4. Payroll

For most businesses, payroll is perhaps the most significant cost of doing business. And, correctly planning for and managing these costs is enormously important to a business. Employees don't tend to stay long if a payday is missed, so payroll is truly the life's blood of the business.

Before looking at the special issues pertaining to payroll accounting, you should first understand who is an "employee." Many services are provided to a business by other than employees. These services may include janitorial support, legal services, air conditioner repairs, audits, and so forth. An employee is defined as a person who works for a specific business and whose activities are directed by that business -- the business controls what will be done and how it will be done. In contrast, an independent contractor is one who performs a designated task or service for a company – the company has the right to control or direct only the result of the work done by an independent contractor. The distinction is very important because the payroll tax and record keeping requirements differ for employees and independent contractors. As a general rule, amounts paid to independent contractors do not involve any "tax withholdings" by the payer; however, the payer may need to report the amount paid to the Internal Revenue Service (IRS) on a Form 1099, with a copy to the independent contractor. But, the obligation for paying taxes rests with the independent contractor.

The employer's handling of payroll to employees is another matter entirely. Let us begin by considering the specifics of a paycheck. You may have some work experience, and if you do, you know that the amount you receive is not the amount you have earned. Your check was likely reduced by a variety of taxes, possibly including federal income tax, state income tax, and FICA (social security taxes and medicare/medicaid). Additionally, your check might have been reduced for insurance costs, retirement savings, charitable contributions, special health and child care deferrals, and other similar items. Before you feel singled out, you also need to know that your employer paid additional FICA contributions on your behalf, unemployment taxes, and maybe insurance costs, workers compensation costs, matching contributions to retirement programs, and other items. A business must correctly account for all of this activity.

4.1 Gross Earnings

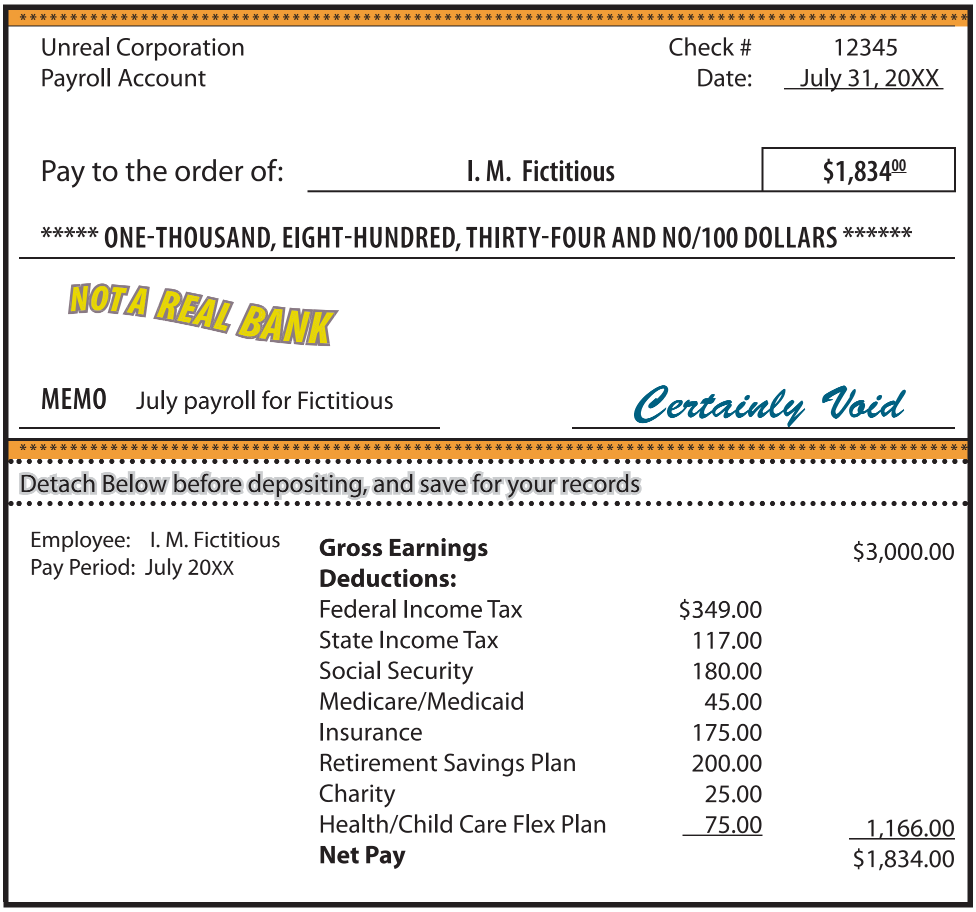
The total earnings of an employee is the "gross pay." For hourly employees, it is the number of hours worked multiplied by the hourly rate. For salaried employees, it is the flat amount for the period, such as $3,000 per month. Gross pay might be increased for both hourly and salaried employees based on applicable overtime rules. Employers are well advised to monitor statutes relating to overtime; by law, certain employees must be paid for overtime.

4.2 Net Earnings

Gross earnings less all applicable deductions is the "net pay." Let's examine a representative paycheck, and the attached stub, as shown on the next page:

You will notice that I. M. Fictitious earned $3,000 during the month, but "took home" only $1,834. The difference was withheld by Unreal Corporation. The withholdings pertained to:

> Income taxes -- Employers are required to withhold federal, state (when applicable), and city (when applicable) income taxes from an employee's pay. The withheld amounts must be remitted periodically to the government by the employer. In essence, the employer becomes an agent of the government, serving to collect amounts for the government. Withheld amounts that have yet to be remitted to the government are carried as a current liability on the employer's books (recall the earlier mention of amounts collected for third parties). The level of withholdings are based on the employee's level of income, the frequency of pay, marital status, and the number of withholding allowances claimed (based on the number of dependents). Employees claim withholding allowances by filing a form W-4 with their employer.



Unreal Corporation
Payroll Account

Check # 12345
Date: July 31, 20XX

Pay to the order of: I. M. Fictitious $1,834.00

***** ONE-THOUSAND, EIGHT-HUNDRED, THIRTY-FOUR AND NO/100 DOLLARS ******

NOT A REAL BANK

MEMO July payroll for Fictitious

Certainly Void

Detach Below before depositing, and save for your records

Employee: I. M. Fictitious
Pay Period: July 20XX

Gross Earnings		$3,000.00
Deductions:		
Federal Income Tax	$349.00	
State Income Tax	117.00	
Social Security	180.00	
Medicare/Medicaid	45.00	
Insurance	175.00	
Retirement Savings Plan	200.00	
Charity	25.00	
Health/Child Care Flex Plan	75.00	1,166.00
Net Pay		$1,834.00

It is very important for you to know that the employer's obligation to protect withheld taxes and make certain they are timely remitted to the government is taken very seriously. Employers who fail to do so are subject to harsh penalties for the obvious reason that the funds do not belong to the employer. Likewise, employees who participate in, or are aware of misapplication of such funds can expect serious legal repercussions. You should never be a part of such an activity. The government has made it very simple for employers to remit withheld amounts, as most commercial banks are approved to accept such amounts from employers. Further, there are online systems that allow easy funds transfer. The frequency of the required remittance is dependent upon the size of the employer and the total payroll.

Social Security/Medicare Taxes are also known as "FICA." FICA stands for Federal Insurance Contributions Act. This Act establishes a tax that transfers money from workers to aged retirees (and certain other persons who are in the unfortunate position of not being able to fully provide for themselves due to disability, loss of a parent, or other serious problem). The social purpose of the tax is to provide a modest income stream to the beneficiaries. This component is the social security tax. Another component of the Act is the medicare/medicaid tax, which provides support for health care costs incurred by retirees (and designated others). You are perhaps aware that these taxes present an actuarial problem, as the aged population is growing relative to the number of workers. And, the tax is a transfer of money from one group to another, rather than being based upon an established insurance-like fund.

The social security tax is presently a designated percentage of income, up to a certain maximum level of annual income per employee. After the maximum is reached, no further amounts are due for that year for that employee. The history of both the rate and maximum level is one of consistent increases over time. For illustrative purposes, I am assuming a 6% social security tax, on an annual income of $100,000. In the above pay stub, you will note that I. M. Fictitious paid $180 in social security tax for the month (6% X $3,000). Since Fictitious has not yet exceeded $100,000 in gross income for the year-to-date, the annual maximum has not been reached. Once Fictitious exceeds the annual limit (for most employees that never occurs), the tax would cease to be withheld -- only to resume anew in January of the following year. If this tax seems high, you need to know that the employee's amount must be matched by the employer. Thus, the burden associated with this tax is actually twice what is apparent to most employees.

The medicare/medicaid tax is also a designated percentage of income. Unlike the social security tax, there is no annual maximum. This tax is levied on every dollar of gross income, without regard to the employees total earnings. I have assumed a 1.5% rate in the above illustration (1.5% X $3,000 = $45). This is another tax the employer must match dollar-for-dollar.

Other Employee Deductions typically occur for employee cost sharing in health care insurance programs, employee contributions to various retirement or other savings plans, charitable contributions, contributions to tax-advantaged health and child care savings programs ("flex accounts"), and so forth. In each case, the employer is acting to collect amounts from the employee, with a resultant fiduciary duty to turn the monies over to another entity.

4.3 The Journal Entry for Payroll

I.M. Fictitious' pay would be recorded as follows:

7-31-XX	Salaries Expense	3,000	
	Federal Income Tax Payable		349
	State Income Tax Payable		117
	Social Security Payable		180
	Medicare/Medicaid Payable		45
	Insurance Payable		175
	Retirement Contribution Payable		200
	Charitable Contribution Payable		25
	Health/Child Flex Payable		75
	Cash		1,834
	To record payroll of Fictitious		

Although not illustrated, as the company remits the withheld amounts to the appropriate entities (i.e., turns the taxes over to the government, retirement contributions to an investment trust, etc.), it would debit the related payable and credit cash.

4.4 Employer Payroll Taxes and Contributions

Recall from above, that social security and medicare/medicaid tax amounts must be matched by employers.

In addition, the employer must pay federal and state unemployment taxes. These taxes are levied to provide funds that are paid to workers who are temporarily unable to find employment. The bulk of unemployment tax is usually levied at the state level since most states choose to administer their own unemployment programs (which is encouraged by the federal government via a system of credits to the federal tax rate). The specific rates will depend on the particular state of employment, and each individual employer's history. Employers who rarely release employees get a favorable rate (since they don't contribute to unemployment problems), but those who do not maintain a stable labor pool will find their rates going higher. Like social security, the unemployment tax stops each year once a certain maximum income level is reached. In this text, I will assume the federal rate is one-half of one percent (0.5%), and the state rate is three percent (3%), on a maximum income of $10,000. Thus, I assume the federal unemployment tax (FUTA) is capped at $50 per employee and the state unemployment tax (SUTA) is capped at $300.

Many employers will carry workers' compensation insurance. The rules about this type of insurance vary from state to state. Generally, this type of insurance provides for payments to workers who sustain on-the-job injuries, and shields the employer from additional claims. But, for companies that do not carry such insurance, the employer has an unlimited exposure to claims related to work place injuries. Nevertheless, the cost of this insurance can be very high (for risky work, like construction), and some employers don't carry such policies. Please be advised that these are very general statements; if you have specific questions about the rules in your state, you should consult appropriate counsel and not rely on this generalization.

Many employers will provide health care insurance and retirement plan contributions. These amounts can often be substantial, perhaps even exceeding the amounts contributed by employees on their own behalf.

As you can see, the employer's cost of an employee goes well beyond the amount reported on the pay check. For many companies, the total cost of an employee can be 125% to 150% of the gross earnings. Of course, these added costs also need to be entered in the accounting records. Below is the entry for I. M. Fictitious:

7-31-XX	Payroll Tax Expense	225	
	Employee Benefits Expense	675	
	Social Security Payable		180
	Medicare/Medicaid Payable		45
	FUTA Payable		0
	SUTA Payable		0
	Insurance Payable		475
	Retirement Contribution Payable		200
	To record employer portion of payroll taxes and benefits		

In preparing this entry it was assumed that (a) FUTA and SUTA bases had already been exceeded earlier in 20XX (hence the related amounts are zero), (b) the employer exactly matched employee contributions to insurance and retirement programs, and (c) the employer incurred workers' compensation insurance of $300 (bringing total insurance to $475 ($175 + $300)). Note that additional accounts could be used to separate employee benefits expense into more specific sub components (like insurance expense, retirement plan expense, etc.).

4.5 Annual Reports

Each employee and the Internal Revenue Service is to receive an annual statement regarding compensation. Shortly after the conclusion of a calendar year, an employer must review their employee records and prepare a summary wage and tax statement (commonly called a W-2). This information helps employees accurately prepare their own annual federal and state income tax returns, and allows the government to verify amounts reported by those individual taxpayers.

4.6 Accurate Payroll Systems

As you can tell, accuracy is vital in payroll accounting. Oftentimes, a business may hire an outside firm that specializes in payroll management and accounting. The business then need only provide the outside firm with information about time worked by each employee (and of course the money to cover the gross payroll). The outside firm manages the rest -- providing individual paychecks/deposits, payroll recordkeeping, government compliance reporting, timely processing of tax deposits, and the like. For many businesses, being relieved of the burden of payroll processing is a great relief and allows them to focus on their product and customer.

But, when a business manages its own payroll, very accurate data must be maintained. Most firms will set up a separate payroll journal or data base that tracks information about each employee, as well as in the aggregate. In addition, it is quite common to open a separate payroll bank account into which the gross pay is transferred and from which paychecks and tax payments are disbursed. This system provides an added control to make sure that employee funds are properly maintained, processed, and reconciled.