

Book II

Recording Accounting Transactions

Account	Debit	Credit	Item [Qty]
Revenue:Sales		720.00	Gardening (2x w)
Revenue:Sales		112.00	Package of Sum
Inventory Asset		50.75	Package of Sum
Cost of Goods Sold	50.75		Package of Sum
Sales Tax Payable		10.36	
Accounts Receivable	842.36		



Check out www.dummies.com/extras/accountingaio for additional guidance on documenting your accounting transactions to leave a clear audit trail.

In this book...

- ✔ Manage your accounting system to keep your books balanced. When you post entries to your accounting system, the total dollar amount of debit entries should equal the credits.
- ✔ Track purchases, inventory, and costs, and pay your bills. For many companies, inventory is the largest cost to the business.
- ✔ Record sales in cash and store credit and account for discounts, returns, and bad debt. These practices help you calculate total sales correctly.
- ✔ Prepare and record payroll to keep track of employee compensation and payroll taxes. This is one of the most complex areas of accounting, because the rules on tax withholdings frequently change.
- ✔ Account for Social Security and Medicare taxes, unemployment compensation, and workers' compensation. Each of these entities receives reports on payroll withholdings, along with payments.

Chapter 1

Keeping the Books

In This Chapter

- ▶ Getting a bird's-eye view of accounts and transactions
 - ▶ Establishing your accounting system
 - ▶ Closing out at the end of a period
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Individuals can get along quite well without much bookkeeping — but the exact opposite is true for a business. In addition to facilitating day-to-day operations, a company's bookkeeping system serves as the source of information for preparing its periodic financial statements, tax returns, and reports to managers. The accuracy of these reports is critical to the business's survival.

Obviously, then, business managers have to be sure that their company's bookkeeping and accounting system is dependable and up to snuff. This chapter shows you what bookkeepers and accountants do, mainly so you have a clear idea of what it takes to be sure that the information coming out of the accounting system is complete, timely, and accurate.

Analyzing the Effect of Business Transactions

This section walks you through the basics of bookkeeping, including the rule of debits and credits and why proper debiting and crediting keeps the financial statements in balance. You also discover the five steps for entering transactions into the accounting records.



Modern financial accounting is a *double-entry system*: For every entry into the company accounting records, there has to be an opposite and equal entry. In other words, debits must always equal credits. Technology gives you a hand here: No accounting software package worth its salt will let you enter an unbalanced transaction into the accounting books. For more about double-entry accounting, see Book I, Chapter 2.

Revisiting the fundamental accounting equation



The *fundamental accounting equation* (also known as the *accounting equation* or the *balance sheet equation*) requires that all transactions balance when they're posted to the equation. It demands that

$$\text{Assets} = \text{Liabilities} - \text{Owners' equity}$$

A truncated version of this equation states

$$\text{Net assets} = \text{Owners' equity}$$

This version of the equation just moves liabilities over to the other side of the equal sign; *net assets* are all assets minus all liabilities. Before you can begin to set up your accounts and enter transactions, you must have a good grasp of this fundamental accounting equation, discussed in Book I, Chapter 1.

Getting familiar with accounts

As an accountant within a business, you summarize accounting transactions into accounts that you use to create financial reports. Every account your company uses is annotated in a list called the *chart of accounts* — a list of all accounts and each account's balance. The business uses that chart of accounts to record transactions in its general ledger. The *general ledger* is the record of all financial transactions within the company during a particular accounting cycle. You find out more about the general ledger later in this chapter.



The chart of accounts isn't a financial report. It's merely a list of all accounts you've previously set up to handle the company transactions.

When you're "doing the books," as the saying goes, you record your normal business transactions by using accounts you set up in the chart of accounts. Each account in the chart of accounts has a unique account number. Regardless of what accounting software package your company uses, the numbering sequence is pretty much set in stone to ensure consistency among companies and among their financial reports. For more about creating and using a chart of accounts, see the section "Categorizing your financial information: The chart of accounts," later in this chapter.

Defining debits and credits

When you understand the basics of accounts and the chart of accounts (see the previous sections), it's time to find out about the mechanism of *journal entries*, which you use to enter financial information into the company's accounting records.

Writing journal entries is a major area of concern for small business owners, first-year accounting students, and students who are taking accounting only because it's required for a business degree. The logistics of presenting the journal entry don't cause the concern; instead, the worry is how to figure out which account is debited and which is credited.



Assets and expense accounts are increased with a debit and decreased with a credit. Liability, revenue, and equity accounts are just the opposite: These accounts are credited for increases and debited for decreases. There are some occasional exceptions to these rules. Book III, Chapter 6 explains accumulated depreciation. This account is a *contra-asset*, which is an asset account that's increased by crediting. Accumulated depreciation is the only exception discussed in the book.

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Knowing more about the transaction methodology

Before you enter an event into a business accounting system, you have to consider the *transaction methodology*, a five-step process for deciding the correctness of whatever entry you're preparing. After you get into the financial accounting rhythm, this process becomes an automatic analysis you do by rote. Here are your five considerations:

- ✓ **What's going on?** This question addresses the precipitating event for the entry. For example, did the company buy a new piece of business equipment or sell some product to a customer?
- ✓ **Which accounts does this event affect?** Is the account an asset, liability, owners' equity, revenue, or expense? Assets would definitely be affected by the purchase of business equipment, and revenue would be affected by a customer sale. To get started, ask yourself whether the event affects cash. Cash is often the most-used account in your chart of accounts.
- ✓ **How are the accounts affected — by a debit or credit?** Looking back to your rules of debits and credits, buying assets adds to the account, so it's a debit. Making a sale adds to a revenue account, so it's a credit.

- ✓ **Do all debits for an entry equal all credits for the same entry?** Think about the fundamental accounting equation discussed earlier in this chapter. Every debit requires an equal credit.
- ✓ **Does the entry make sense?** Do the accounting actions you take match the facts and circumstances of the business event? For example, although the net effect on the books is the same, you can't credit an expense to record revenue.



Each type of account in your chart of accounts has a normal balance. The *normal balance* is the balance you expect to see in an account at any point in time. For example, you debit cash (an asset balance) to increase it. A normal balance for an asset account is a debit balance. If you review account balances and notice a *credit* balance in cash, that fact should be a red flag. It may mean that your cash account is overdrawn or negative.

Managing Your Bookkeeping and Accounting System

Too many business managers and owners ignore their bookkeeping and accounting systems or take them for granted — unless something goes wrong. They assume that if the books are in balance, everything is okay. Book I, Chapter 2 covers exactly what having “books in balance” means — it does *not* necessarily mean that everything is okay.

To determine whether your bookkeeping system is up to snuff, check out the following sections, which provide a checklist of the most important elements of a good system.

Categorizing your financial information: The chart of accounts

Suppose that you're the accountant for a corporation and you're faced with the daunting task of preparing the annual federal income tax return for the business. For instance, the Internal Revenue Service (IRS) requires that you report the following kinds of expenses (and this list contains just the minimum!):

- ✓ Advertising
- ✓ Bad debts
- ✓ Charitable contributions
- ✓ Compensation of officers
- ✓ Cost of goods sold

- ✓ Depreciation
- ✓ Employee benefit programs
- ✓ Interest
- ✓ Pensions and profit-sharing plans
- ✓ Rents
- ✓ Repairs and maintenance
- ✓ Salaries and wages
- ✓ Taxes and licenses

You must provide additional information for some of these expenses. For example, the cost of goods sold expense is determined in a schedule that also requires inventory cost at the beginning of the year, purchases during the year, cost of labor during the year (for manufacturers), other costs, and inventory cost at year-end.



Where do you start? For each category of information that you must report, you need an *account*, a record of the activities in that category. An *account* is basically a focused history of a particular dimension of a business. Individuals can have accounts, too — for example, your checkbook is an account of the cash inflows and outflows and the balance of your checking account (assuming that you remember to record all activities and reconcile your checkbook against your bank statement). You probably don't keep a written account of the coin and currency in your purse, wallet, or pockets, but a business needs to keep track of all its cash no matter where it is. An account serves as the source of information for preparing financial statements, tax returns, and reports to managers.

The formal index or list of all accounts is referred to as the *chart of accounts*. The chart of accounts, even for a relatively small business, often contains more than 100 accounts. Larger business organizations sometimes need thousands of accounts. The larger the number, the more likely that the accounts have number codes according to some scheme — for example, all assets may be in the 100 to 300 range, all liabilities in the 400 to 500 range, and so on. To get the lowdown on how to set up your chart of accounts, check out Book 1, Chapter 2.

Standardizing source document forms and processing procedures

Just as humans need a constant circulation of blood to live, businesses need a constant flow of paperwork. Even in this modern age of the Internet, electronic communication, and computers, a business generates and depends on a lot of paperwork. And much of this paperwork is used in the accounting

process. Placing an order to buy products, selling a product to a customer, determining the earnings of an employee for the month — virtually every business transaction needs paperwork, generally known as *source documents*.

Source documents serve as evidence of the terms and conditions agreed upon by the business and the other person or organization that it's dealing with. Both parties receive some kind of source document. For example, for a sale at a cash register, the customer gets a sales receipt, and the business keeps a running record of all the transactions in the register, which can be printed later if need be.

Clearly, an accounting system needs to standardize the forms and procedures for processing and recording all normal, repetitive transactions and should control the generation and handling of these source documents. From the bookkeeping point of view, these business forms and documents are very important because they provide the input information needed for recording transactions in the business's accounts. Sloppy paperwork leads to sloppy accounting records, which won't do when the time comes to prepare tax returns and financial statements.



If you're the owner of a small business, you may want to check out an office supply store to see the kinds of forms that you can buy right off the shelf. You can find many basic forms and documents for executing and recording business transactions. Also, computer accounting software packages today include templates for most business forms and source documents that a business needs.

Hiring competent personnel

A business shouldn't be penny-wise and pound-foolish: What good is meticulously collecting source documents if the information on those documents isn't entered into your system correctly? You shouldn't try to save a few bucks by hiring the lowest-paid people you can find. Bookkeepers and accountants, like all other employees in a business, should have the skills and knowledge to perform their functions. Here are some guidelines for choosing the right people to enter and control the flow of your business's data and for making sure that those people *remain* the right people:

- ✓ **Education and experience:** The ideal level of education and experience for accounting employees can vary greatly. Many accountants in large business organizations have a college degree with a major in accounting. This may also be the case for the head of accounting in a smaller company. However, as you move down the pay scale in any accounting department, you find that more and more employees don't have a college degree and perhaps don't even have any courses in



accounting — they learned bookkeeping methods and skills through on-the-job training. Even without the degree or formal accounting coursework, these employees can be very effective workers.

- ✓ **Certifications:** When hiring higher-level accountants in a business organization, decide whether they should be certified public accountants (CPAs). Larger businesses insist on this credential, along with a specific number of years' experience in public accounting. Until recently, the other main professional accounting credential was the CMA, or certified management accountant, sponsored by the Institute of Management Accountants (IMA). The CMA credential is American born and bred. In contrast, the Chartered Global Management Accountant, or CGMA designation, is co-sponsored by the American Institute of CPAs and the British Chartered Institute of Management Accountants. Unlike the CPA license, the CMA and CGMA designations recognize professional achievement and experience but the government doesn't regulate these credentials.

A business is prudent to require the CPA, CGMA, or CMA credential for its chief accountant (who usually holds the title of *controller*). Alternatively, a business could regularly consult with a CPA in public practice for advice on its accounting system and on any accounting problems that arise.

Note: For bookkeepers, the American Institute of Professional Bookkeepers sponsors the Certified Bookkeeper designation. For more information, visit www.AIPB.org.

- ✓ **Continuing education:** Bookkeepers and accountants need continuing education to keep up with changes in the income tax law and financial reporting requirements, as well as changes in how the business operates. Ideally, bookkeepers and accountants should be able to spot needed improvements and implement these changes — to make accounting reports to managers more useful. Fortunately, many courses are available at reasonable costs for keeping up on the latest accounting developments. Many continuing education courses are available on the Internet, but be cautious and check out the standards of any Internet course. States generally require that CPAs in public practice take 30 to 40 hours per year of continuing education to keep their licenses.
- ✓ **Integrity:** Possibly the most important quality to look for is also the hardest to judge. Bookkeepers and accountants need to be honest people because of the control they have over your business's financial records. Conduct a careful background check when hiring new accounting personnel. Small-business owners and managers have closer day-in and day-out contact with their accountants and bookkeepers, which can be a real advantage — they get to know their accountants and bookkeepers on a personal level. Even so, you can find many cases where a trusted bookkeeper has embezzled many thousands of dollars over the years.

Enforcing strong internal controls



Any accounting system worth its salt should establish and vigorously enforce effective *internal controls* — additional forms and procedures over and above what's strictly needed to move operations along. These additional procedures serve to deter and detect errors (honest mistakes) and all forms of dishonesty by employees, customers, suppliers, and even managers. Unfortunately, many businesses pay only lip service to internal controls; they don't put into place good internal controls, or they don't seriously enforce their internal controls (they just go through the motions).

Internal controls are like highway truck weigh stations, which make sure that a truck's load doesn't exceed the limits and that the truck has a valid license plate. You're just checking that your staff is playing by the rules. For example, to prevent or minimize shoplifting, most retailers now have video surveillance and security tags in or on their merchandise. Likewise, a business should implement certain procedures and forms to prevent (as much as possible) theft, embezzlement, kickbacks, fraud, and simple mistakes by its own employees and managers.

The Sarbanes-Oxley Act of 2002 (see Book IV, Chapter 1) requires that public companies establish and enforce a special module of internal controls over their external financial reporting. Although the law applies only to public companies, some accountants worry that the law's requirements will have a trickle-down effect on smaller private businesses as well. Unlikely, but it could happen.



Many small-business owners tend to think that they're immune to insider embezzlement and fraud, especially when the people working for them are family members or friends. Yet, in fact, many small businesses are hit very hard by fraud and usually can least afford the consequences. To protect your business, you should put checks and balances into place to discourage dishonest practices and to uncover any fraud and theft as soon as possible.



Following are five common internal control procedures you can implement to protect your business:

- ✓ Require a second signature on cash disbursements over a certain dollar amount.
- ✓ Match receiving reports based on actual counts and inspections of incoming shipments with purchase orders before cutting checks for payment to suppliers.
- ✓ Require both a sales manager's and another high-level manager's approval for *write-offs* of customers' overdue receivable balances (that is, closing the accounts on the assumption that they won't be collected), including a checklist of collection efforts that were undertaken.

- ✔ Require that auditors or employees who don't work in the warehouse take surprise counts of products stored in the company's warehouse and compare the counts with inventory records.
- ✔ Require mandatory vacations by every employee, particularly bookkeepers and accountants, during which time someone else does that person's job (because a second person may notice irregularities or deviations from company policies).

Wrapping Up with End-of-Period Procedures

Suppose that all transactions during the year have been recorded correctly. Your job's done, right? Not so fast. Now you need to tidy up those books and prepare end-of-period reports for management. As you perform those tasks, you also need to be sure to leave clear audit trails and keep an eye out for any out-of-the-ordinary events or developments. The following sections explain what you need to do to wrap it up at the end of a period.

Tidying up the books

Prior to creating financial reports, you need to perform a couple additional procedures at the end of the period to make sure that the accounts are correct and complete. After those steps are completed, you can prepare financial statements and income tax returns for the year. Two main things have to be done at the end of the period:

- ✔ **Record routine adjusting entries:** Depreciation expense isn't a transaction that's recorded during the day-to-day bookkeeping process. (Book IV, Chapter 2 explains depreciation expense.) You record depreciation expense at the end of the accounting period (a month or a year). Accountants refer to these transactions as *adjusting entries*. The purpose of adjusting entries is to update and correct the revenue, income, expense, and loss accounts for the year. Year-end adjusting entries are necessary to have correct balances for determining profit for the period.
- ✔ **Review other business developments that may affect the accuracy of the accounts:** Assume a company discontinued a product line during the year. The product line's remaining inventory may have to be removed from the inventory asset account, with a corresponding loss recorded in the period. Maybe the company settled a long-standing lawsuit, and the amount of damages needs to be recorded. Layoffs and severance packages are another example of what the chief accountant needs to look for before preparing financial reports.



End-of-period accounting procedures can stir up controversy of the heated-debate variety. These procedures require that the accountant make decisions and judgment calls that upper management may not agree with. For example, the accountant may suggest recording major losses that would put a big dent in profit for the year or cause the business to report a loss. The outside CPA auditor (assuming that the business has an independent audit or review of its financial statements) often gets in the middle of the argument. These kinds of debates are precisely why business managers need to know some accounting.

Leaving good audit trails

Good accounting systems leave good audit trails. An *audit trail* is a clear-cut, well-marked path of the sequence of events leading up to an entry in the accounts. The trail starts with the source documents and follows through to the final posting in the accounts. You create an audit trail so an auditor can “re-walk” the path. Even if a business doesn’t have an outside CPA do an annual audit or review, the accountant has frequent occasion to go back to the source documents. An accountant may need to either verify certain information in the accounts or reconstruct the information in a different manner. Suppose that a salesperson is claiming some suspicious-looking travel expenses; the accountant would probably want to go through all this person’s travel and entertainment reimbursements for the past year.



If the IRS comes in for a field audit of your income tax return, you’d better have good audit trails to substantiate all your expense deductions and sales revenue for the year. The IRS has rules about saving source documents for a reasonable period of time and having a well-defined process for making bookkeeping entries and keeping accounts. Think twice before throwing away source documents too soon. Also, ask your accountant to demonstrate and lay out for your inspection the audit trails for key transactions, such as cash collections, sales, cash disbursements, and inventory purchases. Even computer-based accounting systems recognize the importance of audit trails. Well-designed computer programs provide the ability to backtrack through the sequence of steps in the recording of specific transactions.

Staying alert for unusual events and developments



Business managers should encourage their accountants to stay alert to anything out of the ordinary that may require attention. Suppose that the accounts receivable balance for a customer is rapidly increasing — that is, the customer is buying more and more from your company on credit but isn’t paying for these purchases quickly. Maybe the customer has switched more

of his company's purchases to your business and is buying more from you only because he is buying less from other businesses. That's a good thing. But maybe the customer is planning to stiff your business. Or maybe the customer is planning to go into bankruptcy soon and is stockpiling products before the company's credit rating heads south. Two really bad things.

Don't forget internal time bombs: A bookkeeper's reluctance to take a vacation could mean that she doesn't want anyone else looking at the books.

To some extent, accountants have to act as the eyes and ears of the business. Of course, that's one of the main functions of a business manager as well, but the accounting staff can play an important role.

Designing truly useful reports for managers

End-of-period reports include the three biggies — income statement, balance sheet, and cash flow statement — and any other financial statements management requires to do its job. End-of-period reports, when done well, serve several purposes:

- ✓ Fulfill government financial reporting requirements
- ✓ Keep investors posted on the financial state of the business
- ✓ Keep management posted on the financial state of the business
- ✓ Provide financial information to managers, so they can make better business decisions

To produce clear and useful reports, consult management to assess its needs. Proactively study the manager's decision-making responsibilities and provide the information that is most useful, presented in the most easily digestible manner.

In designing the chart of accounts, keep in mind the type of information needed for management reports. To exercise control, managers need much more detail than what's reported on tax returns and external financial statements. Consider regrouping expenses into different categories for management decision-making analysis. A good chart of accounts looks to both the external and the internal (management) needs for information.



So what's the answer for a manager who receives poorly formatted reports? Demand a report format that suits your needs! Books IV and V cover financial reporting in detail.

Chapter 2

Tracking Purchases

In This Chapter

- ▶ Tracking inventory and monitoring costs
 - ▶ Keeping your business supplied
 - ▶ Paying your bills
-

In order to make money, your business must have something to sell. Whether you sell products or offer services, you have to deal with costs directly related to the goods or services you sell. Those costs primarily come from the purchase or manufacturing of the products you plan to sell or the items you need in order to provide the services.



All companies must keep careful watch over the cost of the products to be sold or services to be offered. Ultimately, your company's profits depend on how well you manage those costs because, in most cases, costs increase rather than decrease over time. How often do you find a reduction in the price of needed items? Doesn't happen often. If costs increase but the price to the customer remains unchanged, the profit you make on each sale is less.

In addition to the costs to produce products or services, every business has additional expenses associated with purchasing supplies needed to run the business. The bookkeeper has primary responsibility for monitoring all these costs and expenses as invoices are paid. Bookkeepers can alert company owners or managers when vendors increase prices. This chapter covers how to track purchases and their costs, manage inventory, buy and manage supplies, and pay the bills for your purchases.

Keeping Track of Inventory

Products to be sold are called *inventory*. As a bookkeeper, you use two accounts to track inventory:

- ✓ **Purchases:** Where you record the actual purchase of goods to be sold. You use this account to calculate the *cost of goods sold*, which is an item on the income statement (see Book IV, Chapter 2 for more on the income statement).
- ✓ **Inventory:** Where you track the value of inventory on hand. This value is shown on the balance sheet as an asset in a line item called *inventory* (see Book IV, Chapters 3–5 for more on the balance sheet).

Companies track physical inventory on hand by using one of two methods:

- ✓ **Periodic inventory:** Conducting a physical count of the inventory in the stores and in the warehouse. This count can be done daily, monthly, yearly, or for any other period that best matches your business needs. (Many stores close for all or part of a day when they count inventory.)
- ✓ **Perpetual inventory:** Adjusting inventory counts as each sale is made. In order to use this method, you must manage your inventory by using a computerized accounting system that's tied into your point of sale (usually cash registers).



Even if you use a perpetual inventory method, it's a good idea to periodically do a physical count of inventory to be sure those numbers match what's in your computer system. Because theft, damage, and loss of inventory aren't automatically entered in your computer system, the losses don't show up until you do a physical count of the inventory you have on hand.

When preparing your income statement at the end of an accounting period (whether that period is for a month, a quarter, or a year), you need to calculate the cost of goods sold in order to determine your profit.

In order to calculate the cost of goods sold, you must first find out how many items of inventory were sold. You start with the amount of inventory on hand at the beginning of the month (called beginning inventory), as recorded in the inventory account, and add the amount of purchases, as recorded in the purchases account, to find the goods available for sale. Then you subtract the inventory on hand at the end of the month, which is determined by counting remaining inventory.

Here's how you calculate the number of goods sold:

$$\text{Beginning inventory} + \text{Purchases} = \text{Goods available for sale} - \text{Ending inventory} = \text{Items sold}$$



After you calculate goods available for sale, remember that your goods can end up in only two places: You may sell the goods (cost of goods sold) or have unsold goods sitting on your shelves (ending inventory).

After you determine the number of goods sold, you compare that number to the actual number of items sold by the company during that accounting period, which is based on sales figures collected through the month. If the numbers don't match, you have a problem. The mistake may be in the inventory count, or items may be unaccounted for because they've been misplaced or damaged and discarded. In the worst-case scenario, you may have a problem with theft by customers or employees. These differences are usually tracked within the accounting system in a line item called *inventory shrinkage*.

Entering initial cost

When your company first receives inventory, you enter the initial cost of that inventory into the bookkeeping system based on the shipment's invoice. In some cases, invoices are sent separately, and only a packing slip is included in the order. If that's the case, you should still record the receipt of the goods, because the company incurs the cost from the day the goods are received and must be sure it will have the money to pay for the goods when the invoice arrives and the bill comes due. (You track outstanding bills in the accounts payable account.)

Entering the receipt of inventory is a relatively easy entry in the bookkeeping system. For example, if your company buys \$1,000 of inventory to be sold, you make the following record in the books:

	<i>Debit</i>	<i>Credit</i>
Purchases (Asset account)	\$1,000	
Accounts payable		\$1,000

The purchases account increases by \$1,000 to reflect the additional costs, and the accounts payable account increases by the same amount to reflect the amount of the bill that needs to be paid in the future. The purchases account is used to isolate inventory purchased during the period (month or year). Purchases are part of the formula to calculate cost of goods sold (Book II, Chapter 2 explains this formula in detail):

$$\text{Cost of goods sold} = \text{Beginning inventory} + \text{Purchases} - \text{Ending inventory}$$

When inventory enters your business, in addition to recording the actual costs, you need more detail about what was bought, how much of each item was bought, and what each item cost. You also need to track

- ✔ How much inventory you have on hand.
- ✔ The value of the inventory you have on hand.
- ✔ When you need to order more inventory.

Tracking these details for each type of product bought can be a nightmare, especially if you're trying to keep the books for a retail store. That's because you need to set up a special inventory journal with pages detailing purchase and sale information for every item you carry. (See Book I, Chapter 3 for the scoop on journals.)

Computerized accounting simplifies this process of tracking inventory. Details about inventory can be entered initially into your computer accounting system in several ways:

- ✔ If you pay by check or credit card when you receive the inventory, you can enter the details about each item on the check or credit card form.
- ✔ If you use purchase orders, you can enter the detail about each item on the purchase order, record receipt of the items when they arrive, and update the information when you receive the bill.
- ✔ If you don't use purchase orders, you can enter the detail about the items when you receive them and update the information when you receive the bill.

When you receive inventory with a bill, you can collect the data in a computerized accounting software program. Similar information is collected on the software program's check, credit card, and purchase order forms.

In addition to recording the name of the vendor, date received, and payment amount, you also record details about the items bought, including the quantity and cost. When you load each item into the computerized accounting system, you can easily track cost detail over time.

After you receive the inventory, you then set up an inventory item in the computerized accounting system. Note that in addition to the item name, two descriptions are added to the accounting system: One is an abbreviated version you can use on purchase transactions (to save time), and the other is a longer description that's displayed on customer invoices (sales transactions). You can input a cost and sales price if you want, or you can leave them at zero and enter the cost and sales prices with each transaction.



If you have a set contract purchase price or sales price on an inventory item, it saves time to enter it on this form so you don't have to enter the price each time you record a transaction. But, if the prices change frequently, it's best to leave the space blank so you don't forget to enter the updated price when you enter a transaction.

Your accounting system should collect information about inventory on hand and when inventory needs to be reordered. To be sure your store shelves are never empty, you can enter a number that indicates at what point you want to reorder inventory. Accountants refer to this point as the *reorder point*. When the number of units on hand declines to the reorder point, you order more product.

After you complete and save the form that records the receipt of inventory, your accounting software should automatically:

- ✔ Adjust the quantity of inventory you have in stock.
- ✔ Increase the asset account called inventory.
- ✔ Lower the quantity of items on order (if you initially entered the information as a purchase order).
- ✔ Average the cost of inventory on hand.
- ✔ Increase the accounts payable account.

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Managing inventory and its value

After you record the receipt of inventory, you have the responsibility of managing the inventory you have on hand. You also must know the value of that inventory. You may think that as long as you know what you paid for the items, the value isn't difficult to calculate. Well, accountants can't let it be that simple, so there are actually four different ways to value inventory:

- ✔ **LIFO (last in, first out):** You assume that the last items put on the shelves (the newest items) are the first items to be sold. Retail stores that sell nonperishable items, such as tools, are likely to use this type of system. For example, when a hardware store gets new hammers, workers probably don't unload what's on the shelves and put the newest items in the back. Instead, the new tools are just put in the front, so they're likely to be sold first.
- ✔ **FIFO (first in, first out):** You assume that the first items put on the shelves (the oldest items) are sold first. Stores that sell perishable goods, such as food stores, use this inventory valuation method most often. For example, when new milk arrives at a store, the person stocking the shelves unloads the older milk, puts the new milk at the back of the shelf, and then puts the older milk in front. Each carton of milk (or other perishable item) has a date indicating the last day it can be sold, so food stores always try to sell the oldest stuff first, while it's still sellable.
- ✔ **Weighted average:** You average the cost of goods received, so there's no reason to worry about which items are sold first or last. This method of inventory is used most often in any retail or services environment where

prices are constantly fluctuating and the business owner finds that an average cost works best for managing the cost of goods sold.

- ✓ **Specific identification:** You maintain cost figures for each inventory item individually. Retail outlets that sell big-ticket items, such as cars, which often have a different set of extras on each item, use this type of inventory valuation method.



Accountants are big on consistency. After you choose an accounting method, you should stick with it. If your accounting method is the same each year, your financial results will be comparable year-to-year. A financial statement reader will be able to compare your results and notice trends. If you decide to change the method, you need to explain the reasons for the change in your financial statements. You also have to go back and show how the change in inventory method impacts your prior financial reporting.

Figuring out the best method for you

You may be wondering why it matters so much which inventory valuation method you use. The key to the choice is the impact on your bottom line as well as the taxes your company will pay.



The total cost of your inventory and the number of units purchased and sold are the same — regardless of whether you choose the FIFO, LIFO, or weighted average method (see the previous section for explanations of these methods). Also, if prices rise over time (which is normally the case), your newer inventory items will be more expensive. This analysis assumes that the three inventory methods use the same sale prices per unit. After all your inventory items are sold, your total profit will be the same for the three methods.

FIFO, because it assumes the oldest (and most likely the lowest-priced) items are sold first, results in a low cost of goods sold number. Because cost of goods sold is subtracted from sales to determine profit, a low cost of goods sold number produces a high profit. For more on cost of goods sold, see “Keeping Track of Inventory,” earlier in this chapter.

The opposite is true for LIFO, which uses cost figures based on the last price paid for the inventory (and most likely the highest price). Using the LIFO method, the cost of goods sold number is high, which means a larger sum is subtracted from sales to determine profit. Thus, the profit margin is low. The good news, however, is that the tax bill is low, too.

Rather than constantly dealing with the ups and downs of inventory costs, the weighted average method smooths out the numbers used to calculate a business’s profits. Cost of goods sold, taxes, and profit margins for this method fall between those of LIFO and FIFO. If you’re operating a business in which inventory prices are constantly going up and down, you should definitely choose this method.

Comparing the methods

To show you how much of an impact inventory valuation can have on profit margin, this section compares three of the most common methods: FIFO, LIFO, and weighted average (see the earlier section “Managing inventory and its value” for details on each). In this example, assume Company A bought the inventory in question at different prices on three different occasions. Beginning inventory is valued at \$500 (that’s 50 items at \$10 each).

Here’s the calculation for determining the number of items sold (see “Keeping Track of Inventory”):

$$\text{Beginning inventory} + \text{Purchases} = \text{Goods available for sale} - \text{Ending inventory} = \text{Items sold}$$

$$50 + 500 = 550 - 75 = 475$$

Here’s what the company paid to purchase the inventory:

<i>Date</i>	<i>Quantity</i>	<i>Unit Price</i>
April 1	150	\$10
April 15	150	\$25
April 30	200	\$30

Here’s an example of how you calculate the cost of goods sold by using the weighted average method:

<i>Account</i>	<i>Units and Dollar Amounts</i>	<i>Total</i>
Beginning inventory	50 units	\$500
Purchases	150 units @\$10	\$1,500
	150 units @\$25	\$3,750
	200 units @\$30	\$6,000
Total inventory	550 units	\$11,750
Average inventory cost	\$11,750 ÷ 550 units = \$21.36	
Cost of goods sold	475 units × \$21.36 = \$10,146	
Ending inventory	75 units @\$21.36 = \$1,602	

As mentioned earlier in the section “Keeping Track of Inventory,” your goods available for sale can end up in only two places: cost of goods sold or ending inventory. The total inventory listed in the previous table is also goods available for sale. Your total inventory (\$11,750) should equal the sum of cost of goods sold and ending inventory (\$10,146 + \$1,602 = \$11,748). The slight difference is due to rounding the weighted average cost per unit. Use this formula to check any inventory valuation method.

Here's an example of how you calculate the cost of goods sold by using the FIFO method. With this method, you assume that the first items received are the first ones sold, and because the first items received here are those in beginning inventory, this example starts with them:

Account	Units and Dollar Amounts	Total
Beginning inventory	50 units @\$10	\$500
Next in — April 1	150 units @\$10	\$1,500
Then — April 15	150 units @\$25	\$3,750
Then — April 30	125 units @\$30	<u>\$3,750</u>
Cost of goods sold	475 units	\$9,500
Ending inventory	75 units @\$30	\$2,250

Note: Only 125 of the 200 units purchased on April 30 are used in the FIFO method. Because this method assumes that the first items into inventory are the first items sold (or taken out of inventory), the first items used are those on April 1. Then the April 15 items are used, and finally the remaining needed items are taken from those bought on April 30. Because 200 were bought on April 30 and only 125 were needed, 75 of the items bought on April 30 are left in ending inventory.

Here's an example of how you calculate the cost of goods sold by using the LIFO method. With this method, you assume that the last items received are the first ones sold, and because the last items received were those purchased on April 30, this example starts with them:

Account	Units and Dollar Amounts	Total
April 30	200 units @\$30	\$6,000
Next — April 15	150 units @\$25	\$3,750
Then — April 1	125 units @\$10	<u>\$1,250</u>
Cost of goods sold	475 units	\$11,000
Ending inventory	75 units @\$10	\$750

Note: Because LIFO assumes the last items to arrive are sold first, the ending inventory includes the 25 remaining units from the April 1 purchase plus the 50 units in beginning inventory.

Here's how the use of inventory under the LIFO method impacts the company profits. The example assumes the items are sold to the customers for \$40 per unit, which means total sales of \$19,000 for the month (that's \$40 × 475 units sold). This example looks only at the *gross profit*, which is the profit from sales before considering expenses incurred for operating the company. See Book IV, Chapter 2 for information about the different profit types and what they mean. Gross profit is calculated with the following equation:

$$\text{Sales} - \text{Cost of goods sold} = \text{Gross profit}$$

Table 2-1 shows a comparison of gross profit for the three methods used in this example scenario.

<i>Income Statement Line Item</i>	<i>FIFO</i>	<i>LIFO</i>	<i>Weighted Average</i>
Sales	\$19,000	\$19,000	\$19,000
Cost of Goods Sold	\$9,500	\$11,000	\$10,146
Gross Profit	\$9,500	\$8,000	\$8,854

Looking at the comparisons of gross profit, you can see that inventory valuation can have a major impact on your bottom line. LIFO is likely to give you the lowest profit because the last inventory items bought are usually the most expensive. FIFO is likely to give you the highest profit because the first items bought are usually the cheapest. And the profit produced by the weighted average method is likely to fall somewhere between the two.

Keep in mind that all three inventory valuation methods generate the same total cost and total profit, when all the inventory items are sold, as explained earlier in this section.

Buying and Monitoring Supplies

In addition to inventory, all businesses must buy supplies that are used to operate the business, such as paper, pens, and paper clips. If the supply cost can't be directly traced to the manufacturing or purchase of goods or services for sale, the cost is immediately *expensed*.



Your best bet is to carefully track supplies that make a big dent in your budget with an individual account. For example, if you anticipate paper usage will be very high, monitor that usage with a separate account called “paper expenses.”

Many companies don't use the bookkeeping system to manage their supplies. Instead, they designate one or two people as office managers or supply managers and keep the number of accounts used for supplies to a minimum. Other businesses decide they want to monitor supplies by department or division and set up a supply account for each one. That puts the burden of monitoring supplies in the hands of the department or division managers.

Staying on Top of Your Bills

Eventually, you have to pay for both the inventory and the supplies you purchase for your business. In most cases, the bills are posted to the accounts payable account when they arrive, and they're paid when due. A large chunk of the cash paid out of your cash account (see Book VIII for more information on the cash account and handling cash) is in the form of the checks sent out to pay bills due in accounts payable, so you need to have careful controls over the five key functions of accounts payable:

- ✓ Entering the bills to be paid into the accounting system
- ✓ Preparing checks to pay the bills
- ✓ Signing checks to pay the bills
- ✓ Sending out payment checks to vendors
- ✓ Reconciling the checking account

As you pay bills, you need to take precautions to keep everyone honest and try to take advantage of any discounts vendors offer for early payment, as discussed in the following sections.

Segregating duties to prevent theft



Segregation of duties is the process of delegating different tasks to different people to prevent fraud. To segregate duties, assign one person to each of the following three roles:

- ✓ **Custodian:** An individual in your organization who has *physical custody* of assets, such as the checkbook and keys to the company warehouse.
- ✓ **Check signer:** The check signer has *authority* to access or move assets. When you write a check, you're moving cash.
- ✓ **Record keeper:** After the transaction is completed, the *record keeper* records the transaction in the accounting system.

In your business, the person who enters the bills to be paid into the system probably also prepares the payment checks, but someone else should do the other tasks. You should never allow the person who prepares the checks to review the bills to be paid and sign the checks, unless of course that person's you, the business owner.

Properly managing accounts payable can save your company a lot of money by avoiding late fees or interest and by taking advantage of discounts offered for paying early. If you're using a computerized accounting system, the bill due date and any discount information should be entered when you receive the inventory or supplies.

If you're working with a paper system rather than a computerized accounting system, you need to set up some way to be sure you don't miss bill due dates. Because an increasing number of businesses are using computerized systems, this book won't spend more time explaining the nuances of a paper system.

Taking advantage of discounts



In some cases, companies offer a discount to customers who pay their bills early. Assume a vendor gives you payment terms of "2% 10 Net 30." That means that if the bill is paid in 10 days, the vendor company can take a 2 percent discount; otherwise, the amount due must be paid in full in 30 days. In addition, many companies state that interest or late fees will be charged if a bill isn't paid in 30 days.

A firm has an amount due for the bill of \$1,000. If the company pays the bill in ten days, it can take a 2 percent discount, or \$20. That may not seem like much, but if your company buys \$100,000 of inventory and supplies in a month and each vendor offers a similar discount, you can save \$2,000. Over the course of a year, discounts on purchases can save your business a significant amount of money and improve your profits.

Chapter 3

Counting Your Sales

In This Chapter

- ▶ Taking in cash and offering in-store credit
 - ▶ Staying on top of discounts, returns, and allowances
 - ▶ Monitoring customer payments due
 - ▶ Dealing with bad debt
-

Every business loves to take in money, and that means bookkeepers have a lot to do to make sure sales are properly tracked and recorded in the books. In addition to recording the sales, you must track customer accounts, discounts offered to customers, and customer returns and allowances. Unfortunately, some customers never pay, in which case you must adjust the books to reflect nonpayment as a bad debt.

This chapter reviews the basic responsibilities that fall to a business's bookkeeping and accounting staff for tracking sales, making adjustments to those sales, monitoring customer accounts, and alerting management to slow- and no-paying customers.

Collecting on Cash Sales

Most businesses collect some form of cash as payment for the goods or services they sell. Cash receipts include more than just bills and coins; checks and credit cards also are considered cash sales for the purpose of bookkeeping. In fact, with electronic transaction processing, a deposit is usually made to the business's checking account the same day (sometimes within just seconds of the transaction, depending on the type of system the business sets up with the bank).



The only type of payment that doesn't fall under the umbrella of a cash payment is purchases made on *store credit* — credit offered to customers directly by your business rather than through a third party, such as a bank credit card or loan. See “Selling on Credit,” later in this chapter, for details.

Discovering the value of sales receipts

Businesses generate sales receipts in one of three ways: by the cash register, by the credit card machine, or by hand (written out by the salesperson). Whichever of these three methods you choose for your sales transactions, the sales receipt serves two purposes:

- ✓ Gives the customer proof that the item was purchased on a particular day at a particular price in your store, in case he needs to exchange or return the merchandise.
- ✓ Gives the store a receipt that can be used at a later time to enter the transaction into the company's books. At the end of the day, the receipts also are used to prove out the cash register and ensure that the cashier has taken in the right amount of cash based on the sales made.

You're probably familiar with cash receipts. To show you how much useable information can be generated on a sales receipt, here's a sample receipt from a sale at a bakery:

Sales Receipt 4/25/2015

<i>Item</i>	<i>Quantity</i>	<i>Price</i>	<i>Total</i>
White Serving Set	1	\$40	\$40
Cheesecake, Marble	1	20	20
Cheesecake, Blueberry	1	20	<u>20</u>
			80.00
Sales Tax @ 6%			<u>4.80</u>
			84.80
Cash Paid			<u>90.00</u>
Change			5.20

A look at a receipt, such as this one, tells you the amount of cash collected, the type of products sold, the quantity of products sold, and the amount of sales tax collected.

Your company may use some type of computerized system at the point of sale (usually the cash register) that's integrated into the company's accounting system. Sales information is collected throughout the day by the cash register. The automated system can post accounting entries to sales, sales tax collected, cash, inventory, and other accounts.

If you don't use a computerized system, you can post accounting entries manually, based on cash register activity. Here's what an entry in the cash receipts journal would look like for the receipt of cash:

	<i>Debit</i>	<i>Credit</i>
Cash in checking	\$84.80	
Sales		\$80.00
Sales tax collected		4.80
<i>Cash receipts for April 25, 2015</i>		

Here's an explanation of each line item in the receipts journal

- ✓ **Cash in checking**, an asset account on the balance sheet, is debited, which increases the asset account.
- ✓ **Sales** is a revenue account that's posted to the income statement. The credit to sales increases the revenue account.
- ✓ **Sales tax collected** is a liability account in the balance sheet. (See Book IV for more about balance sheets and income statements.) The credit to sales tax collected increases the liability account.

Note that total debits equal total credits (\$84.80). This is referred to as a *balanced entry*. Debits and credits are discussed in Book I, Chapter 2.



Businesses pay sales tax to state and local government entities either monthly or quarterly, depending on rules set by the states. Your business must hold the money owed in a liability account to be certain you're able to pay the taxes collected from customers when they're due.

Recording cash transactions in the books



If you're using a computerized accounting system, you can enter more detail from the day's receipts and track inventory sold as well. A standard sales receipt includes the following key pieces of information:

- ✓ Customer's name and address and perhaps the ID number you assign to that customer
- ✓ A description of the item(s) sold, along with the number or quantity sold
- ✓ Payment method; for example, cash, check, credit card, or debit
- ✓ The option to print the receipt or e-mail it to the client

In addition to the information included in the cash receipts journal, a computerized accounting system also collects information about the items sold in each transaction. The system then automatically updates inventory information, reducing the amount of inventory on hand as product is sold. When the inventory number falls below the reorder number you set (see Chapter 2), the accounting system alerts you to pass the word on to whoever is responsible for ordering more inventory.



If your company accepts credit cards, expect sales revenue to be reduced by the fees paid to credit card companies. You may face monthly fees as well as fees per transaction; however, each company sets up individual arrangements with its bank regarding these fees. Sales volume impacts how much you pay in fees, so when researching bank services, be sure to compare credit card transaction fees to find a good deal. A company records these fees in a credit card fee expense account.

Selling on Credit

Many businesses decide to sell to customers on *direct credit*, meaning credit offered by the business and not through a bank or credit card provider. This approach offers more flexibility in the type of terms you can offer your customers, and you don't have to pay bank fees. However, it involves more work for you, the bookkeeper, and more risk if a customer doesn't pay what he or she owes.



If you accept a customer's bank-issued credit card for a sale and the customer doesn't pay the bill, you get your money, and the bank is responsible for collecting from the customer and takes the loss if he or she doesn't pay. That's not the case if you decide to offer credit to your customers directly. If a customer doesn't pay, your business takes the loss.

Deciding whether to offer store credit

The decision to set up your own store credit system depends on what your competition is doing. For example, if you run an office supply store and all other office supply stores allow store credit to make it easier for their customers to get supplies, you probably need to offer store credit to stay competitive.



If you want to allow your customers to buy on store credit, the first thing you need to do is set up some ground rules. You have to decide

- ✔ How you plan to check a customer's credit history
- ✔ What the customer's income level needs to be to be approved for credit
- ✔ How long you give the customer to pay the bill before charging interest or late fees
- ✔ What maximum dollar amount you plan to give the customer as a credit limit

The harder you make it to get store credit and the stricter you make the bill-paying rules, the less chance you have of a taking a loss. However, you may lose customers to a competitor with less restrictive credit rules. Keep in mind that if you loosen your qualification criteria and bill-paying requirements, you have to carefully monitor your customer accounts to be sure they're not falling behind. The key risk you face is selling product for which you're never paid.

Recording store credit transactions in the books

When sales are made on store credit, you have to enter specific information into the accounting system. In addition to inputting information regarding cash receipts (see "Collecting on Cash Sales" earlier in this chapter), you update the customer accounts to be sure each customer is billed and the money is collected. You debit the accounts receivable account, an asset account shown on the balance sheet (see Book IV), which shows money due from customers.

Here's how a journal entry of a sale made on store credit looks:

	<i>Debit</i>	<i>Credit</i>
Accounts receivable	\$84.80	
Sales		\$80.00
Sales tax collected		4.80
<i>Cash receipts for April 25, 2015</i>		

In addition to making this journal entry, you enter the information into the customer's account so that accurate customer statements can be sent out at the end of the month. When the customer pays the bill, you update the individual customer's record to show that payment has been received and enter the following into the bookkeeping records:

	<i>Debit</i>	<i>Credit</i>
Cash	\$84.80	
Accounts receivable		\$84.80
<i>Payment from S. Smith on invoice 123.</i>		

You'll send the customer an *invoice* (a bill). You see in the previous table that S. Smith was sent invoice #123. Most of the information on the invoice is similar to the sales receipt form (see "Collecting on Cash Sales"), but the invoice also has space to enter a different address for shipping (the "ship to" field) and includes payment terms (the "terms" field).

An automated accounting system uses the information on the invoice form to update the following accounts:

- ✓ Accounts receivable
- ✓ Inventory
- ✓ The customer's account
- ✓ Sales tax collected

When the time comes to bill the customer at the end of the month, your accounting system can generate statements for all customers with outstanding invoices (unpaid bills). You can easily generate statements for specific customers or all customers on the books.

When you receive payment from a customer (as you do earlier in the chapter with the S. Smith invoice), here's what happens:

- 1. Accounts receivable is reduced by crediting.**
- 2. Cash is increased with a debit.**
- 3. The customer's individual account is updated to reflect the payment.**

If your company uses a point of sale program that's integrated into the computerized accounting system, recording store credit transactions is even easier for you. Sales details feed into the system as each sale is made, so you don't have to enter the detail at the end of day. These point of sale programs save a lot of time.

Even if customers don't buy on store credit, point of sale programs provide businesses with an incredible amount of information about their customers and what they like to buy. This data can be used in the future for direct marketing and special sales to increase return business.

Proving Out the Cash Register

To ensure that cashiers don't pocket a business's cash, at the end of each day, cashiers must *prove out* cash. This is a process to show that the cashier has the correct amount of cash in the register. The cash balance changes based on the sales transactions during the day. The balance is also affected by the amount of cash, checks, and charges that the cashier took in during the day.

This process of proving out a cash register actually starts at the end of the previous day, when cashier John Doe and his manager agree to the amount of cash left in John's register drawer. Cash sitting in cash registers or cash drawers is recorded as part of the cash on hand account.

When John comes to work the next morning, he starts out with the amount of cash left in the drawer. At the end of the business day, either he or his manager runs a summary of activity on the cash register for the day to produce a report of the total sales taken in by the cashier. John counts the amount of cash in his register as well as totals the checks, credit card receipts, and store credit charges. He then completes a cash-out form that looks something like this:

Cash Register: John Doe, 4/25/2015

Receipts	Sales	Total
Beginning cash		<u>\$100</u>
Cash sales	\$400	
Credit card sales	800	
Store credit sales	200	
Total sales		<u>1,400</u>
Sales on credit		<u>1,000</u>
Cash received		<u>400</u>
Total cash in register		<u>500</u>

A store manager reviews John Doe's cash register summary (produced by the actual register) and compares it to the cash-out form. If John's ending cash (the amount of cash remaining in the register) doesn't match the cash-out form, he and the manager try to pinpoint the mistake. If they can't find a mistake, they fill out a cash-overflow or cash-shortage form. Some businesses charge the cashier directly for any shortages; others take the position that the cashier's fired after a certain number of shortages of a certain dollar amount (say, three shortages of more than \$10). Most companies post cash shortages to a shortage expense account.

The store manager decides how much cash to leave in the cash drawer or register for the next day and deposits the remainder. He does this task for each of his cashiers and then deposits all the cash and checks from the day in a night deposit box at the bank. He sends a report with details of the deposit to the bookkeeper so that the data makes it into the accounting system. The bookkeeper enters the data on the cash receipts form (see the previous table) if a computerized accounting system is being used or into the cash receipts journal if the books are being kept manually.

Tracking Sales Discounts

Most businesses offer discounts at some point in order to generate more sales. Discounts are usually in the form of a sale with 10 percent, 20 percent, or even more off purchase price.

When you offer discounts to customers, it's a good idea to track your sales discounts in a separate account so you can keep an eye on how much you discount sales in each month. If you find you're losing more and more money to discounting, look closely at your pricing structure and competition to find out why it's necessary to frequently lower your prices in order to make sales. You can track discount information very easily by using the data found on a standard sales register receipt. The following receipt from a bakery includes sales discount details.

Sales Receipt 4/25/2015

<i>Item</i>	<i>Quantity</i>	<i>Price</i>	<i>Total</i>
White Serving Set	1	\$40	\$40
Cheesecake, Marble	1	20	20
Cheesecake, Blueberry	1	20	<u>20</u>
			80.00
Sales Discount @ 10%		<u>(8.00)</u>	
			72.00
Sales Tax @ 6%		<u>4.32</u>	
			76.32
Cash Paid		<u>80.00</u>	
Change		3.68	

From this example, you can see clearly that the stores take in less cash when discounts are offered. When recording the sale in the cash receipts journal, you record the discount as a debit. This debit increases the sales discount account, which is subtracted from the sales account to calculate the net

sales. (Book IV, Chapter 2 walks you through all these steps and calculations as it discusses preparing the income statement.) Here's the bakery's entry for this particular sale in the cash receipts journal:

	<i>Debit</i>	<i>Credit</i>
Cash in checking	\$76.32	
Sales discounts	8.00	
Sales		\$80.00
Sales tax collected		4.32
<i>Cash receipts for April 25, 2015</i>		



If you use a computerized accounting system, add the sales discount as a line item on the sales receipt or invoice, and the system automatically adjusts the sales figures and updates your sales discount account.

Book II

Recording
Accounting
Transactions

Recording Sales Returns and Allowances

Most stores deal with *sales returns* on a regular basis. Instituting a no-return policy is guaranteed to produce unhappy customers, so to maintain good customer relations; you should generally allow sales returns.

Sales allowances (sales incentive programs) are becoming more popular with businesses. Sales allowances are most often in the form of a gift card. A gift card that's sold is actually a liability for the company because the company has received cash, but no merchandise has gone out. For that reason, gift card sales are entered in a gift card liability account.

When a customer makes a purchase at a later date by using the gift card, the gift card liability account is reduced (debited) and inventory is also reduced (with a credit). Monitoring the gift card liability account allows businesses to keep track of how much is yet to be sold without receiving additional cash.

Accepting sales returns can be a more complicated process than accepting sales allowances. Usually, a business posts a set of rules for returns that may include:

- ✓ Returns will be allowed within only 30 days of purchase.
- ✓ You must have a receipt to return an item.
- ✓ If you return an item without a receipt, you can receive only store credit.



You can set whatever rules you want for returns. For internal control purposes, the key to returns is monitoring how your staff handles them. In most cases, you should require a manager's approval on returns. Also, be sure your staff pays close attention to how the customer originally paid for the item being returned. You certainly don't want to give a customer cash if she paid on store credit — that's just handing over your money! After a return's approved, the cashier returns the amount paid by either cash or credit card. Customers who bought the items on store credit don't get any money back. That's because they didn't pay anything when they purchased the item, but expected to be billed later. Instead, a form is filled out so that the amount of the original purchase can be subtracted from the customer's store credit account.

You use the information collected by the cashier who handled the return to input the sales return data into the books. For example, a customer returns a \$40 item that was purchased with cash. You record the cash refund in the cash receipts journal like this:

	<i>Debit</i>	<i>Credit</i>
Sales returns and allowances	\$40.00	
Sales tax collected @ 6%	2.40	
Cash in checking		\$42.40
<i>To record return of purchase, 4/30/2015.</i>		



If the item had been bought with a discount, you'd list the discount as well and adjust the price to show that discount.

In this journal entry,

- ✓ The sales returns and allowances account increases. This account normally carries a debit balance and is subtracted from sales when preparing the income statement, thereby reducing revenue received from customers.
- ✓ The debit to the sales tax collected account reduces the amount in that account because sales tax is no longer due on the purchase.
- ✓ The credit to the cash in checking account reduces the amount of cash.

Monitoring Accounts Receivable

Making sure customers pay their bills is a crucial responsibility of the bookkeeper. Before sending out the monthly bills, you should prepare an *aging summary report* that lists all customers who owe money to the company and how old each debt is.

If you keep the books manually, you collect the necessary information from each customer account. If you keep the books in a computerized accounting system, you can generate this report automatically. Either way, your aging summary report should look similar to this example report from a bakery:

Aging Summary — As of April 30, 2015

<i>Customer</i>	<i>Current</i>	<i>31–60 Days</i>	<i>61–90 Days</i>	<i>>90 Days</i>
S. Smith	\$84.32	\$46.15		
J. Doe			\$65.78	
H. Harris	89.54			
M. Man				\$125.35
Totals	173.86	46.15	65.78	125.35

The aging summary quickly tells you which customers are behind in their bills. In this example, customers are cut off from future purchases when their payments are more than 60 days late, so J. Doe and M. Man aren't able to buy on store credit until their bills are paid in full.



Give a copy of your aging summary to the sales manager so he can alert staff to problem customers. He can also arrange for the appropriate collections procedures. Each business sets up its own collections process, but usually it starts with a phone call, followed by letters, and possibly even legal action, if necessary.

Accepting Your Losses

You may encounter a situation in which a customer never pays your business, even after an aggressive collections process. In this case, you have no choice but to write off the purchase as a *bad debt* and accept the loss.

Most businesses review their aging reports monthly and decide which accounts need to be written off as bad debt. Accounts written off are tracked in a general ledger account called *bad debt*. (See Book I, Chapter 3 for more

information about the general ledger.) The bad debt account appears as an expense account on the income statement. When you write off a customer's account as bad debt, the bad debt account increases (debit), and the accounts receivable account decreases (credit).

To give you an idea of how you write off an account, assume that one of your customers never pays the \$105.75 due. Here's what your journal entry looks like:

	<i>Debit</i>	<i>Credit</i>
Bad debt	\$105.75	
Accounts receivable		\$105.75

In a computerized accounting system, you enter the information by using a customer payment form and allocating the amount due to the bad debt expense account. Finally, make a note of the bad debt on each customer's individual account. Going forward, you'll know which customers didn't pay an invoice. That information will help you make a decision about doing business with the customer going forward.

Chapter 4

Processing Employee Payroll and Benefits

In This Chapter

- ▶ Hiring employees
 - ▶ Collecting and depositing employee taxes
 - ▶ Keeping track of benefits
 - ▶ Preparing and recording payroll
-

Unless your business has only one employee (you, the owner), you'll most likely hire employees, and that means you'll have to pay them, offer benefits, and manage a payroll.

Responsibilities for hiring and paying employees usually are shared among the human resources staff and the bookkeeping staff. As the bookkeeper, you must be sure that all government tax-related forms are completed and handle all payroll responsibilities including paying employees, collecting and paying employee taxes, collecting and managing employee benefit contributions, and paying benefit providers. This chapter examines the various employee staffing issues that bookkeepers need to be able to manage.

Staffing Your Business

After you decide that you want to hire employees for your business, you must be ready to deal with a lot of government paperwork. In addition to paperwork, you face many decisions about how employees will be compensated and who will be responsible for maintaining the paperwork required by state, local, and federal government entities.

Knowing what needs to be done to satisfy government bureaucracies isn't the only issue you must consider before hiring your first employee; you also must decide how frequently you'll pay employees and what type of wage and salary scales you want to set up.

Completing government forms

Even before you sign your first employee, you need to start filing government forms related to hiring. If you plan to hire staff, you must first apply for an *Employer Identification Number*, or EIN. Government entities use this number to track your employees, the money you pay them, and any taxes collected and paid on their behalf.

Before employees start working for you, they must fill out forms including the W-4 (tax withholding form), I-9 (citizenship verification form), and W-5 (for employees eligible for the Earned Income Credit). The following sections explain each of these forms as well as the EIN.

Employer Identification Number (EIN)

Every company must have an EIN to hire employees. If your company is incorporated (see Book VI, Chapter 2 for the lowdown on corporations and other business types), which means you've filed paperwork with the state and become a separate legal entity, you already have an EIN. Otherwise, to get an EIN you must complete and submit Form SS-4, which you can see in Figure 4-1.



Luckily, the government offers four ways to submit the necessary information and obtain an EIN. The fastest way is to call the IRS's Business & Specialty Tax Line at 800-829-4933 and complete the form by telephone. IRS officials assign your EIN over the telephone. You can also apply online at www.irs.gov, or you can download Form SS-4 at www.irs.gov/pub/irs-pdf/fss4.pdf and submit it by fax or by mail.

In addition to tracking pay and taxes, state entities use the EIN number to track the payment of unemployment taxes and workers' compensation taxes, both of which the employer must pay (see Chapter 5 for details).

W-4

Every person you hire must fill out a W-4 form called the "Employee's Withholding Allowance Certificate." You've probably filled out a W-4 at least once in your life, if you've ever worked for someone else. You can download this form and make copies for your employees at www.irs.gov/pub/irs-pdf/fw4.pdf.

This form, shown in Figure 4-2, tells you, the employer, how much to take out of your employees' paychecks in income taxes. On the W-4, employees indicate whether they're married or single. They can also claim additional allowances if they have children or other major deductions that can reduce their tax bills. The amount of income taxes you need to take out of each employee's check depends upon how many allowances he or she claimed on the W-4.

Figure 4-1:
You must file IRS Form SS-4 to get an Employer Identification Number before hiring employees.

Form SS-4 (Rev. January 2010) Department of the Treasury Internal Revenue Service		Application for Employer Identification Number (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ See separate instructions for each line. ▶ Keep a copy for your records.		OMB No. 1545-0003 EIN	
Type or print clearly.	1 Legal name of entity (or individual) for whom the EIN is being requested				
	2 Trade name of business (if different from name on line 1)		3 Executor, administrator, trustee, "care of" name		
	4a Mailing address (room, apt., suite no. and street, or P.O. box)		5a Street address (if different) (Do not enter a P.O. box.)		
	4b City, state, and ZIP code (if foreign, see instructions)		5b City, state, and ZIP code (if foreign, see instructions)		
	6 County and state where principal business is located				
	7a Name of responsible party			7b SSN, ITIN, or EIN	
	8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? <input type="checkbox"/> Yes <input type="checkbox"/> No			8b If 8a is "Yes," enter the number of LLC members ▶	
	8c If 8a is "Yes," was the LLC organized in the United States? <input type="checkbox"/> Yes <input type="checkbox"/> No				
	9a Type of entity (check only one box). Caution. If 8a is "Yes," see the instructions for the correct box to check.				
	<input type="checkbox"/> Sole proprietor (SSN) _____ <input type="checkbox"/> Estate (SSN of decedent) _____ <input type="checkbox"/> Partnership <input type="checkbox"/> Plan administrator (TIN) _____ <input type="checkbox"/> Corporation (enter form number to be filed) ▶ _____ <input type="checkbox"/> Trust (TIN of grantor) _____ <input type="checkbox"/> Personal service corporation <input type="checkbox"/> National Guard <input type="checkbox"/> State/local government <input type="checkbox"/> Church or church-controlled organization <input type="checkbox"/> Farmers' cooperative <input type="checkbox"/> Federal government/military <input type="checkbox"/> Other nonprofit organization (specify) ▶ _____ <input type="checkbox"/> REMIC <input type="checkbox"/> Indian tribal governments/enterprises <input type="checkbox"/> Other (specify) ▶ _____ <input type="checkbox"/> Group Exemption Number (GEN) if any ▶ _____				
9b If a corporation, name the state or foreign country (if applicable) where incorporated		State	Foreign country		
10 Reason for applying (check only one box)					
<input type="checkbox"/> Started new business (specify type) ▶ _____ <input type="checkbox"/> Banking purpose (specify purpose) ▶ _____ <input type="checkbox"/> Changed type of organization (specify new type) ▶ _____ <input type="checkbox"/> Purchased going business <input type="checkbox"/> Hired employees (Check the box and see line 13.) <input type="checkbox"/> Created a trust (specify type) ▶ _____ <input type="checkbox"/> Compliance with IRS withholding regulations <input type="checkbox"/> Created a pension plan (specify type) ▶ _____ <input type="checkbox"/> Other (specify) ▶ _____					
11 Date business started or acquired (month, day, year). See instructions.			12 Closing month of accounting year		
13 Highest number of employees expected in the next 12 months (enter -0- if none). If no employees expected, skip line 14.			14 If you expect your employment tax liability to be \$1,000 or less in a full calendar year and want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be \$1,000 or less if you expect to pay \$4,000 or less in total wages.) If you do not check this box, you must file Form 941 for every quarter. <input type="checkbox"/>		
Agricultural			Household		
Other					
15 First date wages or annuities were paid (month, day, year). Note. If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) ▶					
16 Check one box that best describes the principal activity of your business.					
<input type="checkbox"/> Construction <input type="checkbox"/> Rental & leasing <input type="checkbox"/> Transportation & warehousing <input type="checkbox"/> Health care & social assistance <input type="checkbox"/> Wholesale-agent/broker <input type="checkbox"/> Real estate <input type="checkbox"/> Manufacturing <input type="checkbox"/> Finance & insurance <input type="checkbox"/> Accommodation & food service <input type="checkbox"/> Wholesale-other <input type="checkbox"/> Retail <input type="checkbox"/> Other (specify)					
17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.					
18 Has the applicant entity shown on line 1 ever applied for and received an EIN? <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," write previous EIN here ▶					
Third Party Designee	Complete this section only if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.				
	Designee's name		Designee's telephone number (include area code)		
Address and ZIP code		Designee's fax number (include area code)			
Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.				Applicant's telephone number (include area code)	
Name and title (type or print clearly) ▶				()	
Signature ▶				Applicant's fax number (include area code)	
Date ▶				()	
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form SS-4 (Rev. 1-2010)					

Figure 4-2:
 IRS Form
 W-4
 should be
 completed
 by all
 employees
 when
 they're hired
 so that you
 know how
 much to
 take out
 of their
 paychecks
 for taxes.

Separate here and give Form W-4 to your employer. Keep the top part for your records.

Form W-4 Department of the Treasury Internal Revenue Service		Employee's Withholding Allowance Certificate		OMB No. 1545-0074 2013
► Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.				
1 Your first name and middle initial		Last name		2 Your social security number
Home address (number and street or rural route)			3 <input type="checkbox"/> Single <input type="checkbox"/> Married <input type="checkbox"/> Married, but withhold at higher Single rate. <small>Note. If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.</small>	
City or town, state, and ZIP code			4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. <input type="checkbox"/>	
5 Total number of allowances you are claiming (from line H above or from the applicable worksheet on page 2)				5
6 Additional amount, if any, you want withheld from each paycheck				6 \$
7 I claim exemption from withholding for 2013, and I certify that I meet both of the following conditions for exemption. • Last year I had a right to a refund of all federal income tax withheld because I had no tax liability, and • This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here <input type="checkbox"/> 7				
<small>Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.</small>				
Employee's signature <small>(This form is not valid unless you sign it.) ►</small>				Date ►
8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)			9 Office code (optional)	10 Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10220Q Form **W-4** (2013)

Courtesy of IRS



It's a good idea to ask an employee to fill out a W-4 immediately, but you can allow the employee to take the form home if he or she wants to discuss allowances with a spouse or an accountant. If an employee doesn't complete a W-4, you must take income taxes out of his or her check based on the highest possible amount for that person. See "Collecting Employee Taxes" later in this chapter.

An employee can always fill out a new W-4 to reflect life changes that impact the tax deduction. For example, if the employee was single when he started working for you and gets married a year later, he can fill out a new W-4 and claim his spouse, lowering the amount of taxes that must be deducted from his check. Another common life change that can reduce an employee's tax deduction is the birth or adoption of a child.

I-9

All employers in the United States must verify that any person they intend to hire is a U.S. citizen or has the right to work in the United States. As an employer, you verify this information by completing and keeping on file an I-9 form from U.S. Citizenship and Immigration Services (USCIS). The new hire fills out Section 1 of the form by providing information, including name and address, birth history, Social Security number, and U.S. Citizenship or work permit.

You fill out Section 2, which requires you to check for documents that establish identity and prove employment eligibility. Workers can provide a driver's license; a military ID, student ID, or official state ID; or a Social Security card, birth certificate, or U.S. passport. Instructions provided with the form list all acceptable documents you can use to verify work eligibility. You must complete Section 2 of the I-9; making copies of the employment eligibility documents (IDs) for your files isn't enough.

Figure 4-3 shows a sample I-9 form. You can download the form and its instructions from the U.S. Citizenship and Immigration Services website at www.uscis.gov/files/form/i-9.pdf.

Section 2. Employer or Authorized Representative Review and Verification			
<p><i>(Employers or their authorized representative must complete and sign Section 2 within 3 business days of the employee's first day of employment. You must physically examine one document from List A OR examine a combination of one document from List B and one document from List C as listed on the "Lists of Acceptable Documents" on the next page of this form. For each document you review, record the following information: document title, issuing authority, document number, and expiration date, if any.)</i></p>			
Employee Last Name, First Name and Middle Initial from Section 1:			
List A Identity and Employment Authorization	OR	List B Identity	AND
			List C Employment Authorization
Document Title:		Document Title:	Document Title:
Issuing Authority:		Issuing Authority:	Issuing Authority:
Document Number:		Document Number:	Document Number:
Expiration Date (if any)(mm/dd/yyyy):		Expiration Date (if any)(mm/dd/yyyy):	Expiration Date (if any)(mm/dd/yyyy):
Document Title:			
Issuing Authority:			
Document Number:			
Expiration Date (if any)(mm/dd/yyyy):			
Document Title:			
Issuing Authority:			
Document Number:			
Expiration Date (if any)(mm/dd/yyyy):			
			3-D Barcode Do Not Write in This Space
Certification			
I attest, under penalty of perjury, that (1) I have examined the document(s) presented by the above-named employee, (2) the above-listed document(s) appear to be genuine and to relate to the employee named, and (3) to the best of my knowledge the employee is authorized to work in the United States.			
The employee's first day of employment (mm/dd/yyyy): _____ (See instructions for exemptions.)			
Signature of Employer or Authorized Representative		Date (mm/dd/yyyy)	Title of Employer or Authorized Representative
Last Name (Family Name)		First Name (Given Name)	Employer's Business or Organization Name
Employer's Business or Organization Address (Street Number and Name)		City or Town	State Zip Code
Section 3. Reverification and Rehires (To be completed and signed by employer or authorized representative.)			
A. New Name (if applicable) Last Name (Family Name) First Name (Given Name)		Middle Initial	B. Date of Rehire (if applicable) (mm/dd/yyyy):
C. If employee's previous grant of employment authorization has expired, provide the information for the document from List A or List C the employee presented that establishes current employment authorization in the space provided below.			
Document Title:	Document Number:	Expiration Date (if any)(mm/dd/yyyy):	
I attest, under penalty of perjury, that to the best of my knowledge, this employee is authorized to work in the United States, and if the employee presented document(s), the document(s) I have examined appear to be genuine and to relate to the individual.			
Signature of Employer or Authorized Representative:		Date (mm/dd/yyyy):	Print Name of Employer or Authorized Representative:

Figure 4-3:
U.S. employers must verify a new hire's eligibility to work in the United States by completing Form I-9.

W-5

Some employees you hire may be eligible for the Earned Income Credit (EIC), which is a tax credit that refunds some of the money the employee would otherwise pay in taxes, such as Social Security or Medicare. In order to get this credit, the employee must have a child and meet other income qualifications that are detailed on the form's instructions.

The government started the EIC credit, which reduces the amount of tax owed, to help lower-income people offset increases in living expenses and Social Security taxes. Having an employee complete Form W-5 allows you to advance the expected savings of the EIC to the employee on his paycheck each pay period rather than make him wait to get the money back at the end of the year after filing tax forms. The advance amount isn't considered income, so you don't need to take out taxes on this amount.

As an employer, you aren't required to verify an employee's eligibility for the EIC tax credit. The eligible employee must complete a W-5 each year to indicate that he still qualifies for the credit. If the employee doesn't file the form with you, you can't advance any money to the employee. If an employee qualifies for the EIC, you calculate his paycheck the same as you would any other employee's paycheck, deducting all necessary taxes to get the employee's net pay. Then you add back in the EIC advance credit that's allowed.

Any advance money you pay to the employee can be subtracted from the employee taxes you owe to the government. For example, if you've taken out \$10,000 from employees' checks to pay their income, Social Security taxes, and Medicare taxes and then returned \$500 to employees who qualified for the EIC, you subtract that \$500 from the \$10,000 and pay the government only \$9,500.

You can find out more about form W-5 and its instructions at www.irs.gov.

Picking pay periods

Deciding how frequently you'll pay employees is an important point to work out before hiring staff. Most businesses choose one or more of these four pay periods:

- ✓ **Weekly:** Employees are paid every week, and payroll must be done 52 times a year.
- ✓ **Biweekly:** Employees are paid every two weeks, and payroll must be done 26 times a year.
- ✓ **Semimonthly:** Employees are paid twice a month, commonly on the 15th and last day of the month, and payroll must be done 24 times a year.
- ✓ **Monthly:** Employees are paid once a month, and payroll must be done 12 times a year.

You can choose to use any of these pay periods, and you may even decide to use more than one type. For example, some companies pay hourly employees (employees paid by the hour) weekly or biweekly and pay salaried employees (employees paid by a set salary regardless of how many hours they work) semimonthly or monthly. Whatever your choice, decide on a consistent pay period policy and be sure to make it clear to employees when they're hired.



For each employee who's paid hourly, you need to have some sort of time sheet to keep track of work hours. These time sheets are usually completed by the employees and approved by their managers. Completed and approved time sheets are then sent to the bookkeeper so that checks can be calculated based on the exact number of hours worked.

Determining wage and salary types

You have a lot of leeway regarding the level of wages and salary you pay your employees, but you still have to follow the rules laid out by the U.S. Department of Labor. When deciding on wages and salaries, you have to first categorize your employees. Employees fall into one of two categories:

- ✓ **Exempt employees** are exempt from the Fair Labor Standards Act (FLSA), which sets rules for minimum wage, equal pay, overtime pay, and child labor laws. Executives, administrative personnel, managers, professionals, computer specialists, and outside salespeople can all be exempt employees. They're normally paid a certain amount per pay period with no connection to the number of hours worked. Often, exempt employees work well over 40 hours per week without extra pay.
- ✓ **Nonexempt employees** must be hired according to rules of the FLSA, meaning that companies within certain parameters must pay a minimum hourly wage. Any nonexempt employee who works more than 40 hours in a seven-day period must be paid a higher hourly rate for the additional hours worked, often called *overtime*. Minimum wage doesn't have to be paid in cash. The employer can pay some or all of the wage in room and board provided it doesn't make a profit on any noncash payments. Also, the employer can't charge the employee to use its facilities if the employee's use of a facility is primarily for the employer's benefit. For details about who can be designated an exempt employee, visit the U.S. Department of Labor's website at www.dol.gov.



Federal and state minimum wage laws change over time, so be sure to check with your state department of labor to be certain you're meeting the wage guidelines.



If you plan to hire employees who are under the age of 18, pay attention to child labor laws. Federal and state laws restrict what kind of work children can do, when they can do it, and how old they have to be to do it, so be sure you become familiar with the laws before hiring employees who are younger than 18. For minors below the age of 16, work restrictions are even tighter than for teens aged 16 and 17. (You can hire your own child without worrying about these restrictions.)



You can get a good summary of all labor laws at the Business Owner's Toolkit online at www.toolkit.cch.com/text/p05_4037.asp.

Collecting Employee Taxes

In addition to following wage and salary guidelines set for your business, when calculating payroll, you, the bookkeeper, must also be familiar with how to calculate the employee taxes that must be deducted from each employee's paycheck. These taxes include Social Security; Medicare; and federal, state, and local withholding taxes.

Sorting out Social Security tax

Employers and employees share the Social Security tax equally: Each must pay a certain percentage of her income toward Social Security up to a specified cap per year per person. The amount an employee earns above the cap may not be subject to Social Security tax. The federal government adjusts the cap each year based on salary level changes in the marketplace. Essentially, the cap gradually increases as salaries increase.

The calculation for Social Security taxes is relatively simple. For example, for an employee who makes \$1,000 per pay period, assuming a rate of 6.2 percent for Social Security, you calculate Social Security tax this way:

$$\$1,000 \times 0.062 = \$62$$

The bookkeeper deducts \$62 from this employee's gross pay, and the company also pays the employer's share of \$62. Thus, the total amount submitted in Social Security taxes for this employee is \$124.

Making sense of Medicare tax

Employees and employers also share Medicare taxes. However, unlike Social Security taxes, the federal government places no cap on the amount that must be paid in Medicare taxes. So even if someone makes \$1 million per

year, the Medicare tax percentage is calculated for each pay period and paid by both the employee and the employer. Here's an example of how you calculate the Medicare tax for an employee who makes \$1,000 per pay period, assuming a Medicare tax rate of 1.45 percent:

$$\$1,000 \times 0.0145 = \$14.50$$

The bookkeeper deducts \$14.50 from this employee's gross pay, and the company also pays the employer's share of \$14.50. Thus, the total amount submitted in Medicare taxes for this employee is \$29.

Figuring out federal withholding tax



To avoid dealing with nearly all withholdings from pay, you can hire a payroll company to handle the task. ADP and Paychex are two large providers of payroll services. You may find that the rate you pay an outside company is far less than the time and expense of performing this task yourself.

For bookkeepers and accountants, deducting federal withholding taxes is a much more complex task than deducting Social Security or Medicare taxes. You not only have to worry about an employee's tax rate, but also must consider the number of withholding allowances the employee claimed on her W-4 and whether the employee is married or single. Generally speaking, the first so many thousands of dollars are taxed at one low rate. As an individual or couple earns more, that income may bump them into higher tax brackets, meaning that extra income gets taxed at a higher rate.

Trying to figure out taxes separately for each employee based on his or her tax rate and number of allowances would be an extremely time-consuming task, but luckily, you don't have to do that. The IRS publishes tax tables in Publication 15, "Employer's Tax Guide," that let you just look up an employee's tax obligation based on the taxable salary and withholdings. You can access the IRS Employer's Tax Guide online at www.irs.gov/publications/p15/index.html. You can find tables for calculating withholding taxes at www.irs.gov/publications/p15/ar03.html.

The IRS's tax tables give you detailed numbers for levels of withholding allowances. Table 4-1 shows a sample tax table with only seven allowances because of space limitations. But even with seven allowances, you get the idea — just match the employee's wage range with the number of allowances he or she claims, and the box where they meet contains the amount of that employee's tax obligation. For example, if you're preparing a paycheck for an employee whose taxable income is \$1,000 per pay period, and he claims three withholding allowances — one for himself, one for his wife, and one for his child — then the amount of federal income taxes you deduct from his pay is \$106.

<i>If Wages Are:</i>		<i>And the Number of Allowances Claimed Is:</i>						
<i>At Least</i>	<i>But Less Than</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>
\$1,000	\$1,010	\$144	\$125	\$106	\$91	\$80	\$68	\$57
1,010	1,020	146	127	109	92	81	70	59
1,020	1,030	149	130	111	94	83	71	60

Settling up state and local withholding taxes

In addition to the federal government, most states have income taxes, and some counties and cities even have local income taxes. You can find all state tax rates and forms online at www.payroll-taxes.com. If your state, county, or city has income taxes, they need to be taken out of each employee's paycheck.

Determining Net Pay

Net pay (commonly referred to as *take-home pay*) is the amount a person is paid after subtracting all tax and benefit deductions.

After you figure out all the necessary taxes to be deducted from an employee's paycheck, you can calculate the check amount. Here's the equation and an example of how you calculate the net pay amount:

$$\text{Gross pay} - (\text{Social Security} + \text{Medicare} + \text{Federal withholding tax} + \text{State withholding tax} + \text{Local withholding tax} + \text{Benefit deductions}) = \text{Net pay}$$

$$1,000 - (62 + 14.50 + 106 + 45 + 0 + 0) = 772.50$$



Many businesses offer their employees health, retirement, and other benefits but expect the employees to share a portion of those costs. The fact that some of these benefits are tax deductible and some aren't makes a difference in when you deduct the benefit costs. If an employee's benefits are tax deductible and taken out of the check *before* federal withholding taxes are calculated, the federal tax rate may be lower than if the benefits are deducted *after* calculating federal withholding taxes. Many states follow the federal government's lead on tax-deductible benefits, so the amount deducted for state taxes will be lower as well.

Surveying Your Benefits Options

Benefits include programs that you provide your employees to better their lives, such as health insurance and retirement savings opportunities. Some benefits are tax-exempt, which means that the employee isn't taxed for them. However, some benefits are taxable, so the employee has to pay taxes on the money or the value of the benefits received. This section reviews the different tax-exempt and taxable benefits you can offer your employees.

Tax-exempt benefits

Some benefits are *tax-exempt* (not taxed). In some cases, healthcare and retirement benefits are tax-exempt. You may have a flexible spending plan at work, for example. Your company provides tax-exempt payments that you can use to pay for medical expenses. In fact, accident and health benefits and retirement benefits make up the largest share of employers' pay toward employees' benefits. If the benefits are tax-exempt, anything an employee pays toward them is deducted from the gross pay, so the employee doesn't have to pay taxes on that part of his salary or wage. The rules change frequently, so check with a tax advisor.

For example, if an employee's share of tax-exempt health insurance is \$50 per pay period and he makes \$1,000 per pay period, his taxable income is actually \$1,000 minus the \$50 health insurance premium contribution, or \$950. As the bookkeeper, you calculate taxes in this situation on \$950 rather than \$1,000.

Employee contributions to the retirement plan you offer may be tax deductible, too. Here's an example, assuming the tax deduction is allowed: If an employee contributes \$50 per pay period to your company's 401(k) retirement plan, that \$50 can also be subtracted from the employee's gross pay before you calculate net pay. So if an employee contributes \$50 to health insurance and \$50 to retirement, the \$1,000 taxable pay is reduced to only \$900 taxable pay.

You can offer a myriad of other benefits to employees, as well, including:

- ✓ **Adoption assistance:** You can provide up to a certain cap per child that an employee plans to adopt without having to include that amount in taxable gross income. The value of this benefit must be included when calculating Social Security and Medicare taxes, however.
- ✓ **Athletic facilities:** You can offer your employees the use of a gym on premises your company owns or leases without having to include the value of the gym facilities in gross pay. In order for this benefit to qualify as tax-exempt, the facility must be operated by the company primarily for the use of employees, their spouses, and their dependent children.

- ✔ **Dependent care assistance:** You can help your employees with dependent care expenses, which can include children and elderly parents, provided you offer the benefit in order to make it possible for the employee to work.
- ✔ **Education assistance:** You can pay employees' educational expenses up to a certain amount without having to include that payment in gross income.
- ✔ **Employee discounts:** You can offer employees discounts on the company's products without including the value of the discounts in their gross pay, provided the discount isn't more than 20 percent less than what's charged to customers.
- ✔ **Group term life insurance:** You can provide group term life insurance up to a specified coverage level to your employees without including the value of this insurance in their gross pay. Premiums for coverage above the cap may be added to calculations for Social Security and Medicare taxes.
- ✔ **Meals:** Meals that have little value (such as coffee and doughnuts) don't have to be reported as taxable income. Also, occasional meals brought in so employees can work late don't have to be reported in employees' income.
- ✔ **Moving expense reimbursements:** If you pay moving expenses for employees, you don't have to report these reimbursements as employee income as long as the reimbursements are for items that would qualify as tax-deductible moving expenses on an employee's individual tax return. Employees who have been reimbursed by their employers can't deduct the moving expenses for which the employer paid.

Again, check with a tax professional on the deductibility and taxability of these benefits.

Taxable benefits

You may decide to provide some benefits that are taxable. These benefits may include the personal use of a company automobile, life insurance premiums for coverage over the cap, and benefits that exceed allowable maximums.

Dealing with cafeteria plans

Cafeteria plans are benefit plans that offer employees a choice of benefits based on cost. Employees can pick and choose from those benefits and put together a benefit package that works best for them within the established cost structure.

Cafeteria plans are becoming more popular among larger businesses, but not all employers decide to offer their benefits this way. Managing a cafeteria plan can be much more time consuming for the bookkeeping and human resources staff. Many small businesses that offer a cafeteria plan for benefits do so by outsourcing benefit management services to an outside company that specializes in managing cafeteria plans.

For example, a company tells its employees that it will pay up to \$5,000 in benefits per year and values its benefit offerings this way:

Health insurance	\$4,600
Retirement	1,200
Child care	1,200
Life insurance	800

Joe, an employee, then picks from the list of benefits until he reaches \$5,000. If Joe wants more than \$5,000 in benefits, he pays for the additional benefits with a reduction in his paycheck.

The list of possible benefits could be considerably longer, but in this case, if Joe chooses health insurance, retirement, and life insurance, the total cost is \$6,600. Because the company pays up to \$5,000, Joe needs to copay \$1,600, a portion of which is taken out in each paycheck. If Joe gets paid every two weeks for a total of 26 paychecks per year, the deduction for benefits from his gross pay (with rounding) is \$61.54 ($\$1,600 \div 26$).

Preparing Payroll and Posting It in the Books

When you know the details about your employees' withholding allowances and their benefit costs, you can then calculate the final payroll and post it to the books.

Calculating payroll for hourly employees

When you're ready to prepare payroll for nonexempt (hourly) employees, the first thing you need to do is collect time records from each person who is paid hourly. Some companies use time clocks, and some use time sheets

to produce the required time records. Whatever method is used, the manager of each department usually reviews the time records for each employee supervised. After the manager's review, he or she sends those time records to you, the bookkeeper.

With time records in hand, you have to calculate gross pay for each employee. For example, if a nonexempt employee worked 45 hours and is paid \$12 an hour, you calculate gross pay like so:

$$40 \text{ regular hours} \times \$12 \text{ per hour} = \$480$$

$$5 \text{ overtime hours} \times \$12 \text{ per hour} \times 1.5 \text{ overtime rate} = \$90$$

$$\$480 + \$90 = \$570$$

In this case, because the employee isn't exempt from the FLSA (see "Determining wage and salary types" earlier in this chapter), overtime must be paid for any hours worked over 40 in a seven-day workweek. This employee worked five hours more than the 40 hours allowed, so assume he needs to be paid at time plus one-half (the hourly rate paid over 40 hours may change).

Doing out funds to salaried employees

In addition to preparing payroll for hourly employees, you also must prepare payroll for salaried employees. Paychecks for salaried employees are relatively easy to calculate — all you need to know are their base salaries and their pay period calculations. For example, if a salaried employee makes \$30,000 per year and is paid twice a month (totaling 24 pay periods), that employee's gross pay is \$1,250 for each pay period.

Totaling up for commission checks

Running payroll for employees paid based on commission can involve complex calculations. To show you a number of variables, this section calculates a commission check based on a salesperson who sells \$60,000 of product during one month.

For a salesperson on a straight commission of 10 percent, you calculate pay by using this formula:

$$\text{Total amount sold} \times \text{Commission percentage} = \text{Gross pay}$$

$$\$60,000 \times 0.10 = \$6,000$$

For a salesperson with a guaranteed base salary of \$2,000 plus an additional 5 percent commission on all products sold, you calculate pay by using this formula:

$$\text{Base salary} + (\text{Total amount sold} \times \text{Commission percentage}) = \text{Gross pay} \\ \$2,000 + (\$60,000 \times 0.05) = \$5,000$$

Although this employee may be happier having a base salary he can count on each month, he actually makes less with a base salary because the commission rate is so much lower. By selling \$60,000 worth of products, he earned only \$3,000 in commission at 5 percent. Without the base pay, he would have made 10 percent on the \$60,000 or \$6,000. The salesperson actually got paid \$1,000 less with a base pay structure that includes a lower commission pay rate.

If he has a slow sales month of just \$30,000 worth of products sold, his pay would be:

$$\$30,000 \times 0.10 = \$3,000 \text{ on straight commission of 10 percent}$$

and

$$\$30,000 \times 0.05 = \$1,500 \text{ plus } \$2,000 \text{ base salary, or } \$3,500$$

For a slow month, the salesperson would make more money with the base salary than with the higher commission rate.

There are many other ways to calculate commissions. One common way is to offer higher commissions on higher levels of sales. Using the figures in the next example, this type of pay system encourages salespeople to keep their sales levels over \$30,000 to get the best commission rate.

With a graduated commission scale, a salesperson can make a straight commission of 5 percent on his first \$10,000 in sales, then 7 percent on his next \$20,000, and finally 10 percent on anything over \$30,000. Here's what his gross pay calculation looks like, using this commission pay scale:

$$(\$10,000 \times 0.05) + (\$20,000 \times 0.07) + (\$30,000 \times 0.10) = \$4,900 \text{ Gross pay}$$

One other type of commission pay system involves a base salary plus tips. This method is common in restaurant settings in which servers receive between \$2.50 and \$5 per hour plus tips.

Businesses that pay less than minimum wage must prove that their employees make at least minimum wage when tips are accounted for. Today, that's relatively easy to prove because most people pay their bills with credit cards and include tips on their bills. Businesses can then come up with an average tip rate by using that credit card data.

Employees must report tips to their employers on an IRS Form 4070, Employee's Report of Tips to Employer, which is part of IRS Publication 1244, Employees Daily Record of Tips and Report to Employer. If your employees receive tips and you want to supply the necessary paperwork, you can download it at www.irs.gov/pub/irs-pdf/p1244.pdf. The publication provides details about what the IRS expects you and your employees to do if they work in an environment where tipping is common.

As an employer, you must report an employee's gross taxable wages based on salary plus tips. Here's how you calculate gross taxable wages for an employee whose earnings are based on tips and wages:

$$\text{Base wage} + \text{Tips} = \text{Gross taxable wages}$$

$$(\$3 \times 40 \text{ hours per week}) + \$300 = \$420$$

If your employees are paid by using a combination of base wage plus tips, you must be sure that your employees are earning at least the minimum wage rate. Checking this employee's gross wages, the hourly rate earned is \$10.50 per hour.

$$\text{Hourly wage} = \$10.50 (\$420 \div 40)$$



Taxes due are calculated on the base wage plus tips, so the check you prepare for the employee in this example is for the base wage minus any taxes due.

Putting it together to prepare payroll

After calculating paychecks for all your employees, you prepare the payroll, make up the checks, and post the payroll to the books. In addition to cash, many accounts are impacted by payroll, including:

- ✓ **Accrued federal withholding payable**, where you record the liability for future federal tax payments.
- ✓ **Accrued state withholding payable**, where you record the liability for future state tax payments. Many companies have withholding accounts for FICA, Medicare, local taxes, and other categories.
- ✓ **Accrued employee medical insurance payable**, where you record the liability for future medical insurance premiums.
- ✓ **Accrued employee elective insurance payable**, where you record the liability for miscellaneous insurance premiums, such as life or accident insurance.

When you post the payroll entry, you indicate the withdrawal of money from the cash account as well as record liabilities for future cash payments that

will be due for taxes and insurance payments. As an example of the proper setup for a payroll journal entry, assume the total payroll is \$10,000 with \$1,000 set aside for each type of withholding payable. In reality, your numbers will be much different, and your payables will probably never be all the same. Here's what your journal entry for posting payroll should look like:

	<i>Debit</i>	<i>Credit</i>
Salaries and wages expense	\$10,000	
Accrued federal withholding payable		\$1,000
Accrued state withholding payable		1,000
Accrued medical insurance payable		1,000
Accrued elective insurance payable		1,000
Cash		6,000

To record payroll for May 27, 2015.

In this entry, you increase the expense account for salaries and wages as well as all the accounts in which you accrue future obligations for taxes and employee insurance payments.

When cash payments are made for the taxes and insurance payments, you post those payments in the books. Here's an example of the entry you would post to the books after making the federal withholding tax payment:

	<i>Debit</i>	<i>Credit</i>
Accrued federal withholding payable	\$1,000	
Cash in checking		\$1,000

To record the payment of May federal taxes for employees.

Depositing Employee Taxes

Any taxes collected on behalf of employees must be deposited in a financial institution authorized to collect those payments for the government or in the Federal Reserve Bank in your area. Most major banks are authorized to collect these deposits; check with your bank to see whether it is or to get a recommendation of a bank you can use. IRS Form 8109, Federal Tax Deposit (FTD) Coupon, is the coupon businesses use to deposit taxes. You can't get a copy of this form online; it's available only from the IRS or a bank that handles your deposits.

Form 8109 can be used to deposit many different kinds of federal payments, including:

- ✓ Form 941, Employer's Quarterly Federal Tax Return (includes federal withholding taxes, Social Security taxes, and Medicare taxes)
- ✓ Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return
- ✓ Form 1120, U.S. Corporation Income Tax Return



When depositing funds by using Form 8109, be sure to include the EIN and name of the company on the coupon as well as the form number related to the payment. The IRS tracks payments by EIN number and form number filed.

For the purposes of tax payments collected from employees for the federal government, you must complete Form 941, which is shown in Figure 4-4. This form summarizes the tax payments made on behalf of employees. You can get instructions and Form 941 online at www.irs.gov — just search on the site for the term “Form 941.” (For more about the various forms employers must file, see Chapter 5.)

During the first year as an employer, the company will have to make monthly deposits of employee taxes. Monthly payments must be made by the 15th day of the month following when the taxes were deducted. For example, taxes collected from employees in April must be paid by May 15. If the date the deposit is due falls on a weekend or bank holiday, the payment is due on the next day the banks are open.

As your business grows, you may need to make more frequent deposits. You can also make employee tax payments electronically by using the Electronic Federal Tax Payment System (EFTPS). To find out more, check out IRS Publication 15 at www.irs.gov.

950213	
<small>Name (not your trade name)</small>	<small>Employer identification number (EIN)</small>
Part 2: Tell us about your deposit schedule and tax liability for this quarter.	
<small>If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see Pub. 15 (Circular E), section 11.</small>	
<p>16 Check one: <input type="checkbox"/> Line 10 on this return is less than \$2,500 or line 10 on the return for the prior quarter was less than \$2,500, and you did not incur a \$100,000 next-day deposit obligation during the current quarter. If line 10 for the prior quarter was less than \$2,500 but line 10 on this return is \$100,000 or more, you must provide a record of your federal tax liability. If you are a monthly schedule depositor, complete the deposit schedule below; if you are a semiweekly schedule depositor, attach Schedule B (Form 941). Go to Part 3.</p> <p><input type="checkbox"/> You were a monthly schedule depositor for the entire quarter. Enter your tax liability for each month and total liability for the quarter, then go to Part 3.</p> <p style="margin-left: 40px;">Tax liability: Month 1 <input style="width: 100px;" type="text"/></p> <p style="margin-left: 80px;">Month 2 <input style="width: 100px;" type="text"/></p> <p style="margin-left: 80px;">Month 3 <input style="width: 100px;" type="text"/></p> <p style="margin-left: 40px;">Total liability for quarter <input style="width: 100px;" type="text"/> Total must equal line 10.</p> <p><input type="checkbox"/> You were a semiweekly schedule depositor for any part of this quarter. Complete Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors, and attach it to Form 941.</p>	
Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.	
<p>17 If your business has closed or you stopped paying wages <input type="checkbox"/> Check here, and enter the final date you paid wages <input style="width: 50px;" type="text"/>.</p> <p>18 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . . <input type="checkbox"/> Check here.</p>	
Part 4: May we speak with your third-party designee?	
<small>Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.</small>	
<p><input type="checkbox"/> Yes. Designee's name and phone number <input style="width: 150px;" type="text"/> <input style="width: 100px;" type="text"/></p> <p style="margin-left: 40px;">Select a 5-digit Personal Identification Number (PIN) to use when talking to the IRS. <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/></p> <p><input type="checkbox"/> No.</p>	
Part 5: Sign here. You MUST complete both pages of Form 941 and SIGN it.	
<small>Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.</small>	
	<p>Sign your name here <input style="width: 200px; height: 30px;" type="text"/></p> <p style="margin-left: 40px;">Date <input style="width: 50px;" type="text"/> / <input style="width: 50px;" type="text"/> / <input style="width: 50px;" type="text"/></p> <p style="text-align: right;">Print your name here <input style="width: 100px;" type="text"/></p> <p style="text-align: right;">Print your title here <input style="width: 100px;" type="text"/></p> <p style="text-align: right;">Best daytime phone <input style="width: 100px;" type="text"/></p>
Paid Preparer Use Only	
<small>Check if you are self-employed . . . <input type="checkbox"/></small>	
Preparer's name <input style="width: 150px;" type="text"/>	PTIN <input style="width: 100px;" type="text"/>
Preparer's signature <input style="width: 150px;" type="text"/>	Date <input style="width: 50px;" type="text"/> / <input style="width: 50px;" type="text"/> / <input style="width: 50px;" type="text"/>
Firm's name (or yours if self-employed) <input style="width: 150px;" type="text"/>	EIN <input style="width: 100px;" type="text"/>
Address <input style="width: 150px;" type="text"/>	Phone <input style="width: 100px;" type="text"/>
City <input style="width: 100px;" type="text"/> State <input style="width: 50px;" type="text"/>	ZIP code <input style="width: 100px;" type="text"/>

Figure 4-4:
(continued)

Chapter 5

Computing and Reporting Payroll Taxes

In This Chapter

- ▶ Tallying the employer's share of Social Security and Medicare
 - ▶ Filing and paying unemployment taxes
 - ▶ Figuring out workers' compensation
 - ▶ Keeping accurate employee records
-

After your company hires employees, you need to complete regular reports for the government regarding the taxes you must pay toward the employees' Social Security and Medicare, as well as unemployment taxes. In most states, employers also are required to buy workers' compensation insurance based on employees' salary and wages.

This chapter reviews the federal, state, and local government reporting requirements for employers as well as the records you, the accountant, must keep in order to complete these reports. You also find out about the requirements for buying workers' compensation insurance.

Paying Employer Taxes on Social Security and Medicare

In the United States, both employers and employees must contribute to the Social Security and Medicare systems. In most cases, employers share equally with employees the tax obligation for both Social Security and Medicare.

As discussed in Chapter 4, the employer and the employee each must pay a certain percentage of an employee's compensation for Social Security. Employer and employee must also pay a percentage of wages toward Medicare.

When you finish calculating payroll checks, you calculate the employer's portion of Social Security and Medicare. When you post the payroll to the books, you set aside the employer's portion of Social Security and Medicare in an accrual account.

Filing Form 941

Each quarter you must file federal Form 941, *Employer's Federal Tax Return*, which details the number of employees who received wages, tips, or other compensation for the quarter. In Chapter 4, you can see what the form looks like. Table 5-1 shows you what months are reported during each quarter and when the reports are due.

Table 5-1 Filing Requirements for Employer's Quarterly Federal Tax Return (Form 941)

<i>Months in Quarter</i>	<i>Report Due Date</i>
January, February, March	On or before April 30
April, May, June	On or before July 31
July, August, September	On or before October 31
October, November, December	On or before January 31

The following key information must be included on Form 941:

- ✓ Number of employees who received wages, tips, or other compensation in the pay period
- ✓ Total of wages, tips, and other compensation paid to employees
- ✓ Total tax withheld from wages, tips, and other compensation
- ✓ Taxable Social Security and Medicare wages
- ✓ Total paid out to employees in sick pay
- ✓ Adjustments for tips and group-term life insurance
- ✓ Amount of income tax withholding

- ✓ Advance earned income credit payments made to employees (see Chapter 4 for an explanation)
- ✓ Amount of tax liability per month

Knowing how often to file

As an employer, you file Form 941 on a quarterly basis, but you may have to pay taxes more frequently. Most new employers start out making monthly deposits for taxes due by using Form 8109 (shown in Chapter 4), which is a payment coupon that your company can get from a bank approved to collect deposits or from the Federal Reserve branch near you. Others make deposits online by using the IRS's Electronic Federal Tax Payment System (EFTPS). For more information on EFTPS, go to www.eftps.gov.

Employers on a monthly payment schedule (usually small companies) must deposit all employment taxes due by the 15th day of the following month. For example, the taxes for the payroll in April must be paid by May 15. Larger employers must pay taxes more frequently, depending on the number of workers employed and the dollar amount of payroll.

Book II

Recording
Accounting
Transactions

Completing Unemployment Reports and Paying Unemployment Taxes

As an employer, you're responsible for paying a share of unemployment compensation based on your record of firing and laying off employees. The fund you pay into is known as the Federal Unemployment Tax Act (FUTA) fund. For FUTA, employers pay a percentage rate based on each employee's earnings.

The employee earnings are capped at a certain dollar amount. So, even though each employee earns a different level of salary, FUTA taxes are calculated only on the first dollars each employee earns. As of this writing, the cap for FUTA taxes is on the first \$7,000 of income.

States also collect taxes to fill their unemployment fund coffers. The federal government allows you to subtract a portion of the state unemployment payments from your federal contributions. Essentially, the amount you pay to the state can serve as a credit toward the amount you must pay to the federal government.

Each state sets its own unemployment tax rate. Many states also charge additional fees for administrative costs and job-training programs. You can check out the full charges for your state at payroll-taxes.com.

How states calculate the FUTA tax rate

States use four different methods to calculate how much you may need to pay in FUTA taxes:

- ✓ **Benefit ratio formula:** The state looks at the ratio of benefits collected by former employees to your company's total payroll over the past three years. States also adjust your rate depending upon the overall balance in the state unemployment insurance fund.
- ✓ **Benefit wage formula:** The state looks at the proportion of your company's payroll that's paid to workers who become unemployed and receive benefits, and then divides that number by your company's total taxable wages.
- ✓ **Payroll decline ratio formula:** The state looks at the decline in your company's payroll from year to year or from quarter to quarter.
- ✓ **Reserve ratio formula:** The state keeps track of your company's balance in the unemployment reserve account, which gives a cumulative representation of its use by your former employees who were laid off and paid unemployment. This recordkeeping dates back from the date you were first subject to the state unemployment rate. The reserve account is calculated by adding up all your contributions to the account and then subtracting total benefits paid. This amount is then divided by your company's total payroll. The higher the reserve ratio, the lower the required contribution rate.



These formulas can be very complicated, so your best bet is to contact your state's unemployment office to review how your company's unemployment rate will be set. In addition to getting a better idea of what may impact your FUTA tax rate, you can also discuss how best to minimize that rate.

Calculating FUTA tax

After you know what your rate is, calculating the actual FUTA tax you owe isn't difficult. Here's what you do:

1. **Multiply \$7,000 by the federal unemployment tax rate to determine how much you owe per employee in federal unemployment.** That \$7,000 is the cap on earnings, which was discussed earlier.

2. **Multiply the result from Step 1 by the number of employees to determine the total federal unemployment tax you owe.** If the state rate is lower than the federal rate, you're done. You pay the federal program the federal calculation, less the amount you pay into the state unemployment fund. If the state rate is higher than the federal rate, proceed to Step 3.
3. **Subtract the state rate from the federal rate.**
4. **Multiply the result from Step 3 by \$7,000 to determine the additional amount of state unemployment tax you must pay per employee.**
5. **Multiply the result from Step 4 by the number of employees.**
6. **Add the amounts from Steps 2 and 5.**

Here's an example, assuming a state tax rate of 2.7 percent and a federal rate of 6.2 percent:

State unemployment taxes:

$$\$7,000 \times 0.027 = \$189 \text{ per employee}$$

$$\$189 \times 10 \text{ employees} = \$1,890$$

Federal unemployment taxes:

$$\$7,000 \times 0.062 = \$434$$

$$\$434 \times 10 \text{ employees} = \$4,340$$

Because the federal rate is higher than the state rate, you can subtract the amount in state unemployment tax you owe from the total. In this case, you would pay \$1,890 to the state, and \$2,450 (\$4,340 – \$1,890) to the federal unemployment fund.

Each year, you must file IRS Form 940 *Federal Unemployment (FUTA) Tax Return*, shown in Figure 5-1. You can find Form 940 online at www.irs.gov/pub/irs-pdf/f940.pdf.

Form 940 for 2012: Employer's Annual Federal Unemployment (FUTA) Tax Return
Department of the Treasury — Internal Revenue Service

850112
OMB No. 1545-0028

Employer identification number (EIN) -

Name (not your trade name)

Trade name (if any)

Address

Number Street Suite or room number

City State ZIP code

Type of Return
(Check all that apply.)

a. Amended

b. Successor employer

c. No payments to employees in 2012

d. Final: Business closed or stopped paying wages

Instructions and prior-year forms are available at www.irs.gov/form940.

Read the separate instructions before you complete this form. Please type or print within the boxes.

Part 1: Tell us about your return. If any line does NOT apply, leave it blank.

1a If you had to pay state unemployment tax in one state only, enter the state abbreviation 1a

1b If you had to pay state unemployment tax in more than one state, you are a multi-state employer 1b Check here. Complete Schedule A (Form 940).

2 If you paid wages in a state that is subject to CREDIT REDUCTION 2 Check here. Complete Schedule A (Form 940).

Part 2: Determine your FUTA tax before adjustments for 2012. If any line does NOT apply, leave it blank.

3 Total payments to all employees 3

4 Payments exempt from FUTA tax 4

Check all that apply: 4a Fringe benefits 4c Retirement/Pension 4e Other

4b Group-term life insurance 4d Dependent care

5 Total of payments made to each employee in excess of \$7,000 5

6 Subtotal (line 4 + line 5 = line 6) 6

7 Total taxable FUTA wages (line 3 - line 6 = line 7) (see instructions) 7

8 FUTA tax before adjustments (line 7 x .006 = line 8) 8

Part 3: Determine your adjustments. If any line does NOT apply, leave it blank.

9 If ALL of the taxable FUTA wages you paid were excluded from state unemployment tax, multiply line 7 by .054 (line 7 x .054 = line 9). Go to line 12 9

10 If SOME of the taxable FUTA wages you paid were excluded from state unemployment tax, OR you paid ANY state unemployment tax late (after the due date for filing Form 940), complete the worksheet in the instructions. Enter the amount from line 7 of the worksheet 10

11 If credit reduction applies, enter the total from Schedule A (Form 940) 11

Part 4: Determine your FUTA tax and balance due or overpayment for 2012. If any line does NOT apply, leave it blank.

12 Total FUTA tax after adjustments (lines 8 + 9 + 10 + 11 = line 12) 12

13 FUTA tax deposited for the year, including any overpayment applied from a prior year 13

14 Balance due (If line 12 is more than line 13, enter the excess on line 14.)
 • If line 14 is more than \$500, you must deposit your tax.
 • If line 14 is \$500 or less, you may pay with this return. (see instructions) 14

15 Overpayment (If line 13 is more than line 12, enter the excess on line 15 and check a box below.) 15

▶ You **MUST** complete both pages of this form and **SIGN** it. Check one: Apply to next return. Send a refund.

Next

For Privacy Act and Paperwork Reduction Act Notice, see the back of Form 940-V, Payment Voucher. Cat. No. 112340 Form **940** (2012)

Figure 5-1:
Employers report their FUTA tax on Form 940.

Name (not your trade name)		Employer identification number (EIN) 850212
Part 5: Report your FUTA tax liability by quarter only if line 12 is more than \$500. If not, go to Part 6.		
16 Report the amount of your FUTA tax liability for each quarter; do NOT enter the amount you deposited. If you had no liability for a quarter, leave the line blank.		
16a 1st quarter (January 1 – March 31)	16a	<input type="text"/>
16b 2nd quarter (April 1 – June 30)	16b	<input type="text"/>
16c 3rd quarter (July 1 – September 30)	16c	<input type="text"/>
16d 4th quarter (October 1 – December 31)	16d	<input type="text"/>
17 Total tax liability for the year (lines 16a + 16b + 16c + 16d = line 17)		17 <input type="text"/> Total must equal line 12.
Part 6: May we speak with your third-party designee?		
Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.		
<input type="checkbox"/> Yes.	Designee's name and phone number <input style="width: 150px;" type="text"/> <input style="width: 150px;" type="text"/>	
Select a 5-digit Personal Identification Number (PIN) to use when talking to IRS <input style="width: 20px;" type="text"/> <input style="width: 20px;" type="text"/> <input style="width: 20px;" type="text"/> <input style="width: 20px;" type="text"/> <input style="width: 20px;" type="text"/>		
<input type="checkbox"/> No.		
Part 7: Sign here. You MUST complete both pages of this form and SIGN it.		
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments made to employees. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
X Sign your name here	<input style="width: 150px;" type="text"/>	Print your name here <input style="width: 150px;" type="text"/>
		Print your title here <input style="width: 150px;" type="text"/>
Date <input style="width: 40px;" type="text"/> / <input style="width: 40px;" type="text"/> / <input style="width: 40px;" type="text"/>	Best daytime phone <input style="width: 100px;" type="text"/>	
Paid Preparer Use Only Check if you are self-employed <input type="checkbox"/>		
Preparer's name <input style="width: 150px;" type="text"/>	PTIN <input style="width: 50px;" type="text"/>	
Preparer's signature <input style="width: 150px;" type="text"/>	Date <input style="width: 40px;" type="text"/> / <input style="width: 40px;" type="text"/> / <input style="width: 40px;" type="text"/>	
Firm's name (or yours if self-employed) <input style="width: 150px;" type="text"/>	EIN <input style="width: 50px;" type="text"/>	
Address <input style="width: 150px;" type="text"/>	Phone <input style="width: 50px;" type="text"/>	
City <input style="width: 50px;" type="text"/> State <input style="width: 50px;" type="text"/>	ZIP code <input style="width: 50px;" type="text"/>	

Figure 5-1:
(continued)



You can pay taxes for Form 940 by using the same coupon (Form 8109) used to pay Form 941 taxes (see “Filing Form 941” earlier in this chapter for an explanation). Most employers pay unemployment taxes quarterly.

Filing and paying unemployment taxes to state governments

Many states collect their unemployment taxes on a quarterly basis, and most states allow you to pay your unemployment taxes online. Check with your state to find out how to file and make unemployment tax payments.

Unfortunately, the filing requirements for state unemployment taxes may be more difficult to complete than those for federal taxes (see the discussion of Federal Form 940 in the previous section). States require you to detail each employee by name and Social Security number. The state must know how much an employee was paid each quarter in order to determine his or her unemployment benefit, if the need arises. Some states also require you to report the number of weeks an employee worked in each quarter because the employee's unemployment benefits are calculated based on the number of weeks worked.

Each state has its own form and filing requirements. Some states require a detailed report as part of your quarterly wage and tax reports. Other states allow a simple form for state income tax and a more detailed report with your unemployment tax payment.

Carrying Workers' Compensation Insurance

Taxes aren't the only thing you need to worry about when figuring out your state obligations after hiring employees. Nearly every state requires employers to carry *workers' compensation insurance*, which covers your employees in case they're injured on the job.

If an employee gets hurt on the job, workers' compensation covers costs of lost income, medical expenses, vocational rehabilitation, and, if applicable, death benefits. Each state sets its own rules regarding how much medical coverage you must provide. If the injury also causes the employee to miss work, the state determines the percentage of the employee's salary you must pay and how long you pay that amount. If the injury results in the employee's death, the state also sets the amount you must pay toward funeral expenses and the amount of financial support you must provide the employee's family.

Each state makes up its own rules about how a company must insure itself against employee injuries on the job. Some states create state-based workers' compensation funds to which all employers must contribute. Other states allow you the option of participating in a state-run insurance program or buying insurance from a private company. A number of states permit employers to use HMOs, PPOs, or other managed-care providers to handle workers' claims.

If your state doesn't have a mandatory state pool, you have some other resources to obtain workers' compensation insurance coverage. States set the requirements for coverage, and either a national rating bureau called the National Council on Compensation Insurance (NCCI) or a state rating bureau establishes the premiums. For the lowdown on NCCI and workers' compensation insurance, visit www.ncci.com.

You may find lower rates over the long term if your state allows you to buy private workers' compensation insurance. Many private insurers give discounts to companies with good safety standards in place and few past claims. So the best way to keep your workers' compensation rates low is to encourage safety and minimize your company's claims.

Your company's rates are calculated based on risks identified in two areas:

- ✔ **Classification of the business:** These classifications are based on historic rates of risk in different industries. For example, if you operate a business in an industry that historically has a high rate of employee injury, such as a construction business, your base rate for workers' compensation insurance is higher than that of a company in an industry without a history of frequent employee injury, such as an office that sells insurance.
- ✔ **Classification of the employees:** The NCCI publishes classifications of hundreds of jobs in a book called the *Scopes Manual*. Most states use this manual to develop the basis for their classification schedules. For example, businesses that employ most workers at desk jobs pay less in workers' compensation than businesses with a majority of employees operating heavy machinery.

Be careful how you classify your employees. Many small businesses pay more than needed for workers' compensation insurance because they misclassify employees. Be sure you understand the classification system and properly classify your employee positions before applying for workers' compensation insurance. Be sure to read the information at www.ncci.com before classifying your employees.



When computing insurance premiums for a company, the insurer (whether the state or a private firm) looks at employee classifications and the rate of pay for each employee. For example, consider the position of an administrative assistant who earns \$25,000 per year. If that job classification is rated at 29 cents per \$100 of income, the workers' compensation premium for that employee is:

$$(\$25,000 \div 100) \times 0.29 = \$72.50$$



Most states allow you to exclude any overtime paid when calculating workers' compensation premiums. You may also be able to lower your premiums by paying a *deductible* on claims. A deductible is the amount you would have to pay before the insurance company pays anything. Deductibles can lower your premium by as much as 25 percent, so consider that as well to keep your upfront costs low.

Maintaining Employee Records

When you consider all the state and federal filing requirements for employee taxes that you must keep, it's clear that you must have very good employee records. Otherwise, you'll have a hard time filling out all the necessary forms and providing detail on your employees and your payroll. The best way to track employee information is to set up an employee journal and create a separate journal page for each employee. You can set this up manually, or through an automated accounting system.

The detailed individual records you keep on each employee should include this basic information, most of which is collected or determined as part of the hiring process:

- ✓ Name, address, phone number, and Social Security number
- ✓ Department or division within the company
- ✓ Start date with the company
- ✓ Pay rate
- ✓ Pay period (weekly, biweekly, semimonthly, or monthly)
- ✓ Whether hourly or salaried
- ✓ Whether exempt or nonexempt
- ✓ W-4 withholding allowances
- ✓ Benefits information
- ✓ Payroll deductions
- ✓ All payroll activity



If an employee asks to change the number of withholding allowances and file a new W-4 or asks for benefits changes, his or her record must be updated to reflect such changes.

The personal detail that doesn't change each pay period should appear at the top of the journal page. Then, you divide the remaining information into columns. Here's a sample showing what the top of an employee's journal page may look like.

Name: _____ **SS#:** _____
Address: _____
Tax Info: Married, 2 WH
Pay Information: \$8 hour, nonexempt, biweekly
Benefits: None

Book II

Recording
Accounting
Transactions

The following is an example of the body of the journal page. It contains columns for date of check, taxable wages, Social Security and Medicare tax (in one total), federal tax withholding, state tax withholding, and the net check amount.

<i>Date</i>	<i>Taxable Wages</i>	<i>SS & Med</i>	<i>Fed WH</i>	<i>State WH</i>	<i>Check</i>
4/8/2015	\$640	\$39.68	\$9.28	\$8.62	\$582.42
4/22/2015	640	38.68	9.28	8.62	582.42

You may want to add other columns to your employee journal to keep track of things such as

✔ **Non-taxable wages**

Examples include health or retirement benefits that are paid before taxes are taken out.

✔ **Benefits**

If the employee receives benefits, you need at least one column to track any money taken out of the employee's check to pay for those benefits. In fact, you may want to consider tracking each benefit in a separate column. Check out Chapter 4 for more on benefits.

✔ **Sick time**

✔ **Vacation time**

Clearly, these employee journal sheets can get very lengthy very quickly. That's why many small businesses use computerized accounting systems to monitor both payroll and employee records. Figures 5-2 and 5-3 show you how a new employee is added to the QuickBooks system.

Figure 5-2:
New employee personal and contact information can be added in QuickBooks to make it easier to keep track of employees.

New Employee

Information for: _____

Change tabs: Personal Info

Personal | Address and Contact | Additional Info

Mr./Ms./... _____

Legal Name _____

First Name _____ M.I. _____

Last Name _____

Print on Checks as _____

SS No. _____

Gender: _____

Date of Birth: _____

Employee is inactive

Order Business Cards

OK
Cancel
Next
Help

Figure 5-3:
QuickBooks enables you to track salary and deduction information, as well as information about sick time and vacation time.

Sick & Vacation for Laura Lake

Sick

Hours available as of 06/01/2005: 24:00

Hours used in 2005: 16:00

Accrual period: _____

Beginning of year: _____

Hours accrued at beginning of year: 0:00

Maximum number of hours: 80:00

Reset hours each new year?

Year begins on: January Day: 1

Begin accruing sick time on: 01/01/2005

Vacation

Hours available as of 06/01/2005: 0:00

Hours used in 2005: 40:00

Accrual period: _____

Beginning of year: _____

Hours accrued at beginning of year: 0:00

Maximum number of hours: 80:00

Reset hours each new year?

Year begins on: January Day: 1

Begin accruing vacation time on: 01/01/2005

OK
Cancel
Help