Accounting is the language of business. *Human resource* (HR) management deals with the major asset of a business: the employee. Therefore, when dealing with employee issues, shouldn't HR professionals use the language of business? Shouldn't a connection exist between these important dimensions? Yet, as often noted by various people, HR management and accounting (finance also) come from different planets. This disconnect was discussed in an article published in the *WorldatWork* journal<sup>1</sup> a few years ago, "Finance Is from Mars, Human Resources Is from Venus," by Wade Lindenberger, CPA, and Kayoko Lindenberger, CBP, Employee Benefits Training and Solutions. But both of these planets are from the same solar system, and commonsense logic suggests that both should be connected by the same force field.<sup>2</sup>

So, why are they not connected? What are the main disconnects? What are the reasons for this disconnect? Why does the chasm exist? Why the gaps? What can be done to strengthen the links? What are the knowledge and skill gaps? What specific knowledge areas need to be addressed?

This book seeks to answer these questions, discussing in detail the specific connection points between accounting and finance and HR management.

Throughout this book, accounting and finance are combined into one discipline, although they are not necessarily the same. Simply stated, accounting people are record keepers, and finance people are the analyzers. However, both group's core foundations are the numbers of the organization. Both groups have to be proficient in the language of business: accounting. Accountants keep the records of the numbers and are responsible for reporting those numbers using

<sup>1</sup> WorldatWork is a premier association, globally, for compensation and benefits professionals.

<sup>2</sup> Lindenberger, W., and K. Lindenberger, "Finance Is from Mars, Human Resources Is from Venus," *Workspan, The Magazine of WorldatWork*, January 2009, pp. 41–44.

the guidelines and rules laid out for them by the rule-setting bodies (GAAP, IFRS, SEC, AICPA,<sup>3</sup> and others). Finance people are analysts and interpreters of the record. Therefore, a case can clearly be made that accountants and finance people are from the same planet, whereas HR professionals are from a different planet. The goal in this book is to bring these two force fields closer together by imparting to the HR community the finance and accounting skills needed (in a comprehensive manner) to talk the language of business. But why are these groups so far apart? After all, HR professionals also have to talk the language of business if they want to make strategic business decisions.

HR management as a function started off in the enlightened period of management, when employee productivity enhanced through improvement in morale, motivation, and commitment. During this period, work behavior started to be considered an important element in overall organizational success. The origins were in Western Electric via the Hawthorne studies. For the first time, studies showed that management had to pay attention to the welfare of employees if they were to achieve organizational success. From those early days, management got a new focus: employee relations. Management hired people to help them with employee welfare. These early employee welfare professionals were usually called employee relation specialists. *Specialist* here was a stretch. These early staffers were mostly administrators helping managers with the tasks associated with employee welfare. But, then workers started seeing that they could raise their bargaining power with their employers if they joined forces to form unions. Managers started seeing that they needed staffers to help them handle union-related issues, and thus came the advent of labor relation specialists.

Along with the growth in labor relation professionals, organizations during this period saw the growth of personnel administrators. Managers hired personnel administrators to assist them with employee management responsibilities. And so grew the functional

<sup>3</sup> GAAP (Generally Accepted Accounting Principles), IFRS (International Financial Reporting Standards), SEC (Securities and Exchange Commission), AICPA (American Institute of Certified Public Accountants).

specialties of personnel management: recruitment, wage and salary administration, policies and procedures, training and labor relations.

After Douglas McGregor's bestselling book *The Human Side of the Enterprise* started gaining traction, the personnel department was renamed to HR management. The idea was to bring in more consideration to the *human* side of an organization. Therefore, managers hired and sought the guidance of "people specialists": the HR professional.

HR people would be "people persons" (touch-feely or soft-skill experts). They would be guardians of the people side of the business. They would be advocates to management for the employee's view of things and simultaneously represent to employees the management view of things. But the HR functions would continue to be responsible for helping managers with the day-to-day employee management issues, such as recruiting, compensation, benefits, training, development, and employee relations.

The skills and knowledge HR professionals needed to have to do their jobs effectively remained uncertain, and still does. Senior managers decided that HR professionals mainly needed people skills or soft skills. However, what were really the required core competencies vital for the HR professional? The answer was not clear and remains unclear still today.

During the past 20 years, attempts have been made to define HR core competencies. David Ulrich's landmark book is a case in point, *Human Resource Champions*.<sup>4</sup> Over the past 50 years, whether you are an internal HR staff member or an outside HR consultant or even an HR professor, it can safely be said that there still remains uncertainty as to what knowledge, skill, and core competencies are needed for the HR professional. Also, we remain unsure as to whether HR management is indeed even a profession.

Let's look at what the criteria are for a particular occupation to be regarded as a profession. For a class of activities to be considered a

<sup>4</sup> Ulrich, D. *Human Resource Champions: The Next Agenda for Adding Value and Delivering Results*, Harvard Business School Press, 1997.

profession, the class jointly should have the following characteristics, among others:

- The public must recognize the occupation as a profession.
- There needs to be a central regulatory body.
- There needs to be a code of conduct.
- There has to be a careful management of knowledge.
- The activities the profession engages in should satisfy an essential societal need.
- There must be an official recognition of professional status by the government.
- There needs to be standards of competence.

From further analysis, consider these two intriguing characteristics:<sup>5</sup>

- “A profession is based on one or more undergirding disciplines from which it builds its own applied knowledge and skills.”
- “Preparation for and induction into the profession are provided through a protracted academic program, usually in a professional school on a college or university campus.” This should be accentuated with rigorous testing and examination. Based on these criteria, many organizational activities certainly cannot be considered a profession.

Over time, things have changed. Indeed, the times are still changing. Now organizations all over the world are in a period of turmoil. Some call it *creative destruction*. Pressures have increased to create efficiencies, to reduce expenses, to manage costs, to stay focused on business strategies, to improve financial performance. This is the era of the “lean mean fighting machine.” Intense global competition, scarcity of resources, dried-up funding sources—all represent real organizational success impediments. In most organizations, labor costs are typically the largest cost component.

<sup>5</sup> Adapted from a post written by R.J. Kizik, found at [www.adprima.com/profession.htm](http://www.adprima.com/profession.htm).

know the language of accounting and finance. Many organizations have efforts underway to develop the accounting and finance skills of HR professionals. In a January 2009 article in the *Workspan* magazine of the WorldatWork,<sup>7</sup> authors Wade Lindenberger, CPA, and Kayoko Lindenberger, CBP, talk about American Express Company's mandatory effort through a training program to develop the "financial acumen of our HR professionals."

But we think this knowledge gap is huge. WorldatWork in its credentialing education courses does have a course titled "Accounting and Finance for the Human Resource Professional." But this general course covers subjects in a broad manner without going into the specifics and details of the connections between HR management topics and accounting and finance. This book is designed to fill this gap.

The HR department has many functions, including recruitment, compensation and benefits, and training. Among them, compensation and benefits is the most technical, requiring hard skills. This is because this function involves dealing with numbers. The activities involved in compensation and benefits are therefore the most affected by accounting and finance implications.

Also compensation and benefit expenses are often the largest individual line item expense in any organizational setting.<sup>8</sup> Relevant data shows that total compensation expenses in organizations fall within 20% to 60% of gross revenue. In the service sector, this percentage is in the 50% to 60% range. If one considers salaries as a percentage of operating expense, the range can be from 15% to 50%. Data from the Bureau of Labor Statistics in 2008 suggests that in the healthcare industry the salaries to operating expenses ratio was as high as 52%. In for-profit service organizations, the ratio was 50%. In durable goods manufacturing, construction/mining, and oil/gas, the ratio was 22%. And in the retail sector, the salaries to operating expenses ratio was as low as 18%.

<sup>7</sup> Lindenberger, W., and K. Lindenberger, "Finance Is from Mars, Human Resources Is from Venus," *Workspan: The Magazine of WorldatWork*, January 2009, pp. 41-44.

<sup>8</sup> In fact, in the national economy, wages represent nearly three quarters of total costs.

Compensation and benefits is the largest expense item for any organization. Therefore, there is a need to clearly understand and articulate the links between compensation and benefits and accounting (finance). It also suggests a need for a closer alignment of accounting (finance) with the activities of compensation and benefits.

Note, as well, that many financial problems can be explained by compensation systems or by the specifics of the tax code. When one cannot explain a firm's behavior with economic logic, the real answer may often lie in compensation systems. We will explore these connections in more detail throughout the book.

This book's main objective is to fully examine the connection between compensation and benefits and accounting (finance). This book explores various aspects of accounting and finance as they relate to compensation and benefit analysis.

HR-related accounting and finance implications are usually captured in accounting and finance texts in an unconnected manner. In contrast, this book brings into focus in one single publication all of these compensation and benefit and accounting (finance) topics, discussing the major compensation and benefit subfunctions one by one. Within each subtopic, you learn the relevant accounting and finance implications.

Throughout this book, the compensation and benefit topics that have major accounting (finance) implications are discussed. Each chapter deals with a specific compensation and benefit topic, with no particular connective flow between the chapters. A lot of topics covered came from the author's college lectures teaching accounting and finance and from compensation and benefit courses.

In recent years, there has been a transformation from independent applications of various compensation and benefits elements. Now organizations focus on the total compensation system to manage total compensation costs and to educate employees on the true costs of their total compensation package. A new term has been used recently: *total rewards*. Total rewards nomenclature is just a different way of referring to total compensation. Keeping this total compensation focus in mind, this book covers the major elements and program costs wherever necessary.

Before going into the detailed analytical connections between compensation and benefits and accounting (finance), it is important to understand the basics. So, defining terminology is an important first step. The basic framework for the connection that currently exists between the functions also needs to be understood. The first chapter lays the foundation before detailed analytical connections are explored.

When talking about compensation and benefits, you must consider that a total compensation program consists of various elements. Normally, a total compensation structure includes the following elements:

- Base
- Cash incentives or bonuses
- Equity compensation
- Cash-based long-term incentives
- Executive compensation
- Sales compensation
- Expatriate compensation
- Risk benefits
- Retirement benefits
- Perquisites
- Other Benefits

This book analyzes the accounting and finance implications for most of the elements of a total compensation structure. Note here that some of the compensation and benefit topics are more influenced by accounting and finance know-how than others. So, in this book, the topics that have more of an accounting and finance angle are covered in more detail. A good example of this is employee share plans and pension accounting; these topics are covered in longer chapters.

Part I of this book discusses terms and key concepts to lay a conceptual framework for the book.

- Chapter 1, "Introduction: Setting the Stage, covers the foundations of the total compensation system. Terms are defined,

concepts are explained, and connections to finance and accounting are established.

- Chapter 2, “Business, Financial, and Human Resource Planning,” presents the connection between business/financial planning and compensation and benefit planning. Assuming that compensation and benefit expenses are indeed the highest expense category of any organization, Chapter 2 emphasizes the importance and explains the connections between the two critical planning processes.
- Chapter 3, “Projecting Compensation Costs,” introduces a financial projection model for forecasting fixed compensation costs. Again, the fixed element or the base salary of the compensation package can be the highest cost element in any organization. So, this discussion recognizes its importance by explaining a detailed cost forecasting model and process.
- Chapter 4, “Incentive Compensation,” deals with one of the most important elements of the total compensation package: incentive compensation. In an era of limited resources and cost reduction, incentive compensation has become important. A concept called *pay at risk* is being discussed a lot. This concept suggests reducing the fixed or base component of the pay package below the market average and then increasing the incentive component. The goal being the total cash compensation (base plus incentive) will be targeted much above the average in the market. If the financial goals of the company are met or exceeded, the employee’s total compensation will be above the market averages. The financial and accounting dimensions of incentive compensation are explained. Some financially rigorous metrics to be used as the triggering mechanisms for incentive and compensation programs are introduced. These concepts are economic value added, free cash flow, and residual income.
- Chapter 5, “Share-Based Compensation Plans,” discusses all the accounting and finance issues for share-based compensation plans. This area of a total compensation system has many finance and accounting implications, and therefore the discussions in this chapter are quite extensive.



- Chapter 6, “International and Expatriate Compensation,” covers all the finance and accounting dimensions of international compensation programs. This chapter focuses especially on expatriate compensation, which has many finance and accounting nuances.
- Chapter 7, “Sales Compensation Accounting,” provides a detailed analysis of the various accounting and finance issues that impact the effective development, design, and administration of sales compensation programs. Sales commission plan administration accounting is covered. This chapter briefly looks at the software packages available for administering sales commission plans.
- Chapter 8, “Employee Benefit Accounting,” discusses the accounting and finance issues impacting employee benefit programs. The accounting standards framework for employee benefit plan accounting is also discussed.<sup>9</sup>
- Chapter 9, “Healthcare Benefits Cost Management,” covers employee healthcare benefits and costing. Because healthcare benefits cost is the compensation cost component with the highest inflation, this whole chapter is devoted to employee healthcare benefit cost containment. This topic is a hot-button issue in many contemporary debates and discussions.
- Chapter 10, “The Accounting and Financing of Retirement Plans,” covers retirement program financing and accounting in its entirety and discusses defined contribution and benefit plans in detail. This is another area of a total compensation system dominated by accounting and finance implications, so we devote a great deal of attention to thoroughly discussing all of these implications. After studying this chapter, you can appreciate all the finance and accounting nuances of defined benefit retirement programs

<sup>9</sup> Financial reporting standards under U.S. *Generally Accepted Accounting Principles* (GAPP) and the *International Financial Accounting Standards* (IFRS) are covered.

these standards into one is well on its way. With the advent of the global economy and preponderance of multinationals, the accounting profession realizes that it does not make sense to operate within a dual standard framework: U.S. GAAP + IFRS. Therefore, an effort is ongoing to converge the standards. A roadmap has been laid, and a transition plan has been implemented. Therefore, both these standards are discussed, when relevant, throughout this book.

Although this book is U.S. centric, it also has wide coverage of accounting and finance issues with implications for global HR management.

Finally, note that the tax accounting implications for global HR systems are discussed wherever appropriate in each chapter. If you want to learn more about relevant tax issues, refer to legal and tax publications.

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# Part I

We start this part of the book with some foundational concepts. First, we cover the basics within the total compensation structure. Second, we discuss the concept of planning and the need to connect total compensation planning with the strategic and operational planning of the organization. Third, we discuss base compensation cost forecasting, and we cover forecasting other total cost elements in specific chapters.

Part I of the book deals with topics that cover the entire total compensation structure. These include base, incentive, sales, international, and equity (share-based) compensation. We also cover topics within the total compensation structure that are commonly known as employee benefits, concentrating mainly on health and retirement plans.

Our focus is to cover the finance and accounting principles within each compensation element. The discussion for each topic stays within the framework of accounting principles and standards as established by the Generally Accepted Accounting Principles (GAAP) and International Accounting Financial Standards (IFRS).

We do not discuss the normal concepts and techniques of designing or developing the elements of the total compensation structure. The normal concepts and techniques are built around the following principles: internal and external equity, motivation theories, ability to pay, and competitive practices. This discussion is left up to other texts. The sole purpose of Part I of this book is to highlight and then discuss in detail the accounting and finance principles that are integral to all the elements of the total compensation structure.

# 1

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## Introduction: Setting the Stage

### **Aims and objectives of this chapter**

- Set the stage for the discussions in this book
- Discuss the concept of costs versus expenses
- Explain the concepts of OPEX and CAPEX
- Examine various compensation and benefit elements
- Discuss in detail the concept of base salary
- Discuss the treatment of compensation and benefit elements within current accounting systems and structures
- Discuss the current accounting for human resource cost outlays
- Explain the current payroll accounting process for hourly and salaried employees

This introductory chapter examines how finance and accounting principles apply to compensation and benefit program design. The discussion analyzes the current connections and proposes various connection enhancements. In this chapter, you also learn the terms commonly used with regard to compensation and benefits. The chapter also proposes modifications to the accounting process to accommodate a revised classification of compensation and benefit cost outlays and transactions. Thus, the chapter lays the foundation for the finance and accounting analysis of compensation and benefit transactions.

The words *cost* and *expense* are often used interchangeably. Are *human resource* (HR) outlays costs or expenses? What is the difference? Where in the accounting structure and system can one find HR expenditures? Are the current classifications within the accounting framework appropriate? What changes can one anticipate in the

current expense/cost classification resulting from the changes in how work is currently done and how it will be done in the future? These and other questions need to be answered before discussing the various specific techniques and analytical mechanisms within the finance and accounting structure that affects HR management (and specifically compensation and benefits).

In this chapter, after answering some critical questions posed here, the basic flow of compensation and benefits outlays,<sup>1</sup> as defined by HR departments, is traced through the accounting framework and structure.

## The Cost Versus Expense Conundrum

The words *cost* and *expense* are used interchangeably in accounting. But a cost incurred can be an asset or expense depending on the timing of accounting transactions and the concept of periodicity.

Especially in transactions like the acquisition of a physical asset, the cost classification can become an important decision. When a physical asset is acquired, many costs might be involved (for example, purchase price, freight costs, and installation costs). So, the accountant has to decide which cost to include as an asset and which costs to expense immediately. Those costs that are expensed immediately can be called revenue expenditures. And costs that are not expensed immediately but are included in asset accounts are referred to as capital expenditures. Some firms call these expenses *operating expenses* (OPEX) and *capital expenses* (CAPEX). You'll read more about these classifications later in this chapter.

An expense is, in actuality, a cost used up while producing the sales revenue for the business. In other words, expenses are those monetary outlays that flow through to the income statement. In contrast, costs that have not been used up remain a cost and are reported on the balance sheet as an asset. Expenses are those costs that are necessary to make sales within a specific period. A company can incur a

<sup>1</sup> This discussion uses the word *outlay* for HR monetary outflows because, as covered here, some questions exist as to the proper classification of these outflows within prevailing accounting definitions of the terms *cost* and *expense*.

cost and spend cash to pay rent in advance for a six-month period, for example. On the day this transaction is made, however, a debit entry is made to an asset account called Prepaid Rent. Only after a month is over and the premises have been occupied for that month does an expense transaction occur, and for that month only; five months of the cost incurred for prepaying the rent stays on the balance sheet as an asset.

Let's take another example. Suppose a restaurant is gearing up for a Christmas banquet for a big corporate event. The owners go out and buy nonperishable restaurant supplies such as napkins and so forth. The cost of this cash purchase is \$5000. Now let's suppose they use up 30% of these supplies for this big corporate banquet. In this case, \$1500 is classified as an expense for that period (the month and year when financial statements are prepared) and the remaining \$3500 will still be a cost but will be reported on the balance sheet as Restaurant Supplies (an asset). In this case, this cost—an outlay of cash—is both an asset and an expense.

Now, suppose that a business buys a piece of land to build a factory. The cost of that land never becomes an expense. That cost continues to be classified as an asset (because land is never depreciated).

If a hospital buys an MRI machine, any cash or credit purchase is first carried as an asset on the balance sheet. Then, after that, a periodic depreciation expense is recognized in the income statement. So, here again, the entire cost of that MRI machine is not an expense at the time of purchase. Instead, the expense is spread over the useful life of the MRI machine. As a matter of fact, the historical cost of acquiring the MRI machine is always shown on the balance sheet. Depreciation taken each period is recorded as a period expense and also recorded as a contra-asset in an account called accumulated depreciation.

Now consider manufacturing businesses: Cost outlays within a given period for direct materials, direct labor, and manufacturing overhead directly used in making products that were sold within that specific time period are considered expenses for that period and are termed *cost of goods sold*. Cost of goods sold flows into the income statement and is matched with revenue earned during that period. But direct materials, manufacturing overhead (which

includes indirect labor), and direct labor remaining in finished goods or in work in process are considered assets. Therefore, here again, not all costs are expenses. Some are assets (balance sheet), others are expenses (income statement). So, in current accounting practice, some employee monetary outlays are assets, some are expenses.

Furthermore, other transactions in a manufacturing company are considered selling, general, and administrative expenses for a specific period. Compensation outlays for the truck driver who delivers materials to the factory are considered expenses for a period. In contrast, electricity used in the factory might be either an asset or an expense depending on whether manufacturing overhead, including factory electricity, is assigned to products as cost of goods or as work in process inventory or finished goods inventory. But all electricity used in the administrative offices is considered an expense for a particular period.

Adding to the confusion, let's consider monetary outlays for research scientists. Suppose that a firm buys a laboratory machine for a research lab. The cost of this machine might be \$20,000, with an additional \$5,000 expense for installing the machine. As of the date the firm acquires this machine, the accounting system increases an asset account by debiting that account with the total purchase cost of the machine plus all costs necessary to make the machine ready to use. And then the accountant periodically records a debit entry to a depreciation expense account spread over the useful life of the machine, using an acceptable depreciation schedule. This expense is then reported in the income statement, matching it against the current period revenue.

If the same firm were to hire a research scientist during the same period, however, the costs that the firm incurred to hire that scientist—recruitment advertising, search fees (which can be quite large), interviewing costs, and other hiring costs—will all be currently expensed and reported in the income statement. This can lead to a distortion in income measurement because the research scientist's service will extend over more than one year. But currently, the accounting rules require that all the HR cost outlays be expensed during the current period.

Compensation-related outlays for these scientists are all considered expenses for the current period. In accounting systems, though,

the cost outlays for physical products (the machines the scientists use) are considered assets and are expensed only over a period of time (their useful life).

The issue of reporting intangibles also needs to be discussed in connection with the recording of HR outlays. Under current accounting standards, intellectual property that an employee brings and utilizes within the employment setting is not considered a recognizable asset. The current accounting system records as assets only certain other intangibles such as copyrights, patents, and trademarks. The irony is that the intangibles are the outputs of the employees with specifically valuable intellectual property.

In many cases, a big difference can exist in book value versus market value of the assets. For example, in a recent year Google had stockholder equity of \$22.7 billion, whereas its market value during the same period as determined by multiplying Google's market price of its shares by the number of outstanding shares was about \$179 billion. Such a wide difference undermines financial reporting. It can be assumed that most of this big difference results from nonrecognized intangibles. And one of the biggest intangibles is the value of Google's human assets. Part II of this book discusses this concept in greater detail.

So, one can safely say that confusion abounds within current accounting standards frameworks as to how and where HR monetary outlays are classified in accounting systems.

## CAPEX Versus OPEX

The expressions *capital expenses* and *operating expenses* are often used in accounting and finance. Cost or expenditure outlays can either be capitalized (spread out over a period of time) or taken into a specific time period's profit/loss—in other words, in the time period they were incurred (revenue and expense recognition). This is the difference between *capital expenditures* (CAPEX) and *operating expenditures* (OPEX).

With reference to these classifications, employee-related expenditures are classified differently by different groups. The HR-related cost or expenditures can be classified either as CAPEX or OPEX.



CAPEX remain capitalized (a balance sheet classification) until these transactions become expenses for a specific time period. HR accounting proponents suggest that for effective management reporting it might be better to aggregate these accounting entries into one account. If done, it gives business decision makers a more complete picture when making strategic and operational decisions affecting employees.

## The Current HR Cost-Classification Structure

Let's now examine the fundamental elements covered in this book. First, it is important that you understand the terminology commonly used in compensation and benefit analysis. After reviewing this terminology, the discussion turns to these terms within the context of the current accounting framework.<sup>2</sup>

### *Compensation and Benefit Elements*

The most commonly used terminology related to compensation and benefits within the organizations are as follows:

- **Base salary:** Base or basic or fixed pay describes the “fixed” part of pay. This pay element is mainly paid to employees to come to work (to attract employees). It is also paid to employees to do the assigned work by applying the required skills, knowledge, and abilities using normal effort and demonstrating necessary work behaviors. Basic pay is usually the largest component of the total pay package. In other words, basic pay is the amount of nonincentive wages or salaries paid over a period of time for work performed. It may include additional payments that are not directly related to the work effort.

Compensation professionals use the following methods to determine base pay levels:

<sup>2</sup> When the term *accounting framework* is used, it means here the accounting structures and framework as established under *Generally Accepted Accounting Principles* (GAAP) and the *International Financial Accounting Standards* (IFAS).

contingent payments paid to employees only when certain pre-determined financial or individual objectives are met.

- **Allowances:** Allowances are usually temporary adders to the basic pay. Housing allowance, transportation allowance, and education allowance are common. Allowances are widely used in various countries. Allowances are paid for special situations or conditions.
- **Pay adders:** Adders to base pay are common in the United States. Overtime pay, callback pay, on-call pay are examples of pay elements and are provided for work that is done beyond normal working hours. These adders are governed by wage and hour laws in most countries.
- **Risk benefits:** Risk benefits are payments made for medical, disability, and life (actually death) situations. The benefits in this category are provided to employees in lieu of direct cash payments to mitigate the various life risks for employees and their families.
- **Retirement benefits:** Retirement benefits are common compensation elements that organizations provide to assist employees with their post-employment lives. Retirement benefits can take the form of defined benefit or defined contribution plans.
- **Equity compensation:** Employee equity programs in the past had been mostly provided to senior executives to motivate them to increase shareholder value. This component of pay has seen sweeping accounting changes over the past ten years or so. There has been a growth of many different structures for these plans; nonqualified stock options, incentive stock options, restricted stock options, stock appreciation rights are a few. Accounting, tax, and legal implications are integral to the design, development, and administration of these programs. More recently, issues surrounding executive compensation excesses, earnings management, insider trading, ownership culture, stock option pricing and expensing, dilution effects, and overhang have all clouded this pay element with a lot of debate and discussion.
- **Perquisites:** Perquisites are elements of compensation that are normally paid to senior executives. The practice is widespread around the world. Most common are first-class travel,

executive jets, country club memberships, executive physicals, and financial planning. Perquisites can be direct cash payments or are compensation payments in the form of expense reimbursements for approved executive benefits.

- **Expatriate compensation:** Expatriate compensation is made to employees who are sent by companies to live and work abroad. Within this overall category, there can be many sub-categories of payments. Among them are cost-differential payments, housing differential payments, education allowance, tax protection or tax equalization payments, moving expense allowances and foreign-service premiums, and hardship and special area allowances. An expatriate assignment occurs when an employee is transferred to a foreign jurisdiction (different from the headquarters country or the employee's country of permanent domicile).

The appendix at the end of this chapter describes all the terms and words used in the field of total compensation. This will set the stage for a comprehensive analysis of the finance and accounting implications involved in compensation and benefit plan design.

## The Current Accounting for Compensation and Benefit Cost Elements

Now that you know the commonly used terms in compensation and benefits, let's explore how these compensation and benefits cost elements are reflected in accounting systems.

If an employee's job entails directly producing a product (as part of a manufacturing operation), accounting systems classify that employee as direct labor. Another common identifier for this grouping is touch labor. *Touch labor* refers to those people required to touch the product during the manufacturing process. Those employees who are involved in the manufacturing process but are involved in a supporting activity (such as the manufacturing manager or the janitor who cleans the factory floor) are included in manufacturing overhead. A commonly used term for this category is *indirect labor*.

In cost accounting, manufacturing overhead is absorbed into unit product costs through various mechanisms, such as job order costing and process costing. All the specific compensation elements are lumped together by the accounting process into two accounts, normally called direct labor or indirect labor. Both of these account categories become a part of the cost of goods sold cost.

For manufacturing companies, the gross profit is calculated by subtracting cost of goods sold from the revenue. In accounting, therefore, the employees directly involved in making a product contribute toward the achievement of the gross profit of an organization. And in manufacturing, companies' monetary outlays for those employees not involved in making the product are considered period expenses. Normally these expenses are part of the selling, general, and administrative expense account. The selling, general, and administrative expense and other indirect expenses are deducted from gross profit to derive the net income or loss.

Cost of goods sold in the service industry refers to the cost of the employees or machines directly involved in providing the service. Other items like electricity to run the machines and those employees who are not directly connected to providing the service are usually included as part of selling, general, and administrative expenses. This is an overhead or indirect expense. And as stated before, these expenses are deducted after the gross profit is calculated, to arrive at the net profit or income.

Let's look at an example for a construction company. In a construction company, the compensation paid to workers directly involved in construction activities is a part of cost of goods sold, whereas employees who support them (estimators, clerks, material handlers) are included in the selling, general, and administrative expenses.

Note that the actual practice of classifying employee expenses either in cost of goods sold or in overhead expenses can vary from company to company.

In a merchandising business, there are no raw materials, work in process, or finished goods accounts. There is only a merchandise inventory account. All purchases of goods bought for resale become a part of the merchandise inventory account. Only when a specific item sells is the acquisition cost of that item then transferred from

the merchandise inventory account to the cost of goods sold account. It is then subtracted from sales revenue to derive gross income or profit. In merchandising businesses, all employee expenses are classified into general expenses, which appear on the income statement after the calculation of gross profit or income.

In financial reporting, some employee costs are included in the asset section of the balance sheet. In addition, employee-related monetary transactions are often included in the balance sheet in a liability account called salary or wages payable. This suggests that some earned wages have not been paid to employees.

A case can be made that most HR cost outlays can be classified as assets. This argument might have some merit if you consider that the compensation paid to software engineers, scientists, electronic engineers, and development engineers is a CAPEX. A case can be made that these types of employees are indeed the true assets of a company, especially in high-technology and biotechnology firms. They have rare skills, and losing one of these critical skills might result in a decrease in the value of a business. But current accounting thinking does not concur with this line of thought. Current accounting standards state that expenditures should be included in financial statements only if they are clearly measurable in monetary terms and there is reliability and relevance. The accounting profession asserts that there are problems in determining relevant and reliable values for human assets. Accountants believe that human capital measurements are not up to par on reliability and accuracy. If accurate measurements are found, perhaps human capital values can be included in financial statements. But most likely, they would appear as footnote disclosures.

The point to note here is that the HR and payroll systems are identifying employee expense outlays differently from accounting systems. Accounting systems do not capture the true cost flows for the HR financial outlays.

Exhibit 1-1 summarizes all the compensation and benefit cost flows. In one place, it shows the accounting flows of all total compensation elements and also indicates the accounting classification most likely used to record these transactions.

**Exhibit 1-1** A Summary of the Flows

HR Classification	Accounting Classifications
Base pay	Direct labor, indirect labor, selling, general and administrative expenses ----- Could be an income statement expense Could be an asset on balance sheet
Benefits	Direct labor, indirect labor, selling, general and administrative expenses ----- Could be an income statement expense Could be an asset on balance sheet
Incentives	Direct labor, indirect labor, selling, general and administrative expenses ----- Could be an income statement expense Could be an asset on balance sheet
Allowances	Direct labor, indirect labor, selling, general and administrative expenses ----- Could be an income statement expense Could be an asset on balance sheet
Adders to base	Direct labor, indirect labor, selling, general and administrative expenses ----- Could be an income statement expense Could be an asset on the balance sheet
<b>Retirement Benefits</b>	
Define benefits	Pension expense on income statement Net pension liability or asset on balance sheet
Define contribution	Pension expense
Stock related	Stock option expense
Perquisites	Expense: selling, general, and administrative expense
Expatriate compensation	Selling, general, and administrative expense

case, 6 hours are over the 40-hour limit. Suppose John's hourly rate is \$25.20. In that case, his weekly gross pay is calculated in this manner:

$$40 \text{ hours @ } \$25.20 = \$1,008.00$$

$$6 \text{ hours @ } \$25.20 \times 1.5 \text{ or } \$37.80 = \$226.80$$

$$\text{Total gross earnings for the week} = \$1,234.80$$

In the United States, tax is withheld from the gross wage income (which for John Smith is calculated based on his documented deductions on his W-4 form and withholding tax publication—Circular E, provided by the Internal Revenue Service). After that, state income tax withholding is also deducted from gross pay. In addition, the payroll department must withhold Social Security taxes or FICA (*Federal Insurance Contribution Act*). This tax is actually two taxes. One tax is called the *Old-Age, Survivors, and Disability Insurance* (OASDI), and the other is known as Medicare (hospital insurance). The rates for OASDI and Medicare are, respectively, for 2012, 6.2%<sup>9</sup> and 1.45% of gross wages. In addition to these deductions, other deductions will be needed, such as the employee portion of an employee health insurance program (if there are any for the organization).

To further illustrate the gross earnings to net earnings calculation, now let's assume that for the second week, the March 26 to March 30 pay period, John worked 40 hours.

So, here is the gross to net calculation:

Week 1 gross (which includes 6 hours of overtime pay)	1,234.80
Week 2 gross (40 hours $\times$ \$25.20)	1,008.00
Total gross for the pay period	2,242.80
Deductions:	
Federal income tax (assumed numbers in this example)	215.74

<sup>9</sup> There is currently a "tax holiday" in place that relieves employees of this deduction.

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### Note

The federal withholding tax is derived after the employee completes and submits Form W-4, Employee's Withholding Allowance Certificate. This amount is based on marital status and the total number of dependant allowances claimed on the certificate. The amount of tax withheld is provided in the wage bracket table, published by the IRS in Circular E.

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State income tax	179.43
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### Note

The state income tax withholding is calculated in a similar manner using allowances provided on the W-4 form and by using state publications published for the purpose of calculating withholding taxes.

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OASDI tax (6.2% of gross pay)	139.05
Medicare tax (1.45% of gross pay)	32.52
Medical insurance copay (assumed number for this example)	54.00
Total deductions	620.74
Net pay	1,622.06

Other possible payroll deductions and adjustments include the following:

- City and county taxes, if any
- Before-tax employee contributions
- 401(k) employee contributions (disbursed to TPAs\*)
- Health savings account (disbursed to TPAs\*)
- Flexible spending accounts (disbursed to TPAs\*)



## ***Employer Payments***

Also note the potential employer payments made on behalf of an employee:

- *Federal Unemployment Tax (FUTA)*
- *State Unemployment Tax (SUTA)*
- Employer-matching contributions for 401(k) plans
- Workers' compensation premiums
- Employer portion of Social Security taxes paid on behalf of an employee

## ***Accounting Record Keeping***

In the accounting process, employee payment transactions are journalized, posted to the ledger, and recorded in the financial statements in the manner shown in Exhibit 1-4.

**Exhibit 1-4** Employee Payment Transactions

<b>Account Title Affected</b>	<b>Category</b>	<b>Account</b>	<b>Financial Statement</b>
Product or service expense	Expense	Debit	Income statement
Payroll tax expense	Expense	Debit	Income statement
Workers' compensation insurance expense	Expense	Debit	Income statement
FICA payable	Liability	Credit	Balance sheet
FICA Medicare payable	Liability	Credit	Balance sheet
FIT payable	Liability	Credit	Balance sheet
SIT payable	Liability	Credit	Balance sheet
FUTA payable	Liability	Credit	Balance sheet
SUTA payable	Liability	Credit	Balance sheet
Medical insurance payable	Liability	Credit	Balance sheet
Wages salaries payable	Liability	Credit	Balance sheet

This is not necessarily the case in manufacturing companies, where employee payments can be a part of work in process, finished

goods, or cost of goods sold. Exhibit 1-5 gives a description of the accounting entries recorded for payroll transactions.

### Exhibit 1-5 Accounting Entries for Payroll Transactions

Date	Cost of goods sold	XXXX	
	General selling and admin expense	XXXX	
	FIT payable		XXXX
	SIT payable		XXXX
	FICA OASDI payable		XXXX
	FICA Medicare payable		XXXX
	Medical insurance payable		XXXX
	Wages and salaries payable		XXXX
	To record payroll for a period		XXXX
Date	Payroll tax expense	XXXX	
	FICA OASDI payable		XXXX
	FICA Medicare payable		XXXX
	FUTA payable		XXXX
	SUTA payable		XXXX
	To record payroll tax expense for pay period, xx/xx/xxxx, and then when payment is made to employees		XXXX
Date	Wages and salaries payable	XXXX	
	Cash		XXXX
	To record actual payment of current payment accruals		XXXX

Note here that after these transactions are incurred they become payables and remain on the balance sheet until those outlays are paid out from cash. At that point, those transactions become income statement accounts.

### ***Accounting for Payments Made to Salaried Employees***

For employees who are classified as salaried, the payroll status is normally stated as a monthly wage. This is not a job-level designation. It indicates that in the payroll system these employees' compensation payments are recorded on a monthly basis. In the United States, salaried employees are usually exempt from the provisions of the Fair Labor Standards Act. In other words, they do not have to be paid overtime for any hours they work over 40 hours in a week.

Federal law in the United States that governs overtime earnings is called the Fair Labor Standards Act, which is part of the federal wage and hour legislation. All employers engaged in interstate commerce have to adhere to the Fair Labor Standards Act. There are also state wage and hours legislation with which employers must comply.<sup>10</sup>

The payroll system pays these employees their fixed monthly salary on each pay date. If the pay period is biweekly, these salaried employees are paid their monthly rate divided by two. The stated salary rate will be gross pay from which the employee's specific payroll deductions are subtracted. These deductions are similar to those used for hourly employees (as described earlier in this chapter).

### ***Other Technical Payroll Accounting and HR Issues***

First, there is the issue of thirteenth- and fourteenth-month payments made in many countries outside of the United States. Normally, in the United States, the workday is 8 hours in duration. In a 52-week year, that makes 2,080 work hours in a year:

$$8 \text{ hours a day} \times 5 \text{ days a week} \times 52 \text{ weeks in a year} = 2,080 \text{ hours}$$

In the United States, the number of hours employees can work is 2,080. But we know that most employees take at least two weeks of vacation during the year. Those two weeks are paid vacation days. Therefore, in the 52-week year, the employee does not necessarily work the entire 2,080 hours. If the employee takes a two-week

<sup>10</sup> FLSA states that any nonexempt (not exempt from the law) employee who works more than 8 hours in a day or 40 hours in a week has to be paid time and a half for those additional hours. In a state such as California, if the employee works more than 12 hours in a day or on the seventh consecutive day in a week, his or her pay must be double time for those hours.

- Compensation and benefits cost elements
- Understanding base pay
- Base pay outflows
- Current accounting for compensation and benefit cost elements
- Payroll accounting
- Record keeping of HR cost elements within the accounting cycle
- Technical issues with respect to compensation and benefit cost elements
- The definition of all compensation and benefit terms

## Appendix: The Terms

This appendix describes compensation and benefit terms in more detail than described in the main body of this chapter:

- **Base, basic, fixed, “come to work” pay:** The “fixed” part of pay. This element is provided to employees to come to work and do the job by using the required skills, knowledge, abilities, and appropriate work behaviors. Usually, this component is based on market rates combined with some measure of the internal ranking for the job or position, normally through a job-evaluation system.

Base pay can also be identified in many other ways:

- **Wage:** A fixed regular payment typically paid on a daily or weekly basis by an employer to an employee classified as a manual or unskilled worker. In economics, wage is the part of total production that is the return to labor as earned income as compared to dividends received by owners. Some contend that wages are paid to daily workers who are not necessarily employees. The implication is that the word *wage* is used to define the money a worker receives in exchange for labor (that is, physical labor). There seems to be a connotation that wages are given in exchange for physical labor and not brain power (physical strength in contrast to intelligence).

- **Salary:** A fixed regular payment typically paid on a monthly or biweekly basis but often stated as an annual sum. This is payment made by an employer to an employee as opposed to a worker. In other words, it is a payment made to a professional or a white-collar worker. A salary is a form of periodic payment from an employer to an employee, as stated in a recruitment contract. The payment differs from wages. In wage payments, each job or hour is paid separately. The distinction between salary and wages flows from the fact that for salaried employment the effort and output of “office work” is hard to measure in hourly terms.
- **Compensation:** The money received by an employee from an employer as a salary or wage. Therefore, the word *compensation* is used as an encompassing word covering both wages and salaries. But the pure definition of this word is money awarded to a person to compensate that person for his or her time, effort, abilities, knowledge, experience, and skills provided to an employer. This is the basis for an exchange; employer pays compensation, the employee provides the employer various personal attributes. When the exchange is not fair from the point of view of either party, there is dissatisfaction. Effective compensation is based on various motivational theories. A discussion about the theories is beyond the scope of this book.
- **Pay:** Pay means the giving of money to someone that is due to him or her for work done. In other words, it explains the giving of a sum of money in exchange for work done. It also alludes to giving what is due or deserved. The notion of payment arose from the sense of pacifying a creditor. I want to pay him for his work (reward him, reimburse her, compensate him, give payment to him or her, or remunerate him or her).

In the current context, this concept needs some thought. It is not just wages or salaries that are being provided. Organizations are paying their human resources; they are rewarding, they are remunerating. The concept here is that the word *pay* should include both the perspectives of the

giver and receiver of pay. This is a psychological transaction as much as it is an economic transaction. Both the supply (what the organization wants to provide) and the demand side (what the employee, who is the creditor being pacified) of the equation need to be considered to make the transaction fair to both parties.

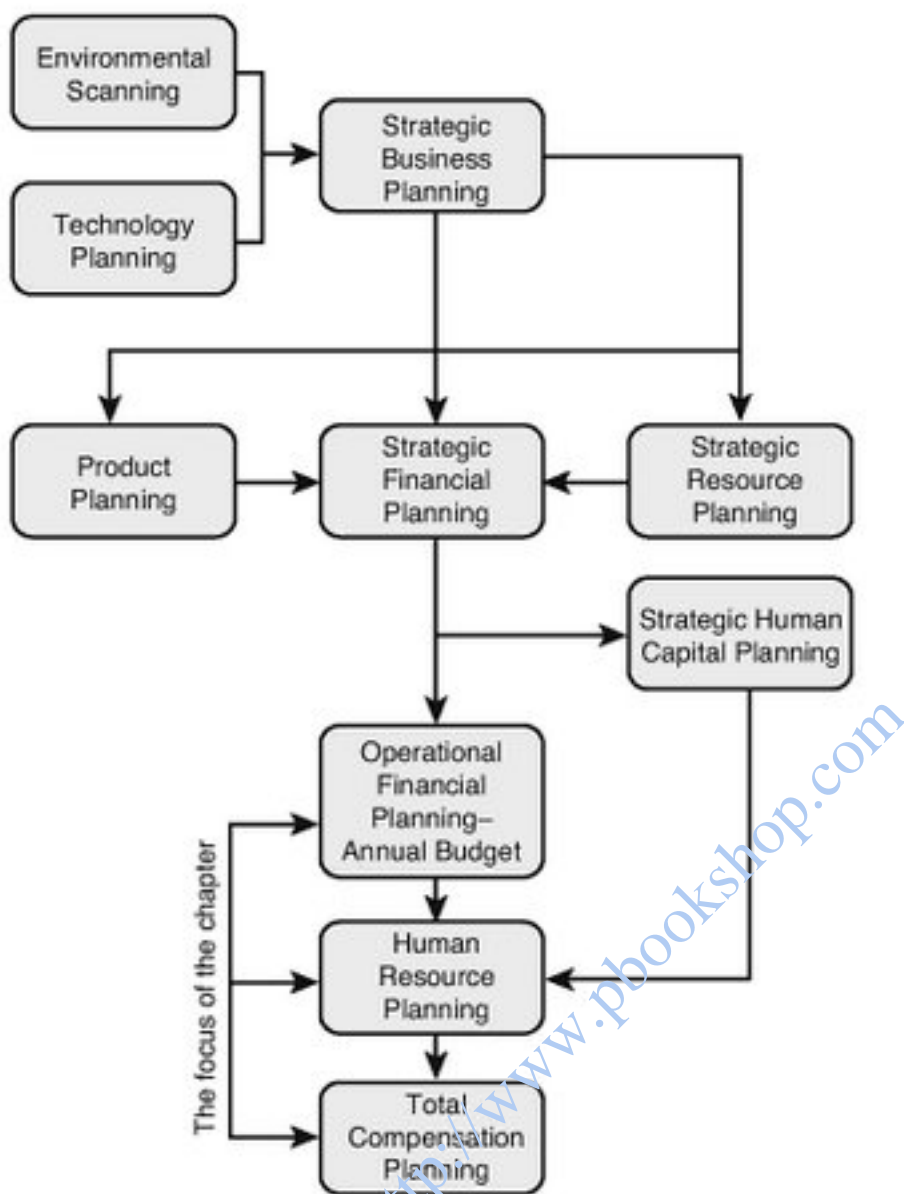
All too often, organizations (both private and public) look at only the supply side and ignore the demand side (what the employee wants), and therefore pay remains one of the most emotionally disturbing work conditions.

- **Remuneration:** One will receive adequate remuneration for the work one has done (that is, a payment, pay, salary, wages; earnings, fees, reward, compensation, reimbursement; formal emoluments). So, this word is also an all-encompassing word.
- **Rewards:** A payment given in recognition of service, effort, or accomplishment. Today, the concepts behind the terminology listed here continue to evolve as part of a system of reward that employers offer to employees. Salary (also now known as fixed pay) is coming to be seen as part of a *total rewards* system, which includes variable pay (such as bonuses, incentive pay, and commissions), benefits and perquisites (or perks), and other schemes employers use to link reward to an employee's individual performance. Tying it into performance in a clear, understandable, and acceptable way remains a continuing challenge. Good in theory, but fraught with real-life issues.
- **Incentives or bonuses:** These payments are provided to employees for achieving time-bound goals and objectives. Words such as *incentive targets*, *objectives (bonus objectives)*, *measurements*, and *ratings* are all contextual terms used in most organizations. In economics and sociology, an incentive is any factor (financial or nonfinancial) that enables or motivates a particular course of action. These payments or gifts are added to what is usual or expected. Incentives are often amounts of money added to wages on a seasonal basis, especially as a reward for good performance (for example, a Christmas bonus).

- **Allowances:** These items are not benefits but are additional cash payments for special circumstances. These types of allowances are widely used in various countries. They are sums of money paid regularly to a person, specifically to meet specified life needs or expenses. It is an amount of money that can be earned or received free of tax or tax neutralized; examples are housing, education, hardship, transportation, special area allowances, foreign service premiums, and tax protection or equalization payments.
- **Adders to base:** These payments are common in the United States. Overtime pay, callback pay, and on-call pay (also called *beeper pay*) are common elements provided for work that is done beyond normal work hours or under special circumstances. Overtime is provided for work done over standard legal working hours. Callback pay is special pay provided to technical workers who are called back to work after normal hours because they are needed to address a specific or an urgent situation. On-call pay is similarly an additional amount paid to employees who are required to be on-call by their employers to come into work when asked to do so. *Beeper pay* is provided to employees who have to keep electronic beepers on all the time so employers can access the workers on short notice.
- **Risk benefits:** Medical, disability, and life insurance. These benefits are provided to employees in lieu of cash to mitigate the various life risks faced by employees and their families. Employee benefits are regarded as nonwage compensation provided to employees in addition to their normal wages. Benefits can be regarded as transactions where the employee exchanges (cash) wages for some other form of economic benefit. This is generally referred to as a *salary-sacrifice* arrangement. In most countries, employee benefits are taxable at least to some degree. Some of these benefits are group insurance (health, dental, life, and so on), medical payment plans, disability income protection, daycare, tuition reimbursement, sick leave, vacation (paid and nonpaid), and Social Security. The purpose of the benefits is to increase the economic security of employees and protect them from unfavorable life situations.

- **Retirement plans:** Employers provide these benefits to assist employees with their post-employment lives. Usually there are two categories of retirement plans: the defined benefit plans and the defined contribution plans. Defined benefits plans are formula based, and defined contribution plans are contribution based. The contributions are made by participating employees. The fundamental objective of these plans is to provide an income-replacement payment. With this payment, participating employees should be able to replace a certain portion of their preretirement income during their retirement years.
- **Equity compensation:** This element in the past was mostly provided to senior executives to motivate them to increase shareholder value. But the equity compensation component of pay has seen many changes over the past ten years or so. There are many versions of these plans: nonqualified stock options, incentive stock options, restricted stock options, stock appreciation rights, among others. There are many accounting, tax, and legal implications to these plans. Some of the issues being discussed within this context are ownership culture, stock option pricing, dilution, and overhang. The equity compensation element has spawned specialists, legal experts, associations, and interest groups (each with their unique opinions and viewpoints). The important issues in equity compensation are (1) whether these programs have any value if distributed all across the whole employee population, even to the lowest employee levels, and (2) whether the organizations that distribute stock options widely to all levels of employees achieve an “ownership culture.”
- **Perquisites:** Many companies provide executives a wide variety of perks. This practice is widespread around the world. The term *perks* is often used colloquially to refer to payments because of their discretionary nature. Often, perks are given to employees who are outstanding performers and those who have seniority. Common perks include company cars, hotel stays, free refreshments, leisure activities during work time (golf and so on), stationery, and lunch allowances.





**Exhibit 2-1** A Conceptual Framework for the Connections between Strategic Business and Financial Planning and HR and Total Compensation Planning

### *The Need for Planning*

Organizations know that success requires planning with regard to both physical and financial resources. (In economics terms, these are the factors of production.) To state an obvious example, electric-generation companies must now plan more carefully than ever to ensure an adequate supply of coal at the right time and place. Electric generation plants require large quantities of coal to operate. It's not just shortages that promote planning, it's the complexity in the form of the global nature of business, of government regulations, of the exponential growth of technology, of human capital challenges, and

all the other interests of various stakeholders. Managing the interconnectivity among these varying forces clearly requires planning.

Planning entails many dimensions, each connected to the other in an integrated approach to planning. Exhibit 2-1 suggests a form of this integrated approach. The exhibit suggests that clear connections do indeed exist between these planning processes. Strategic planning or longer-term planning is important, but this activity (at least an in-depth discussion about it) is beyond the scope of this chapter. The discussion here is limited to the connections between operational financial planning and HR planning and the subsequent connections to total compensation planning.

### ***Strategic Planning***

Let's briefly consider strategic planning here. Strategic planning refers to an organization's process of defining its strategy, or direction, and making decisions about allocating its resources to pursue that strategy. The strategic plan identifies and analyzes the current status, objectives, and strategies of an existing organization to determine the direction of the organization. It is necessary to understand the organization's current position and the possible avenues through which it can pursue alternative courses of action. An organization looks at strategy from a long-term perspective. Therefore, strategic planning is considered a process for determining where an organization is going over the next three to five years (long term).

When looking at the longer term, organizations examine existing or perceived *strengths, weaknesses, threats, and opportunities* (SWOT). Information about the future business and social environment the organization operates in is analyzed in connection with the marketing, production, and research capabilities, which then leads to strategy development covering the following issues:

- Vision
- Mission
- Values
- Strategies
- Goals
- Programs
- Objectives
- Resource allocation

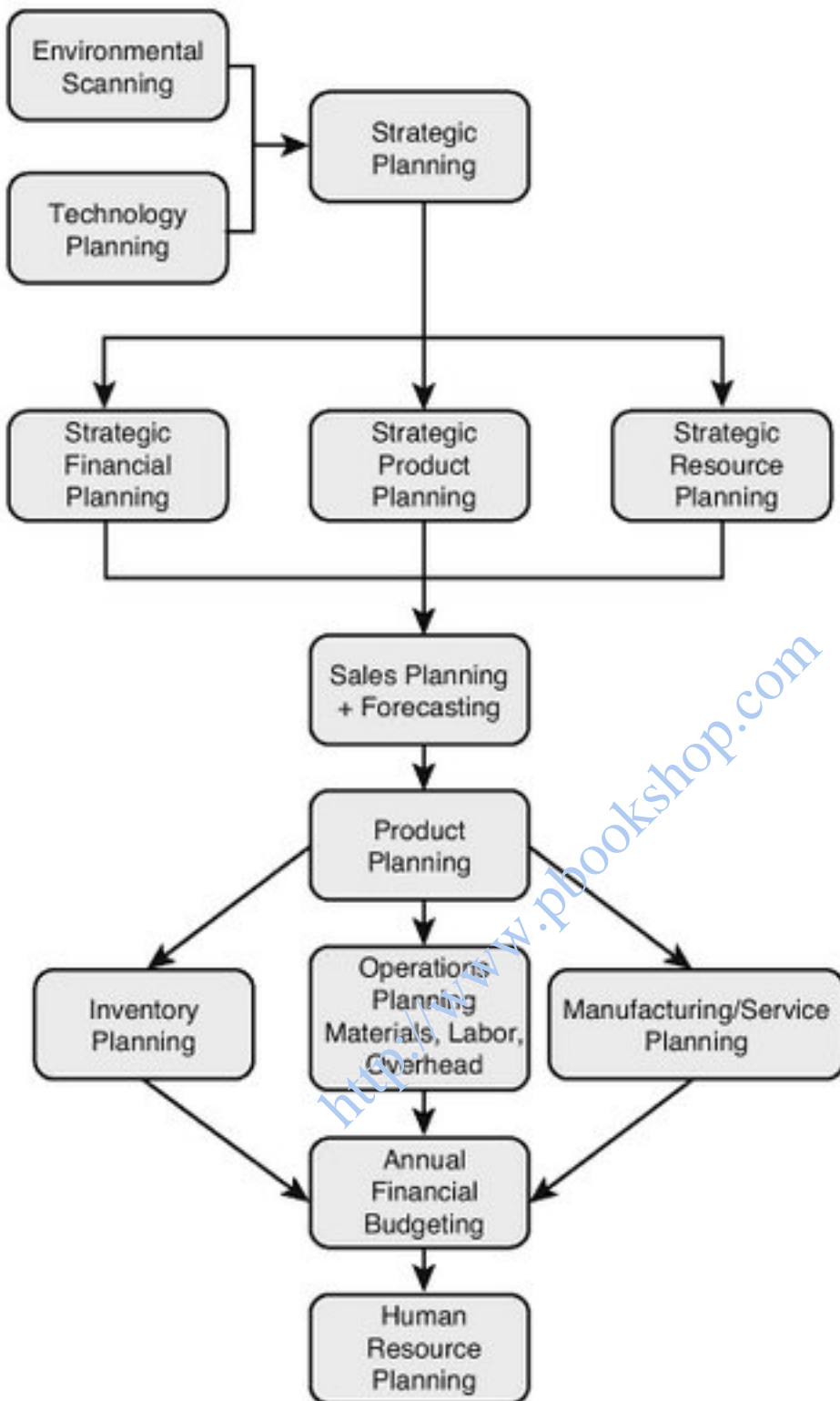
Business plans are derived from strategic planning in terms of the products or services to be produced and the materials, people, and facilities necessary to produce them. All of this is converted to the language of business: finance and accounting.

An integral part of the strategic business planning process is the follow-on strategic financial plan, which codifies the strategic plan in monetary terms over the same long-term time horizon. The strategic financial plan then forms the basis for the short-term operational financial plan, often called the annual financial budget. Thus, strategic financial plans become the triggering point for the annual operational financial budget planning exercise. Operational financial planning is also often called profit planning. Exhibit 2-2 shows these connections in the planning process. It also illustrates how strategic financial planning flows through to the operating profit plans of an organization.

The annual financial budget or the profit plan is important for many reasons, including the following:

- It is a means of communication throughout the organization.
- The financial budgeting process facilitates management planning for resource usage.
- The financial budget is a mechanism that assists with the most efficient allocation of resources within an organization.
- It also assists in uncovering potential trouble areas, before they happen.
- The financial budget assists in coordinating the varied activities within an organization into an integrated focused effort that is in sync with the strategic business plans of the organization.
- The financial budget structure lends itself to the tasks of monitoring and controlling, which are necessary to ensure that progress is measured and all the required activities within an organization are on track.

Therefore, strategic and operational financial planning is certainly a key success factor for any organization. Within this context, the focus now turns to HR planning and the subsequent total compensation planning.



**Exhibit 2-2** The Planning Connections

## HR Planning

The HR function is on a continual talent hunt for the right human resources at the right times and the right places. This is similar to resource acquisition and consumption in other areas throughout the business world. All business functions, including the HR function, face supply issues and therefore must plan for such. This section covers a few of the reasons why such planning is vital.

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## Conclusion

This book has focused on applying finance and accounting principles to HR management systems. From that perspective, it is a technical book.

More often than not, the soft side of human resources is emphasized in practice. But HR management has a harder side, too. This book has attempted to explain the hard side, with an emphasis on the compensation and benefit function.

As discussed at the beginning of this book, the discipline of HR management has multidisciplinary underpinnings. The HR profession is guided by influences from psychology, economics, sociology, philosophy, mathematics, and statistics, as well as from accounting and finance. Many stakeholders suggest that accounting and finance are the languages of business and organizations. In many ways, accounting and finance are core functions in the management of nonprofits as well. HR management is a very important component for both for-profit and nonprofit organizations. Therefore, HR management should also use the core language of organizational management. This book encourages and has attempted to facilitate the use of this language by HR professionals.

We focused on compensation and benefits because this is where accounting and finance has the most impact. The hope with this book is that in ongoing HR management education, especially compensation management, this book can be used to add to the required technical know-how.

The topics and subjects covered in the book are not new. The ideas and concepts can be found in many textbooks and other publications. In this book, we have attempted to compile all relevant topics, ideas, thoughts, concepts, principles, and subjects in one text. We

focused on the core dimensions of compensation and benefits management. We covered accounting and finance implications in base, incentive, sales, international, and equity compensation. We also covered accounting and finance implications of employee benefit plans.

Our primary objective was to develop a single-source publication to serve as a knowledge repository and a reference source. Overall, our hope is that this book will be the impetus to help develop the accounting and finance knowledge of HR professionals.

HR professionals come to this discipline from various paths. There is no discernible singular career path to becoming an HR professional. Quite often, therefore, HR professionals lack accounting and finance knowledge and know-how. This clearly hinders HR professionals in many ways. Some of these hindrances can be seen in HR professionals lacking credibility with senior management. HR professionals are mainly considered “soft-side” professionals and considered advisors and counselors but not core decision makers. Therefore, HR professionals are not always brought to the “decision-makers table.” One of the main ways to change these perceptions is for the HR professional to talk the language of business in a credible fashion using accounting and finance knowledge and know-how. We hope this book facilitates that end. For the HR professional, this knowledge enhancement is not a want, but a need.

## **An HR Finance and Accounting Audit**

We conclude with various questions HR professionals should ask themselves with respect to applying accounting and finance principles to global HR management systems. If an HR professional does not have adequate answers to these questions, he or she should take the necessary steps to develop the requisite skills and knowledge to implement these principles. The questions are in no particular order:

- Does your organization have an adequate system of accurately projecting total compensation expenses that is tied in to the organization’s financial budgeting system?
- If your organization has a defined benefit plan, do you participate in cost determination activities? Do you understand the

funding issues of the plan? Do you understand the calculations involving the ongoing pension expense?

- Are you aware and knowledgeable about the financial triggers used in the determination of sales commissions earned?
- If your organization sends expatriates overseas, who manages the expatriate tax program? Do you understand the specifics of the calculations involved?
- From an accounting point of view, what are the implications of capitalizing HR expenses for your organization?
- Do you know the difference between the VBO, ABO, and PBO in pension accounting?
- Does your organization have a stock option program? Do you know how the stock option expenses are calculated for that program?
- Do you know how the intrinsic value of any business is calculated?
- Do you know how the economic value of any business is calculated?
- Do you understand the various financial ratios commonly used to evaluate the performance of a business?
- Are the linkages between HR programs and the intrinsic value of your organization clearly delineated?
- Can you suggest ways in which HR programs can add economic value to the organization?
- Can you justify HR programs using ROI methodologies and capital budgeting techniques?
- Do you know and understand the details of the stock option pricing models?
- What are specific connections between HR programs and the financial ratios used to measure operating profits?
- In what ways can the HR function improve the company's free cash flow position?
- Do you exclusively rely on outside consultants for technical accounting and financial issues that need to be addressed for HR programs?

- Does your organization regularly monitor and then report performance on HR metrics to senior management?
- Do you engage in industry benchmark comparisons for HR metrics?
- Do you annually engage in employee benefits program costing in coordination with your outside vendors?
- Do you participate with the senior management team in developing linked incentive compensation financial triggers?
- Do you understand the tax implications of your compensation and benefit programs?
- Are you knowledgeable about governmental reporting requirements for (DOL and ERISA) your compensation and benefit programs?
- Are you knowledgeable about accounting requirements under the current accounting standards (GAAP and IFRS)?
- Do you know how your equity compensation programs affect the company's balance sheet, especially the Accumulated Paid-in Capital account?
- Do you know how your equity compensation program affects your company's earnings per share?

If your knowledge is limited in answering these questions, a good place to start is this book.