

# PAYROLL



## THE NAVIGATOR ✓

- Understand *Concepts for Review*

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- Read *Feature Story*

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- Scan *Study Objectives*

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- Read *Preview*

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- Read text and answer *Before You Go On*  
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- Work *Demonstration Problem*

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- Review *Summary of Study Objectives*

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- Complete *Assignments*

## CONCEPTS FOR REVIEW

**Before studying this chapter, you should know or, if necessary, review:**

- a. The assumptions and principles of accounting. (Ch. 2, pp. 36–41)
- b. The difference between the accrual basis and the cash basis of accounting. (Ch. 4, pp. 105–106)
- c. The accounting and financial management departments in hospitality organizations. (Ch. 1, pp. 17–24)

# F FEATURE STORY

## Payroll: A Manageable Cost in the Hospitality Industry

Payroll and related fringe benefits often make up a large percentage of the total revenue in any hospitality business. Why? The answer is quite simple: The hospitality industry is a people industry. Even supplemented by the latest technology, our guests still love the friendly hellos at the door and the turn-down service with a small piece of chocolate on the pillow. It is no secret that the products that we offer are very important. Our food has to be cooked just right, our rooms have to be clean and comfortable, and our golf courses have to be well maintained with perfect greens and fairways. Yet a great meal can be ruined by an ill-trained waitperson, an impeccably maintained golf course can be destroyed by an employee who puts on the wrong fertilizer or chemical, and a \$1,000 weekend stay at a spa can be ruined by rude employees.

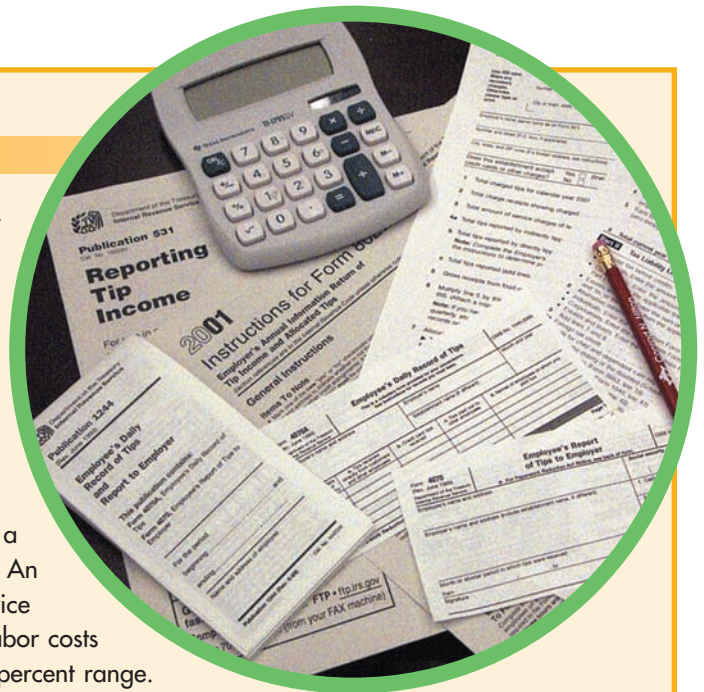
Service is key to the hospitality industry. Service and product go hand in hand. Employee compensation is often the most significant expense a company incurs. An average full-service restaurant has labor costs in the 30 to 35 percent range. Such percentages may fall a bit in quick-service restaurants. In other words, for every dollar that a restaurant brings in through the sale of food, more than 30 cents go toward paying its labor to service the guests. Considering that the entire restaurant industry has over \$537 billion in sales, over 935,000 locations, and 12.8 million workers, labor cost is an important line item on any income statement.

It is also important to understand that labor cost is not limited to salary and wages. Labor cost includes benefits such as vacation, holiday pay, health insurance, dental insurance, life insurance, disability

insurance, and so on. Therefore, you can see why proper accounting and control of payroll are stressed in this chapter.

Companies are also required by law to maintain payroll records for each employee, to file and pay payroll taxes, and to comply with numerous state and federal tax laws related to employee compensation. Accounting for payroll has become much more complex because of these regulations.

SOURCE: [www.restaurant.org/research/ind\\_glance/cmfi](http://www.restaurant.org/research/ind_glance/cmfi).



## S TUDY OBJECTIVES

After studying this chapter, you should be able to

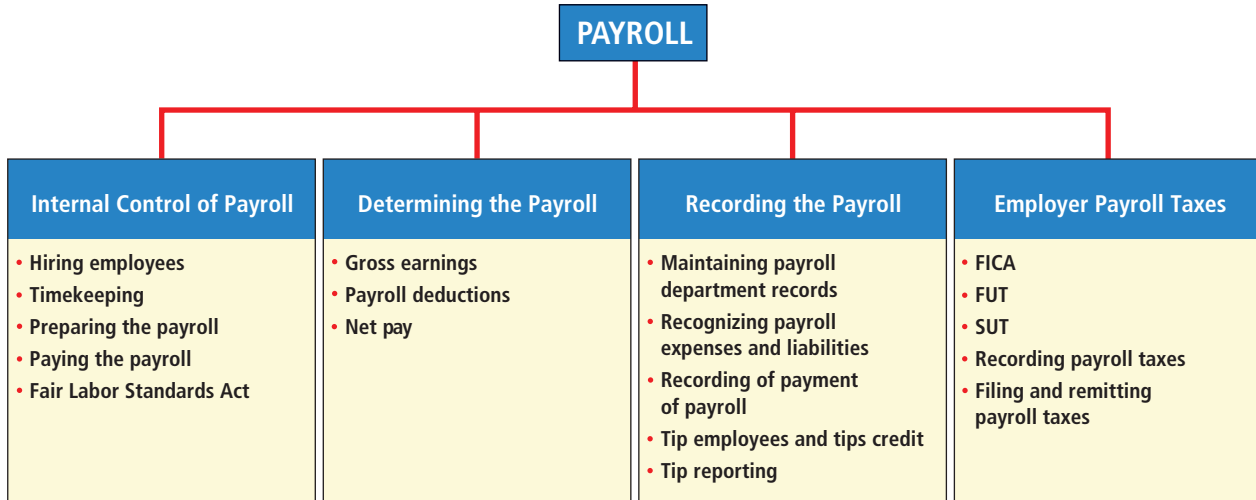
1. Discuss the objectives of internal control for payroll.
2. Compute and record the payroll for a pay period.
3. Compute and record tips under the 8 percent tip regulation.
4. Describe and record employer payroll taxes.



## PREVIEW OF CHAPTER 11

What you see from the feature story is the magnitude of the cost of labor in the restaurant business. Imagine adding the lodging business, the casino business, the club business, the tourism business, and other hospitality enterprises; and you get the picture. In this chapter we will discuss the reasons for payroll and its internal control mechanisms, determination of payroll with all the rules and regulations, the recording and payment of payroll of regular and tipped employees, and the recording and filing of payroll taxes.

The content and organization of Chapter 11 are as follows:



## PAYROLL DEFINED

The term *payroll* pertains to both salaries and wages. Managerial, administrative, and sales personnel are generally paid **salaries**. Salaries are often expressed in terms of a specified amount per month or per year rather than an hourly rate. For example, the faculty and the administrative personnel at the college or university you are attending are paid salaries. In contrast, wait staff, line cooks, room attendants, and bell staff are normally paid **wages**. Wages are based on a rate per hour or on a piecework basis (such as per room cleaned). Frequently, the terms *salaries* and *wages* are used interchangeably.

Payroll does not apply to payments made for services of professionals, such as certified public accountants, attorneys, and architects. Such professionals are independent contractors rather than salaried employees. Payments to them are called **fees** rather than salaries or wages. This distinction is important because government regulations relating to the payment and reporting of payroll taxes apply only to employees.

## INTERNAL CONTROL OF PAYROLL

### STUDY OBJECTIVE 1

Discuss the objectives of internal control for payroll.

Internal control was discussed in depth in Chapter 10. As applied to payrolls, the objectives of internal control are (1) to safeguard company assets against unauthorized payments of payrolls and (2) to ensure the accuracy and the reliability of the accounting records pertaining to payrolls.

Irregularities often result if internal control is lax. Overstating hours, using unauthorized pay rates, adding fictitious employees to the payroll, continuing

terminated employees on the payroll, and distributing duplicate payroll checks are all methods of stealing from a company. Moreover, inaccurate records will result in incorrect paychecks, financial statements, and payroll tax returns.

## TECHNOLOGY IN ACTION



No, it is not Halloween, but you can get spooked by a ghost employee! In the old days, when businesses were small and payroll was given in cash or paychecks were given to employees in person, this was not a problem. With technology and direct deposits, ghost employees seem to surface. Who are ghost employees? They are people who do not exist in your casino, cruise ship, theme park, or hotel but are being paid. They are fictitious employees created by the perpetrator or terminated or deceased employees who are not removed from payroll records. Some dishonest person continues to collect and cash paychecks for people who do not exist. What can be done? Detecting fraud takes a team. Always check bank account numbers, Social Security or identification numbers, addresses, deductions, work location and department, and the like. It may not be a bad idea to also look at sick leave and vacation. Even ghosts need a break. If someone on your payroll is not taking the normal level of sick leave and vacations, you either have a very dedicated employee or a dead one. Either way, it is good for you to find out so that you can reward the former or delete the latter.



Payroll activities involve four functions: hiring employees, timekeeping, preparing the payroll, and paying the payroll. For effective internal control, these four functions should be assigned to different departments or individuals. To illustrate these functions, we will examine the case of Academy Waterparks and one of its employees, Mark Jordan.

### HIRING EMPLOYEES

The human resources (personnel) department is responsible for posting job openings, screening and interviewing applicants, and hiring employees. From a control standpoint, this department provides significant documentation and authorization. When an employee is hired, the human resources department prepares an authorization form. The one used by Academy Waterparks for Mark Jordan is shown in Illustration 11-1 on page 322.

The authorization form is sent to the payroll department, where it is used to place the new employee on the payroll. A chief concern of the human resources department is ensuring the accuracy of this form. The reason is quite simple: One of the most common types of payroll frauds is adding fictitious employees to the payroll.

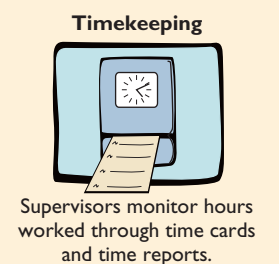
The human resources department is also responsible for authorizing changes in employment status. Specifically, it must authorize (1) changes in pay rates and (2) terminations of employment. Every authorization should be in writing, and a copy of the change in status should be sent to the payroll department. Notice in Illustration 11-1 that Jordan received a pay increase of \$2 per hour.



### TIMEKEEPING

Another area in which internal control is important is timekeeping. Hourly employees are usually required to record time worked by punching a time clock. Times of arrival and departure are automatically recorded by the employee by inserting a time card into the clock. Mark Jordan's time card is shown in Illustration 11-2 on page 322.

In large companies, time clock procedures are often monitored by a supervisor or security guard to make sure that an employee punches only one card. At the end of the pay period, each employee's supervisor approves the hours shown by signing the time card. When overtime hours are involved, approval by a



**Illustration 11-1**

Authorization form prepared by the human resources department

ACADEMY WATERPARKS			
Employee Name <u>Jordan, Mark</u>		Starting Date <u>9/01/05</u>	
<small>LAST FIRST MI</small>			
Classification <u>Skilled-Level 10</u>		Social Security No. <u>329-36-9547</u>	
Department <u>Guest Relations</u>		Division <u>Entertainment</u>	
<b>NEW HIRE</b>	Classification <u>Guest Service Agent</u> Salary Grade <u>Level 10</u> Trans. from Temp. <input type="checkbox"/>		
	Rate \$ <u>10.00</u> per <u>hour</u> Bonus <u>N/A</u> Non-exempt <input checked="" type="checkbox"/> Exempt <input type="checkbox"/>		
<b>RATE CHANGE</b>	New Rate \$ <u>12.00</u> Effective Date <u>9/1/07</u>		
	Present Rate \$ <u>10.00</u>		
	Merit <input checked="" type="checkbox"/> Promotion <input type="checkbox"/> Decrease <input type="checkbox"/> Other _____		
	Previous Increase Date <u>None</u> Amount \$ _____ per _____ Type _____		
<b>SEPARATION</b>	Resignation <input type="checkbox"/> Discharge <input type="checkbox"/> Retirement <input type="checkbox"/> Reason _____		
	Leave of absence <input type="checkbox"/> From _____ to _____ Type _____		
	Last Day Worked _____		
<b>APPROVALS</b>	<u>BEW</u> <u>9/1/07</u>		<u>EMW</u> <u>9-1-07</u>
	BRANCH OR DEPT. MANAGER DATE		DIVISION V.P. DATE
	<u>James E. Speer</u> PERSONNEL DEPARTMENT		

**Illustration 11-2**

Time card

		PAY PERIOD ENDING	
No. 17		1/14/08	
NAME Mark Jordan			
EXTRA TIME		REGULAR TIME	
	1st Day	A.M. IN	8:58
		NOON IN	12:00
		NOON OUT	1:00
		P.M. IN	5:01
	2nd Day	A.M. IN	9:00
		NOON IN	11:59
		NOON OUT	12:59
		P.M. IN	5:00
	3rd Day	A.M. IN	8:59
		NOON IN	12:01
		NOON OUT	1:01
		P.M. IN	5:00
5:00	4th Day	A.M. IN	9:00
9:00		NOON IN	12:00
		NOON OUT	1:00
		P.M. IN	5:00
	5th Day	A.M. IN	8:57
		NOON IN	11:58
		NOON OUT	1:00
		P.M. IN	5:01
	6th Day	A.M. IN	8:00
		NOON IN	1:00
	7th Day	A.M. IN	
		NOON IN	
		P.M. IN	
TOTAL 4		TOTAL	40

supervisor is usually mandatory. This guards against unauthorized overtime. The approved time cards then are sent to the payroll department. For salaried employees, a manually prepared weekly or monthly time report kept by a supervisor may be used to record time worked.

## PREPARING THE PAYROLL

The payroll is prepared in the payroll department on the basis of two inputs: (1) human resources department authorizations and (2) approved time cards. Numerous calculations are involved in determining gross wages and payroll deductions. Therefore, a second payroll department employee, working independently, verifies all calculated amounts; and a payroll department supervisor then approves the payroll. The payroll department is also responsible for preparing (but not signing) payroll checks, maintaining payroll records, and preparing payroll tax returns.

## PAYING THE PAYROLL

The payroll is paid by the treasurer's department. **Payment by check minimizes the risk of loss from theft, and the endorsed check provides proof of payment.** For good internal control, payroll checks should be prenumbered, and all checks should be accounted for. All checks must be signed by the treasurer (or a designated agent). Distribution of the payroll checks to employees should be controlled by the treasurer's department. Checks may be distributed by the treasurer or the paymaster.

Occasionally, the payroll is paid in currency. In such cases, it is customary to have a second person count the cash in each pay envelope. The paymaster should obtain a signed receipt from the employee on payment. If alleged discrepancies arise, adequate safeguards have been established to protect each party involved.

## FAIR LABOR STANDARDS ACT

The **Fair Labor Standards Act** was instituted in 1938 and was amended with additional provisions in 1977. It is commonly known as **FLSA**, and it provides minimum standards for both wages and overtime entitlement. It also spells out administrative procedures by which covered work time must be compensated. Included in the act are other provisions, such as equal pay and child labor. Although you might think that an act or any law applies to everyone, the FLSA exempts specified employees or groups of employees from certain of its provisions. According to the FLSA, employees can be covered by the law under the *enterprise coverage* or *individual coverage*. Therefore, in the hospitality industry, if an enterprise has two or fewer employees and less than \$500,000 a year in business, those two employees will not be covered. As you can see, the act does apply to most hospitality businesses.

The FLSA began applying to employees of the U.S. federal government in 1974. The U.S. Office of Personnel Management works with federal agencies to apply the act to employees of the U.S. federal government.

As mentioned, one item the FLSA regulates is overtime. For the hospitality industry, this means that all employees covered by the act will get one and a half times their regular pay for all hours worked over 40 hours per week. The FLSA, however, does not require extra pay for Saturdays and Sundays and makes no special provisions for vacation pay, sick pay, holiday pay, or severances. Of course, certain union contracts or states have established more advantageous overtime provisions than those stipulated by the FLSA, and these are the ones that will be in effect. This also holds true for conflicting state and federal regulations. In addition, the FLSA has certain rules such as requiring employers to maintain records of worked time of hourly employees. The form of recordkeeping used is up to the employer. In today's technologically advanced world, some businesses have replaced signing in and out on time cards with a fingerprint as a record of clocking in and out.

As of August 23, 2004, a new provision came into effect under the FLSA by which all workers earning less than \$23,660 per year are guaranteed overtime.

### Preparing the Payroll



Two (or more) employees verify payroll amounts; supervisor approves.

### Paying the Payroll



Treasurer signs and distributes checks.

Also, more definition was given under Section 13(a)(1) of the FLSA, which provides an exemption from both overtime and minimum wage to employees who are bona fide professional, administrative, executive, computer, and outside sales employees. It is also stated that simply calling someone an executive or giving someone a title that suggests the aforementioned categories is not sufficient. The specific job duties and salary must meet all the requirements, and the salary should be at least \$455 per week. In the case of the computer employee exemption, the \$455 rate also can be compensated at a rate not less than \$27.63 per hour.

In 2006, owing to the FLSA regulations, over 222,000 employees received \$135.7 million in minimum wage and overtime back wages because of violations. There were over 4,300 cases in the restaurant sector and over 860 cases in the lodging sector. The good news is that the number of these cases has dropped in the past few years. It is therefore important for hospitality managers and owners to be aware of labor rules and regulations. Such updates can be obtained easily from the Web site of the U.S. Department of Labor at [www.dol.gov](http://www.dol.gov). For specific information regarding wage and hour information, please visit [www.wagehour.dol.gov](http://www.wagehour.dol.gov).

## DETERMINING THE PAYROLL

### STUDY OBJECTIVE 2

Compute and record the payroll for a pay period.

Determining the payroll involves computing three amounts: (1) gross earnings, (2) payroll deductions, and (3) net pay.

### GROSS EARNINGS

**Gross earnings** is the total compensation earned by an employee. It consists of wages or salaries plus any bonuses and commissions.

Total *wages* for an employee are determined by multiplying the hours worked by the hourly rate of pay. In addition to the hourly pay rate, most companies are required by law to pay hourly workers a minimum of one and a half times the regular hourly rate for overtime work in excess of 8 hours per day or 40 hours per week. In addition, many employers pay overtime rates for work done at night, on weekends, and on holidays.

Mark Jordan's time card shows that he worked 44 hours for the weekly pay period ending January 14. The computation of his gross earnings (total wages) is shown in Illustration 11-3.

#### HELPFUL HINT

The law that governs pay rates is the Federal Fair Labor Standards Act. It applies to all companies involved in interstate commerce.

#### Illustration 11-3

Computation of total wages

Type of Pay	Hours	×	Rate	=	Gross Earnings
Regular	40	×	\$12.00	=	\$480.00
Overtime	4	×	18.00	=	72.00
<b>Total wages</b>					<b>\$552.00</b>

#### ETHICS NOTE

Bonuses often reward outstanding individual performance, but successful corporations also need considerable teamwork. A challenge is to motivate individuals while preventing an unethical employee from taking another's idea for his or her own advantage.

This computation assumes that Jordan receives one and a half times his regular hourly rate ( $\$12.00 \times 1.5$ ) for his overtime hours. Union contracts often require that overtime rates be as much as twice the regular rates.

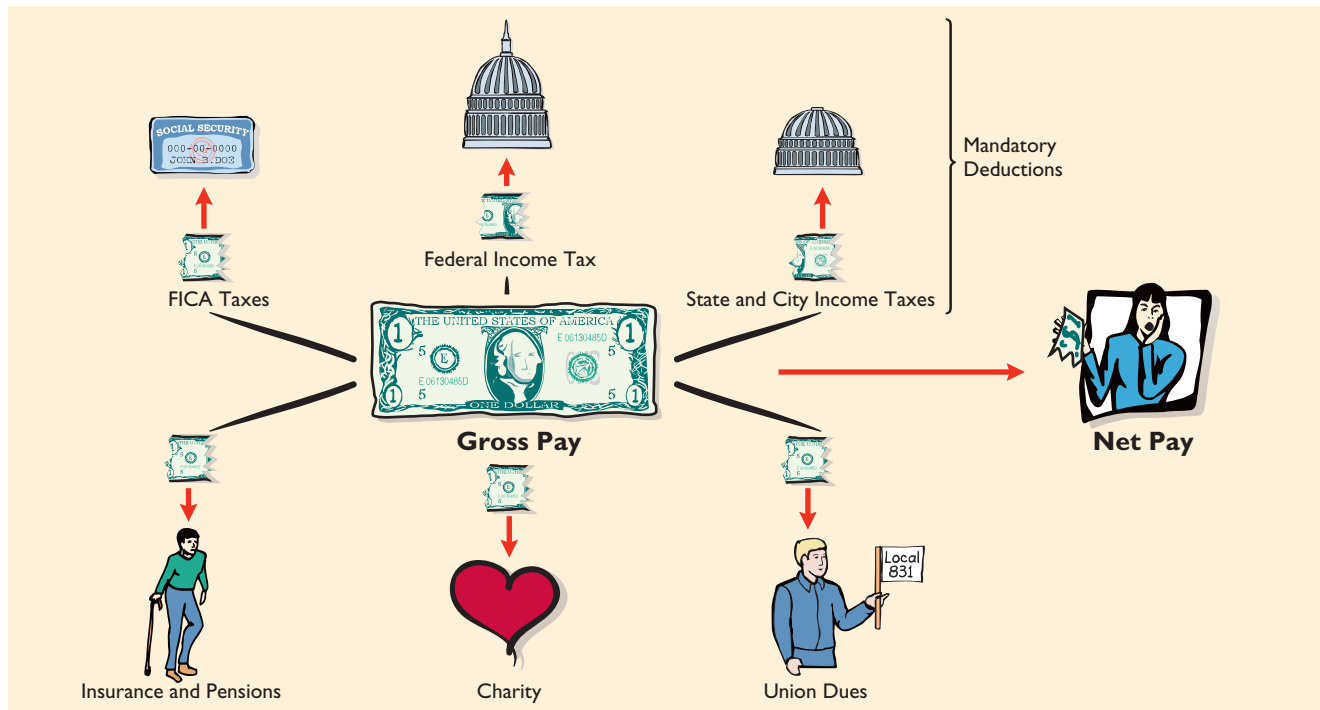
The *salary* for an employee is generally based on a monthly or yearly rate. These rates are then prorated to the payroll periods used by the company. Most executive and administrative positions are salaried. Federal law does not require overtime pay for employees in such positions.

Many companies have **bonus** agreements for management personnel and other employees. Bonus arrangements may be based on such factors as increased sales or net income. Bonuses may be paid in cash and/or by granting executives and employees the opportunity to acquire shares of company stock at favorable prices (called *stock option plans*).

## PAYROLL DEDUCTIONS

As anyone who has received a paycheck knows, gross earnings are usually very different from the amount actually received. The difference is due to **payroll deductions**. Such deductions do not result in payroll tax expense to the employer. The employer is merely a collection agent, who subsequently transfers the amounts deducted to the government and designated recipients. Payroll deductions may be mandatory or voluntary. Mandatory deductions are required by law and consist of Federal Insurance Contribution Act (FICA) taxes and income taxes. Voluntary deductions are at the option of the employee. Illustration 11-4 summarizes the types of payroll deductions.

**Illustration 11-4**  
Payroll deductions



### FICA Taxes

In 1937, Congress enacted the Federal Insurance Contribution Act. **FICA taxes are designed to provide workers with supplemental retirement, employment disability, and medical benefits.** In 1965, benefits were expanded to include Medicare for individuals 65 years of age and older. The benefits are financed by a tax levied on employees' earnings. FICA taxes are commonly referred to as *Social Security taxes*.

The tax rate and the tax base for FICA taxes are set by Congress. When FICA taxes were first imposed, the rate was 1 percent on the first \$3,000 of gross earnings, or a maximum of \$30 per year. The rate and the base have changed dramatically since that time! In 2002, the rate was 7.65 percent (6.2 percent Social Security plus 1.45 percent Medicare) on the first \$84,900 of gross earnings for each employee.<sup>1</sup> For purposes of illustration in this chapter, we will assume a rounded rate of 8 percent on the first \$65,000 of gross earnings, or a maximum of \$5,200. Using the 8 percent rate, the FICA withholding for Jordan for the weekly pay period ending January 14 is \$44.16 (wages of \$552 × 8%).

### Income Taxes

Under the U.S. pay-as-you-go system of federal income taxes, employers are required to withhold income taxes from employees each pay period. The amount to

<sup>1</sup>The Medicare provision also includes a tax of 1.45 percent on gross earnings in excess of \$84,900. In the interest of simplification, we ignore this 1.45 percent charge in our end-of-chapter assignment material. We assume zero FICA withholdings on gross earnings above \$65,000.



be withheld is determined by three variables: (1) the employee's gross earnings, (2) the number of allowances claimed by the employee, and (3) the length of the pay period. The number of allowances claimed typically includes the employee, his or her spouse, and other dependents. To indicate to the Internal Revenue Service the number of allowances claimed, the employee must complete an **Employee's Withholding Allowance Certificate (Form W-4)**. As shown in Illustration 11-5, Mark Jordan claims two allowances on his W-4.

**Illustration 11-5**

W-4 form

Form **W-4** Employee's Withholding Allowance Certificate OMB No. 1545-0010  
 Department of the Treasury Internal Revenue Service For Privacy Act and Paperwork Reduction Act Notice, see page 2. **2007**

1 Type or print your first name and middle initial Last name  
**Mark** **Jordan**

2 Your social security number  
**329-36-9547**

Home address (number and street or rural route)  
**2345 Mifflin Ave.**

3  Single  Married  Married, but withhold at higher Single rate.  
 Note: If married, but legally separated, or spouse is a nonresident alien, check the Single box.

City or town, State, and ZIP code  
**Hampton, MI 48292**

4 If your last name differs from that on your social security card, check here and call 1-800-772-1213 for a new card

5 Total number of allowances you are claiming (from line H above or from the worksheet on page 2 if they apply) **2**

6 Additional amount, if any, you want withheld from each paycheck **\$**

7 I claim exemption from withholding for 2007, 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, enter "Exempt" here **7**

Under penalties of perjury, I certify that I am entitled to the number of withholding allowances claimed on this certificate or entitled to claim exempt status.

Employee's signature **Mark Jordan** Date **September 1, 2007**

8 Employer's name and address (Employer: Complete 8 and 10 only if sending to the IRS) 9 Office code (optional) 10 Employer identification number

Cat. No. 102200

Withholding tables furnished by the Internal Revenue Service (IRS) indicate the amount of income tax to be withheld. Withholding amounts are based on gross wages and the number of allowances claimed. Separate tables are provided for weekly, bi-weekly, semimonthly, and monthly pay periods. The withholding tax table for Mark Jordan (assuming he earns \$552 per week) is shown in Illustration 11-6. For a weekly salary of \$552 with two allowances, the federal income tax to be withheld is \$49.

**Illustration 11-6**

Federal-withholding tax table

MARRIED Persons — WEEKLY Payroll Period (For Wages Paid in 2008)												
If the wages are —		And the number of withholding allowances claimed is —										
At least	But less than	0	1	2	3	4	5	6	7	8	9	10
		The amount of income tax to be withheld is —										
490	500	56	48	40	32	24	17	9	1	0	0	0
500	510	57	49	42	34	26	18	10	3	0	0	0
510	520	59	51	43	35	27	20	12	4	0	0	0
520	530	60	52	45	37	29	21	13	6	0	0	0
530	540	62	54	46	38	30	23	15	7	0	0	0
540	550	63	55	48	40	32	24	16	9	1	0	0
550	560	65	57	49	41	33	26	18	10	2	0	0
560	570	66	58	51	43	35	27	19	12	4	0	0
570	580	68	60	52	44	36	29	21	13	5	0	0
580	590	69	61	54	46	38	30	22	15	7	0	0
590	600	71	63	55	47	39	32	24	16	8	1	0
600	610	72	64	57	49	41	33	25	18	10	2	0
610	620	74	66	58	50	42	35	27	19	11	4	0
620	630	75	67	60	52	44	36	28	21	13	5	0
630	640	77	69	61	53	45	38	30	22	14	7	0
640	650	78	70	63	55	47	39	31	24	16	8	0
650	660	80	72	64	56	48	41	33	25	17	10	2
660	670	81	73	66	58	50	42	34	27	19	11	3
670	680	83	75	67	59	51	44	36	28	20	13	5
680	690	84	76	69	61	53	45	37	30	22	14	6

Most states (and some cities) also require *employers* to withhold income taxes from employees' earnings. As a rule, the amounts withheld are a percentage (specified in the state revenue code) of the amount withheld for the federal income tax. Or they may be a specified percentage of the employee's earnings. For the sake of simplicity, we have assumed that Jordan's wages are subject to state income taxes of 2 percent, or \$11.04 ( $2\% \times \$552$ ) per week.

There is no limit on the amount of gross earnings subject to income tax withholdings. In fact, the higher the earnings, the higher the amount of taxes withheld.

### **Other Deductions**

Employees may voluntarily authorize withholdings for charitable, retirement, and other purposes. All voluntary deductions from gross earnings should be authorized in writing by the employee. The authorization(s) may be made individually or as part of a group plan. Deductions for charitable organizations, such as the United Fund, or for financial arrangements, such as U.S. Savings Bonds and repayment of loans from company credit unions, are made individually. Deductions for union dues, health and life insurance, and pension plans are often made on a group basis. We will assume that Jordan has weekly voluntary deductions of \$10 for the United Fund and \$5 for union dues.

### **NET PAY**

**Net pay** is determined by subtracting payroll deductions from gross earnings. For Mark Jordan, net pay for the pay period is \$432.80, computed in Illustration 11-7.

#### **ALTERNATIVE TERMINOLOGY**

Net pay is also called *take-home pay*.

Gross earnings		\$552.00
Payroll deductions:		
FICA taxes	\$44.16	
Federal income taxes	49.00	
State income taxes	11.04	
United Fund	10.00	
Union dues	5.00	
		<u>119.20</u>
<b>Net pay</b>		<b><u>\$432.80</u></b>

#### **Illustration 11-7**

Computation of net pay

Assuming that Mark Jordan's wages for each week during the year are \$552, total wages for the year are \$28,704 ( $52 \times \$552$ ). Thus all of Jordan's wages are subject to FICA tax during the year. Let's assume that Jordan's department head earns \$1,350 per week, or \$70,200 for the year. Since only the first \$65,000 is subject to FICA taxes, the maximum FICA withholdings on the department head's earnings would be \$5,200 ( $\$65,000 \times 8\%$ ).

## **RECORDING THE PAYROLL**

Recording the payroll involves maintaining payroll department records, recognizing payroll expenses and liabilities, and recording payment of the payroll.

### **MAINTAINING PAYROLL DEPARTMENT RECORDS**

To comply with state and federal laws, an employer must keep a cumulative record of each employee's gross earnings, deductions, and net pay during the year. The record that provides this information is the **employee earnings record**. Mark Jordan's employee earnings record is shown in Illustration 11-8.

**Illustration 11-8**

Employee earnings record

ACADEMY WATERPARKS Employee Earnings Record For the Year 2008													
<b>Name</b>	Mark Jordan				<b>Address</b>	2345 Mifflin Ave.							
<b>Social Security Number</b>	329-36-9547				Hampton, Michigan 48292								
<b>Date of Birth</b>	December 24, 1962				<b>Telephone</b>	555-238-9051							
<b>Date Employed</b>	September 1, 2005				<b>Date Employment Ended</b>								
<b>Sex</b>	Male				<b>Exemptions</b>	2							
<b>Single</b>	<input type="checkbox"/>				<b>Married</b>	<input checked="" type="checkbox"/>							
2008 Period Ending	Total Hours	Gross Earnings				Deductions						Payment	
		Regular	Overtime	Total	Cumulative	FICA	Fed. Inc. Tax	State Inc. Tax	United Fund	Union Dues	Total	Net Amount	Check No.
1/7	42	480.00	36.00	516.00	516.00	41.28	43.00	10.32	10.00	5.00	109.60	406.40	974
<b>1/14</b>	<b>44</b>	<b>480.00</b>	<b>72.00</b>	<b>552.00</b>	<b>1,068.00</b>	<b>44.16</b>	<b>49.00</b>	<b>11.04</b>	<b>10.00</b>	<b>5.00</b>	<b>119.20</b>	<b>432.80</b>	<b>1028</b>
1/21	43	480.00	54.00	534.00	1,602.00	42.72	46.00	10.68	10.00	5.00	114.40	419.60	1077
1/28	42	480.00	36.00	516.00	2,118.00	41.28	43.00	10.32	10.00	5.00	109.60	406.40	1133
Jan.													
<b>Total</b>		<b>1,920.00</b>	<b>198.00</b>	<b>2,118.00</b>		<b>169.44</b>	<b>181.00</b>	<b>42.36</b>	<b>40.00</b>	<b>20.00</b>	<b>452.80</b>	<b>1,665.20</b>	

A separate earnings record is kept for each employee. It is updated after each pay period. The cumulative payroll data on the earnings record are used by the employer to (1) determine when an employee has earned the maximum earnings subject to FICA taxes, (2) file state and federal payroll tax returns (as explained later in the chapter), and (3) provide each employee with a statement of gross earnings and tax withholdings for the year. Illustration 11-10 on page 330 shows this statement.

In addition to employee earnings records, many companies find it useful to prepare a **payroll register**. This record accumulates the gross earnings, deductions, and net pay by employee for each pay period. It provides the documentation for preparing a paycheck for each employee. Academy's payroll register is presented in Illustration 11-9. It shows the data for Mark Jordan in the wages section. In this

**Illustration 11-9**

Payroll register

ACADEMY WATERPARKS Payroll Register For the Week Ending January 14, 2008															
Employee	Total Hours	Earnings			Deductions						Paid		Accounts Debited		
		Regular	Over- time	Gross	FICA	Federal Income Tax	State Income Tax	United Fund	Union Dues	Total	Net Pay	Check No.	Office Salaries Expense	Wages Expense	
<b>Office Salaries</b>															
Arnold, Patricia	40	580.00		580.00	46.40	61.00	11.60	15.00		134.00	446.00	998	580.00		
Canton, Matthew	40	590.00		590.00	47.20	63.00	11.80	20.00		142.00	448.00	999	590.00		
Mueller, William	40	530.00		530.00	42.40	54.00	10.60	11.00		118.00	412.00	1000	530.00		
Subtotal		5,200.00		5,200.00	416.00	1,090.00	104.00	120.00		1,730.00	3,470.00		5,200.00		
<b>Wages</b>															
Bennett, Robin	42	480.00	36.00	516.00	41.28	43.00	10.32	18.00	5.00	117.60	398.40	1025		516.00	
<b>Jordan, Mark</b>	<b>44</b>	<b>480.00</b>	<b>72.00</b>	<b>552.00</b>	<b>44.16</b>	<b>49.00</b>	<b>11.04</b>	<b>10.00</b>	<b>5.00</b>	<b>119.20</b>	<b>432.80</b>	<b>1028</b>		<b>552.00</b>	
Milroy, Lee	43	480.00	54.00	534.00	42.72	46.00	10.68	10.00	5.00	114.40	419.60	1029		534.00	
Subtotal		11,000.00	1,010.00	12,010.00	960.80	2,400.00	240.20	301.50	115.00	4,017.50	7,992.50			12,010.00	
Total		16,200.00	1,010.00	17,210.00	1,376.80	3,490.00	344.20	421.50	115.00	5,747.50	11,462.50		5,200.00	12,010.00	

example, Academy Waterparks' total weekly payroll is \$17,210, as shown in the gross earnings column.

Note that this record is a listing of each employee's payroll data for the pay period. In some companies, a payroll register is a journal or a book of original entry. Postings are made from it directly to ledger accounts. In other companies, the payroll register is a memorandum record that provides the data for a general journal entry and subsequent posting to the ledger accounts. At Academy Waterparks, the latter procedure is followed.

## RECOGNIZING PAYROLL EXPENSES AND LIABILITIES

From the payroll register in Illustration 11-9, a journal entry is made to record the payroll. For the week ending January 14, the entry is

Jan. 14	Office Salaries Expense	5,200.00	
	Wages Expense	12,010.00	
	FICA Taxes Payable		1,376.80
	Federal Income Taxes Payable		3,490.00
	State Income Taxes Payable		344.20
	United Fund Payable		421.50
	Union Dues Payable		115.00
	Salaries and Wages Payable	11,462.50	
	(To record payroll for the week ending January 14)		

<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">A</td> <td style="width: 10%;">=</td> <td style="width: 10%;">L</td> <td style="width: 10%;">+</td> <td style="width: 10%;">SE</td> <td style="width: 10%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+1,376.80</td> <td></td> <td style="text-align: right;">-5,200.00</td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+3,490.00</td> <td></td> <td style="text-align: right;">-12,010.00</td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+344.20</td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+421.50</td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+115.00</td> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">+11,462.50</td> <td></td> <td></td> <td></td> </tr> </table>	A	=	L	+	SE				+1,376.80		-5,200.00				+3,490.00		-12,010.00				+344.20						+421.50						+115.00						+11,462.50			
A	=	L	+	SE																																						
		+1,376.80		-5,200.00																																						
		+3,490.00		-12,010.00																																						
		+344.20																																								
		+421.50																																								
		+115.00																																								
		+11,462.50																																								

Specific liability accounts are credited for the mandatory and the voluntary deductions made during the pay period. In the example, debits to Office Salaries and Wages Expense are used for gross earnings because office workers are on a salary and other employees are paid on an hourly rate. In other companies, there may be debits to other accounts, such as Store Salaries or Sales Salaries. The amount credited to Salaries and Wages Payable is the sum of the individual checks the employees will receive.

## RECORDING PAYMENT OF THE PAYROLL

Payment by check is made from either the employer's regular bank account or a payroll bank account. Each paycheck is usually accompanied by a detachable **statement of earnings** document. This shows the employee's gross earnings, payroll deductions, and net pay for the period and for the year to date. The Academy Waterparks uses its regular bank account for payroll checks. The paycheck and the statement of earnings for Mark Jordan are shown in Illustration 11-10.

Following payment of the payroll, the check numbers are entered in the payroll register. The entry to record payment of the payroll for Academy Waterparks is as follows:

Jan. 14	Salaries and Wages Payable	11,462.50	
	Cash		11,462.50
	(To record payment of payroll)		

<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%;">A</td> <td style="width: 10%;">=</td> <td style="width: 10%;">L</td> <td style="width: 10%;">+</td> <td style="width: 10%;">SE</td> <td style="width: 10%;"></td> </tr> <tr> <td></td> <td></td> <td style="text-align: right;">-11,462.50</td> <td></td> <td style="text-align: right;">-11,462.50</td> <td></td> </tr> </table>	A	=	L	+	SE				-11,462.50		-11,462.50	
A	=	L	+	SE								
		-11,462.50		-11,462.50								

When currency is used in payment, one check is prepared for the payroll's total amount of net pay. This check is then cashed, and the coins and currency are inserted in individual pay envelopes for disbursement to individual employees.

Illustration 11-10

Paycheck and statement of earnings

**HELPFUL HINT**

Do any of the income tax liabilities result in payroll tax expense for the employer? Answer: No. The employer is acting only as a collection agent for the government.

**AW** ACADEMY WATERPARKS No. 1028  
 19 Center St.  
 Hampton, MI 48291 *January 14, 2008* 62-1113  
 610

Pay to the order of Mark Jordan \$ 432.80  
Four Hundred Thirty-two and 80/100 Dollars

City Bank & Trust  
 P.O. Box 3000  
 Hampton, MI 48291

For Payroll Randall C. Barnes

00324477\* ? 1 10

DETACH AND RETAIN THIS PORTION FOR YOUR RECORDS

NAME				SOC. SEC. NO.	EMPL. NUMBER	NO. EXEMP	PAY PERIOD ENDING	
Mark Jordan				320-36-9547		2	1/14/08	
REG. HRS.	O.T. HRS.	OTH. HRS. (1)	OTH. HRS. (2)	REG. EARNINGS	O.T. EARNINGS	OTH. EARNINGS (1)	OTH. EARNINGS (2)	<b>GROSS</b>
40	4			480.00	72.00			\$552.00
FED. W/H TAX	FICA	STATE TAX	LOCAL TAX	OTHER DEDUCTIONS				<b>NET PAY</b>
49.00	44.16	11.04		(1) 10.00	(2) 5.00	(3)	(4)	\$432.80

YEAR TO DATE								
FED. W/H TAX	FICA	STATE TAX	LOCAL TAX	OTHER DEDUCTIONS				NET PAY
92.00	85.44	21.36		(1) 20.00	(2) 10.00	(3)	(4)	\$839.20

**TECHNOLOGY IN ACTION**



In addition to supplying the entry to record the payroll, the output for a computerized payroll system would include (1) payroll checks, (2) a payroll check register sorted by check and department, and (3) updated employee earnings records. Those employee records become the source for monthly, quarterly, and annual reporting of wages to taxing agencies.

**TIPPED EMPLOYEES**

Although other industries pay straight wages to their employees, the hospitality industry has regular-wage employees and tipped employees. It is said that TIPS is the acronym for “To insure prompt service.” A tipped employee earns wages from two sources: a specified rate from the employer and tips from guests. All income earned by an employee, whether it is a wage from the employer or tips from guests, is taxable. Employers need to record tip amounts carefully because such amounts affect the amount of tax the business will pay on behalf of the employee.

What is considered a tip? In a restaurant, any amount left by a guest for the waitstaff or any billed service charge distributed to the waitstaff is defined as a tip. Such tip payments can be in the form of cash or a check or on a charge card or house account, which would be collected by the establishment and paid to the employees later. There are payments that appear to be tips but are really wages and should be classified as such. For instance, if an employer collects all tips and then redistributes the tip payments to all employees, this is wages. This happens mostly in clubs in which the club bills the members for all services with a mandatory gratuity amount. This also applies to hotel banquet departments, which collect a service charge from all customers and redistribute it to all employees. Should an employee receive less than \$20 in “cash” tips during a calendar month, he or she is not required to report the tip amount.

As for wages, as mentioned earlier, the FLSA specifies the amount of minimum wage. The act also allows an employer to take a \$3.02 tip credit on tipped employees. In other words, if the minimum wage set by the act is \$5.15 an hour, an employer need only pay a tipped employee \$2.13 an hour as long as the actual tips earned by the employee are not less than the FLSA maximum allowable tip credit. For example, if a tipped employee earns only \$2.00 in tips rather than the allowable credit of \$3.02, the employer has to pay the employee \$3.15 for the hour. Thus, with the tip of \$2.00 and the employer's wage of \$3.15, the employee will still make the minimum wage of \$5.15 an hour.

As mentioned, the FLSA is strictly federal. Many states have variations of this \$3.02 credit. The Department of Labor Web site does offer a minimum wage and tip credit table that spells out the details of each state ([www.dol.gov](http://www.dol.gov)). Since this information changes according to the state and federal legislatures, please refer to the latest information on the Internet as guidelines.

## TIP REPORTING

Obviously, not all food and beverage operations are the same. You would likely tip in a full-service restaurant but would not leave a tip if you are picking up fast food at a drive-through window. To address these differences, the 1982 **Tax Equity and Fiscal Responsibility Act (TEFRA)** instituted regulations guiding food and beverage operations on tip-reporting requirements. This 8 percent regulation means that if a tipped employee has gross sales of \$100, then it is expected that he or she will at least earn 8 percent of that, or \$8.00, in tips and thus will have to report at least \$8.00 as part of his or her wages.

This 8 percent rule applies to all foodservices except cafeteria and fast-food operations. It also has other provisions to make sure that certain items not usually tipped by guests do not count as gross sales, including takeout orders, complimentary snacks at the bar area, state and local taxes, and a few others. The complimentary items, however, do apply to casinos, because it is customary that guests in casinos will tip for such service. This rule is established so that the true wage earned by a tipped employee can be calculated and the appropriate taxes assessed to both the employee and the employer. Although it is customary for guests to tip about 15 percent of the bill, some will pay more, whereas others will pay less. As the TEFRA rule states, tipped employees need to report only 8 percent of the tips.

In 2002, the U.S. Supreme Court passed a ruling that holds businesses responsible for the shortfall of tip collection. The case resulted when an audit revealed employees at a Californian restaurant did not report at least 8 percent of the tips by customers left on credit cards receipts, let alone the 8 percent collected in the form of cash. If a food-and-beverage operation reports under the 8 percent regulation, it must file an 8027, the Employer's Annual Information Return of Tip Income and Allocated Tips (see Illustration 11-11). The employees may use IRS form 4070 to report tips to the employer (see Illustration 11-12). If you are an owner or a manager of a food-and-beverage establishment, consult the IRS. An agent will be pleased to visit your operation, at no cost to you, and educate your employees on the requirements and forms they need to file.

What happens if employees did not report at least 8 percent of the legitimate gross receipts during a particular period? Do you as an employer need to do anything? Absolutely! It is the employer's responsibility to determine the amount of the shortfall that was not reported and to allocate such amount to the directly tipped employees. The two methods to determine this are the gross receipts method and the hours worked method.

The **gross receipts method** adds all gross receipts of each employee and multiplies the total by 8 percent. This is the amount the employer should report. The difference between this amount and the amount reported by the employee is the shortfall. Each employee's gross receipts are then divided into the total gross receipts to

Form **8027**

## Employer's Annual Information Return of Tip Income and Allocated Tips

OMB No. 1545-0714

2006

Department of the Treasury  
Internal Revenue Service

▶ See separate instructions.

<div style="border: 1px solid black; padding: 5px; margin-bottom: 5px;">                 Name of establishment             </div> <div style="border: 1px solid black; padding: 5px; margin-bottom: 5px;">                 Number and street (see instructions) <span style="float: right;">Employer identification number</span> </div> <div style="border: 1px solid black; padding: 5px;">                 City or town, state, and ZIP code             </div>	Type of establishment (check only one box) <input type="checkbox"/> 1 Evening meals only <input type="checkbox"/> 2 Evening and other meals <input type="checkbox"/> 3 Meals other than evening meals <input type="checkbox"/> 4 Alcoholic beverages
Employer's name (same name as on Form 941)	<b>Establishment number</b> (see instructions)
Number and street (P.O. box, if applicable)	Apt. or suite no.
City, state, and ZIP code (if a foreign address, see instructions)	

Does this establishment accept credit cards, debit cards, or other charges? <input type="checkbox"/> Yes (lines 1 and 2 <b>must</b> be completed) <input type="checkbox"/> No	Check if: Amended Return <input type="checkbox"/> Final Return <input type="checkbox"/>
--	--

**Attributed Tip Income Program (ATIP). See Revenue Procedure 2006-30** ▶

<b>1</b> Total charged tips for calendar year 2006 . . . . .	<b>1</b>	
<b>2</b> Total charge receipts showing charged tips (see instructions) . . . . .	<b>2</b>	
<b>3</b> Total amount of service charges of less than 10% paid as wages to employees . . . . .	<b>3</b>	
<b>4a</b> Total tips reported by indirectly tipped employees . . . . .	<b>4a</b>	
<b>b</b> Total tips reported by directly tipped employees . . . . .	<b>4b</b>	
<b>Note.</b> Complete the <b>Employer's Optional Worksheet for Tipped Employees</b> on page 6 of the instructions to determine potential unreported tips of your employees.		
<b>c</b> Total tips reported (add lines 4a and 4b) . . . . .	<b>4c</b>	
<b>5</b> Gross receipts from food or beverage operations (not less than line 2—see instructions) . . . . .	<b>5</b>	
<b>6</b> Multiply line 5 by 8% (.08) or the lower rate shown here ▶ _____ granted by the IRS. (Attach a copy of the IRS determination letter to this return.) . . . . .	<b>6</b>	
<b>Note.</b> If you have allocated tips using other than the calendar year (semimonthly, biweekly, quarterly, etc.), mark an "X" on line 6 and enter the amount of allocated tips from your records on line 7.		
<b>7</b> Allocation of tips. If line 6 is more than line 4c, enter the excess here . . . . .	<b>7</b>	
▶ This amount must be allocated as tips to tipped employees working in this establishment. Check the box below that shows the method used for the allocation. (Show the portion, if any, attributable to each employee in box 8 of the employee's Form W-2.)		
<b>a</b> Allocation based on hours-worked method (see instructions for restriction) . . . . . <input type="checkbox"/>		
<b>Note.</b> If you marked the checkbox in line 7a, enter the average number of employee hours worked per business day during the payroll period. (see instructions) _____		
<b>b</b> Allocation based on gross receipts method . . . . . <input type="checkbox"/>		
<b>c</b> Allocation based on good-faith agreement (Attach a copy of the agreement.) . . . . . <input type="checkbox"/>		

**8** Enter the total number of directly tipped employees at this establishment during 2006 ▶

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.

Signature ▶ Title ▶ Date ▶

Form **4070**  
(Rev. August 2005)  
Department of the Treasury  
Internal Revenue Service

### Employee's Report of Tips to Employer

OMB No. 1545-0074

**Illustration 11-12**  
IRS Form 4070

Employee's name and address	Social security number : : :
Employer's name and address (include establishment name, if different)	1 Cash tips received
	2 Credit and debit card tips received
	3 Tips paid out
Month or shorter period in which tips were received from _____, _____, to _____,	4 Net tips (lines 1 + 2 - 3)
Signature _____	Date _____

**For Paperwork Reduction Act Notice, see the instructions on the back of this form.** Cat. No. 41320P Form **4070** (Rev. 8-2005)

Date tips rec'd	Date of entry	a. Tips received directly from customers and other employees	b. Credit and debit card tips received	c. Tips paid out to other employees	d. Names of employees to whom you paid tips
16					
17					
18					
19					
20					
21					
22					
23					
24					
25					
<b>Subtotals</b>					

Date tips rec'd	Date of entry	a. Tips received directly from customers and other employees	b. Credit and debit card tips received	c. Tips paid out to other employees	d. Names of employees to whom you paid tips
26					
27					
28					
29					
30					
31					
<b>Subtotals from pages 1, 2, and 3</b>					
<b>Totals</b>					

1. Report total cash tips (col. a) on Form 4070, line 1.
2. Report total credit and debit card tips (col. b) on Form 4070, line 2.
3. Report total tips paid out (col. c) on Form 4070, line 3.

obtain a weighted ratio. The ratio is multiplied by the employee's 8 percent amount to determine the part of the 8 percent amount that should be reported by each employee. This is then compared to the amounts actually reported by each employee. For those employees who report at least their fair share of 8 percent, there is no allocation. For those who report less than their fair share of 8 percent, an allocation will be made to their paycheck, and taxes will be assessed accordingly.

The **hours worked method** is essentially the same in terms of mathematic procedures. The difference is the use of total hours worked, rather than the gross receipts, as the benchmark for calculation. Illustrations 11-13 and 11-14 are examples of the gross receipts method and the hours worked method, respectively.



**Illustration 11-13**

The Gross Receipts Method

**Step 1. Determining the amount of shortfall to be allocated**

Employees	Gross Receipts	Tips Reported	
A	\$ 31,500	\$ 2,125	
B	33,450	2,000	
C	30,050	2,260	
D	24,500	1,400	
E	30,500	2,105	
	<u>\$150,000</u>	<u>\$ 9,890</u>	
Indirectly Tipped Employees		\$ 750	
Total actual tips reported		<u>\$10,640</u>	
Total tips according to 8% rule ( $\$150,000 \times 8\%$ )			\$12,000.00
Total actual tips reported			10,640.00
Shortfall to be allocated			<u>1,360.00</u>
Total tips according to 8% rule			\$12,000.00
Tips reported by indirectly tipped employees			<u>750.00</u>
Tips that should have been reported by tipped employees			<u>\$11,250.00</u>

**Step 2. Determining individual shortfall amounts**

Employee	Tips That Should Have Been Reported	Gross Receipts Ratios	=	Employee's Share of the 8%	-	Actual Reported	=	Shortfall Portion
A	$\$11,250.00 \times$	$31,500/150,000$	=	\$ 2,362.50	-	\$2,125	=	\$ 237.50
B	$\$11,250.00 \times$	$33,450/150,000$	=	2,508.75	-	2,000	=	508.75
C	$\$11,250.00 \times$	$30,050/150,000$	=	2,253.75	-	2,260	=	—
D	$\$11,250.00 \times$	$24,500/150,000$	=	1,837.50	-	1,400	=	437.50
E	$\$11,250.00 \times$	$30,500/150,000$	=	2,287.50	-	2,105	=	182.50
	Totals			<u>\$11,250.00</u>		<u>\$9,890</u>		<u>\$1,366.25</u>
								Total shortfall

**Step 3. Allocation of shortfall**

Employee	Shortfall Ratio	Shortfall to Be Allocated	=	Tip Allocation
A	$237.5/1,366.25$	$\times 1,360$	=	\$ 236.41
B	$508.75/1,366.25$	$\times 1,360$	=	506.42
C	0	$\times 1,360$	=	—
D	$437.5/1,366.25$	$\times 1,360$	=	435.50
E	$182.5/1,366.25$	$\times 1,360$	=	181.67
				<u>\$1,360.00</u>

**Illustration 11-14**

The Hours Worked Method

**Step 1. Determining the amount of shortfall to be allocated**

Employees	Hours Worked	Tips Reported	
A	40	\$ 2,125	
B	45	2,000	
C	40	2,260	
D	30	1,400	
E	30	2,105	
	<u>185</u>	<u>\$ 9,890</u>	
Indirectly Tipped Employees		<u>750</u>	
Total actual tips reported		\$10,640	
Total tips according to 8% rule (\$150,000 × 8%)			\$12,000.00
Total actual tips reported			<u>10,640.00</u>
Shortfall to be allocated			<u>\$ 1,360.00</u>
Total tips according to 8% rule			\$12,000.00
Tips reported by indirectly tipped employees			<u>750.00</u>
Tips that should have been reported by tipped employees			<u>\$11,250.00</u>

**Step 2. Determining individual shortfall amounts**

Employee	Tips That Should Have Been Reported		Hours Worked Ratios	=	Employee's Share of the 8%		Actual Reported	=	Shortfall Portion
A	\$11,250.00	×	40/185	=	\$ 2,432.43	−	\$2,125	=	\$ 307.43
B	11,250.00	×	45/185	=	2,736.49	−	2,000	=	736.49
C	11,250.00	×	40/185	=	2,432.43	−	2,260	=	172.43
D	11,250.00	×	30/185	=	1,824.32	−	1,400	=	424.32
E	11,250.00	×	30/185	=	1,824.32	−	2,105	=	—
			Total		<u>\$11,250.00</u>		<u>\$9,890</u>		<u>\$1,640.67</u>
									Total shortfall

**Step 3. Allocation of shortfall**

Employee	Shortfall Ratio		Shortfall to Be Allocated	=	Tip Allocation
A	307.43/1640.68	×	1,360	=	\$ 254.83
B	736.49/1640.68	×	1,360	=	\$ 610.51
C	172.43/1640.68	×	1,360	=	\$ 142.93
D	424.32/1640.68	×	1,360	=	\$ 351.73
E	0	×	1,360	=	\$ —
					<u>\$1,360.00</u>

## BEFORE YOU GO ON...

## ▶ REVIEW IT

1. Identify two internal control procedures that apply to each payroll function.
2. What are the primary sources of gross earnings?
3. What payroll deductions are (a) mandatory and (b) voluntary?
4. What account titles are used in recording a payroll, assuming only mandatory payroll deductions are involved?

## ▶ DO IT

Your cousin Stan is establishing a small catering business and will have a number of employees working for him. He is aware that documentation procedures are an important part of internal control. But he is confused about the difference between an employee earnings record and a payroll register. He asks you to explain the principal differences because he wants to be sure that he sets up the proper payroll procedures.

## ACTION PLAN

- Determine the earnings and deductions data that must be recorded and reported for each employee.
- Design a record that will accumulate earnings and deductions data and will serve as a basis for journal entries to be prepared and posted to the general ledger accounts.
- Explain the difference between the employee earnings record and the payroll register.

## SOLUTION

An employee earnings record is kept for *each* employee. It shows gross earnings, payroll deductions, and net pay for each pay period. It provides cumulative payroll data for that employee. In contrast, a payroll register is a listing of *all* employees' gross earnings, payroll deductions, and net pay for each pay period. It is the documentation for preparing paychecks and for recording the payroll. Of course, Stan will need to keep both documents.



## EMPLOYER PAYROLL TAXES

### STUDY OBJECTIVE 3

Describe and record employer payroll taxes.

Payroll tax expense for businesses results from three taxes *levied on employers* by governmental agencies. These taxes are (1) FICA, (2) federal unemployment tax, and (3) state unemployment tax. These taxes plus such items as paid vacations and pensions are collectively referred to as **fringe benefits**. As indicated earlier, the cost of fringe benefits in many companies is substantial.

### FICA TAXES

We have seen that each employee must pay FICA taxes. An employer must match each employee's FICA contribution. The matching contribution results in **payroll tax expense** to the employer. The employer's tax is subject to the same rate and maximum earnings applicable to the employee. The account, FICA Taxes Payable, is used for both the employee's and the employer's FICA contributions. For the January 14 payroll, Academy Waterparks' FICA tax contribution is \$1,376.80 ( $\$17,210.00 \times 8\%$ ).

#### HELPFUL HINT

FICA taxes are paid by both the employer and the employee. Federal unemployment taxes and (in most states) state unemployment taxes are borne entirely by the employer.

### FEDERAL UNEMPLOYMENT TAXES

The Federal Unemployment Tax Act (FUTA) is another feature of the federal Social Security program. **Federal unemployment taxes** provide benefits for a limited period of time to employees who lose their jobs through no fault of their

own. Under provisions of the act, the employer is required to pay a tax of 6.2 percent on the first \$9,000 of gross wages paid to each employee during a calendar year. The law allows the employer a maximum credit of 5.4 percent on the federal rate for contributions to state unemployment taxes. Because of this provision, state unemployment tax laws generally provide for a 5.4 percent rate. The effective federal unemployment tax rate thus becomes 0.8 percent (6.2% – 5.4%). **This tax is borne entirely by the employer.** There is no deduction or withholding from employees.

The account Federal Unemployment Taxes Payable is used to recognize this liability. The federal unemployment tax for Academy Waterparks for the January 14 payroll is \$137.68 ( $\$17,210.00 \times 0.8\%$ ).

## STATE UNEMPLOYMENT TAXES

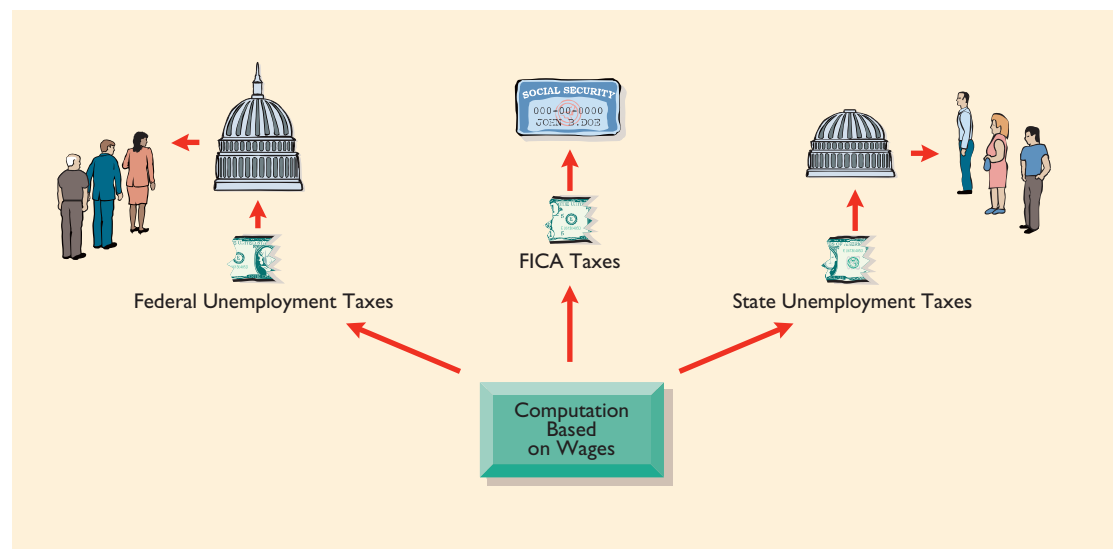
All states have unemployment compensation programs under state unemployment tax acts (SUTAs). Like federal unemployment taxes, **state unemployment taxes** provide benefits to employees who lose their jobs. These taxes are levied on employers.<sup>2</sup> The basic rate is usually 5.4 percent on the first \$9,000 of wages paid to an employee during the year. The basic rate is adjusted according to the employer's experience rating: Companies with a history of unstable employment may pay more than the basic rate. Companies with a history of stable employment may pay less than 5.4 percent. Regardless of the rate paid, the credit on the federal unemployment tax is still 5.4 percent.

The account State Unemployment Taxes Payable is used for this liability. The state unemployment tax for Academy Waterparks for the January 14 payroll is \$929.34 ( $\$17,210.00 \times 5.4\%$ ).

Illustration 11-15 summarizes the types of employer payroll taxes.

### Illustration 11-15

Employer payroll taxes



## RECORDING EMPLOYER PAYROLL TAXES

Employer payroll taxes are usually recorded at the same time the payroll is journalized. The entire amount of gross pay (\$17,210.00) shown in the payroll register in Illustration 11-9 is subject to each of the three taxes previously mentioned.

<sup>2</sup>In a few states, the employee is also required to make a contribution. In this textbook, including the homework, we will assume that the tax is only on the employer.

Accordingly, the entry to record the payroll tax expense associated with the January 14 payroll is

A	=	L	+	SE
		+1,376.80		-2,443.82
		+137.68		
		+929.34		

Jan. 14	Payroll Tax Expense	2,443.82	
	FICA Taxes Payable		1,376.80
	Federal Unemployment Taxes Payable		137.68
	State Unemployment Taxes Payable		929.34
	(To record employer's payroll taxes on January 14 payroll)		

Separate liability accounts are used instead of a single credit to Payroll Taxes Payable. Why? Because these liabilities are payable to different taxing authorities at different dates. The liability accounts are classified in the balance sheet as current liabilities because they will be paid within the next year. Payroll Tax Expense is classified on the income statement as an operating expense.

### FILING AND REMITTING PAYROLL TAXES

Preparation of payroll tax returns is the responsibility of the payroll department. Payment of the taxes is made by the treasurer's department. Much of the information for the returns is obtained from employee earnings records.

For purposes of reporting and remitting to the IRS, FICA taxes and federal income taxes that were withheld are combined. **The taxes must be reported quarterly, no later than one month following the close of each quarter.** The remitting requirements depend on the amount of taxes withheld and the length of the pay period. Remittances are made through deposits in either a Federal Reserve bank or an authorized commercial bank.

Federal unemployment taxes generally are filed and remitted *annually* on or before January 31 of the subsequent year. Earlier payments are required when the tax exceeds a specified amount. State unemployment taxes usually *must be filed and paid by the end of the month following each quarter.* When payroll taxes are paid, payroll liability accounts are debited, and Cash is credited.

The employer is also required to provide each employee with a **Wage and Tax Statement (Form W-2)** by January 31 following the end of a calendar year. This statement shows gross earnings, FICA taxes withheld, and income taxes withheld for the year. The required W-2 form for Mark Jordan, using assumed annual data, is shown in Illustration 11-16.

The employer must send a copy of each employee's Form W-2 to the Social Security Administration. This agency subsequently furnishes the Internal Revenue Service with the income data required.

Illustration 11-16

W-2 Form

a Control number		OMB No. 1545-0008			
b Employer's identification number 36-2167852		1 Wages, tips, other compensation \$26,300.00	2 Federal income tax withheld \$2,248.00		
c Employer's name, address and ZIP code Academy Waterparks 19 Center St. Hampton, MI 48291		3 Social security wages \$26,300.00	4 Social security tax withheld \$2,104.00		
d Employee's social security number 329-36-9547		5 Medicare wages and tips	6 Medicare tax withheld		
e Employee's first name and initial Last name Mark Jordan 2345 Mifflin Ave. Hampton, MI 48292		7 Social security tips	8 Allocated tips		
f Employee's address, and ZIP code		9 Advance EIC payment	10 Dependent care benefits		
15 State Employer's state ID number		16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax
			\$526.00		
					Michigan
Form <b>W-2</b> Wage and Tax Statement		2008		Department of the Treasury—Internal Revenue Service	

**BEFORE YOU GO ON...**

▶ **REVIEW IT**

1. What payroll taxes are levied on employers?
2. What accounts are involved in accruing employer payroll taxes?

▶ **DO IT**

In January, the payroll supervisor determines that gross earnings in Halo Company for the month are \$70,000. All earnings are subject to 8 percent FICA taxes, 5.4 percent state unemployment taxes, and 0.8 percent federal unemployment taxes. You are asked to record the employer's payroll taxes.

**ACTION PLAN**

- Compute the employer's payroll taxes on the period's gross earnings.
- Identify the expense account(s) to be debited.
- Identify the liability account(s) to be credited.

**SOLUTION**

The entry to record the employer's payroll taxes is:

Payroll Tax Expense	9,940	
FICA Taxes Payable (\$70,000 × 8%)		5,600
Federal Unemployment Taxes Payable (\$70,000 × 0.8%)		560
State Unemployment Taxes Payable (\$70,000 × 5.4%)		3,780
(To record employer's payroll taxes on January payroll)		



**D** **EMONSTRATION PROBLEM**

Indiana Jones Company had the following payroll transactions:

- Feb. 28 The payroll for the month consists of Sales Salaries \$32,000 and Office Salaries \$18,000. All wages are subject to 8 percent FICA taxes. A total of \$8,900 federal income taxes are withheld. The salaries are paid on March 1.
- 28 Employer payroll taxes include 8 percent FICA taxes, 5.4 percent state unemployment tax, and 0.8 percent federal unemployment tax.

**Instructions**

- (a) Journalize the February payroll transaction.
- (b) Journalize the payroll adjusting entry at February 28.

**SOLUTION TO DEMONSTRATION PROBLEM**

<b>(a)</b>	Feb. 28	Sales Salaries Expense	32,000	
		Office Salaries Expense	18,000	
		FICA Taxes Payable (\$50,000 × 8%)		4,000
		Federal Income Taxes Payable		8,900
		Salaries Payable		37,100
		(To record February salaries)		
<b>(b)</b>	Feb. 28	Payroll Tax Expense	7,100	
		FICA Taxes Payable		4,000
		Federal Unemployment Taxes Payable (\$50,000 × 0.8%)		400
		State Unemployment Taxes Payable (\$50,000 × 5.4%)		2,700
		(To record employer's payroll taxes on February payroll)		

**ACTION PLAN**

- Base employees' payroll taxes on gross earnings.
- Base employer's payroll taxes on gross earnings.

## SUMMARY OF STUDY OBJECTIVES

- 1. Discuss the objectives of internal control for payroll.** The objectives of internal control for payroll are (1) to safeguard company assets against unauthorized payments of payrolls and (2) to ensure the accuracy of the accounting records pertaining to payrolls.
- 2. Compute and record the payroll for a pay period.** The computation of the payroll involves gross earnings, payroll deductions, and net pay. In recording the payroll, Salaries (or Wages) Expense is debited for gross earnings, individual tax and other liability accounts are credited for payroll deductions, and Salaries (Wages) Payable is credited for net pay. When the payroll is paid, Salaries and Wages Payable is debited, and Cash is credited.
- 3. Compute and record tips under the 8 percent tip regulation.** The computation and recording of the 8 percent tip

regulation is based on 8 percent of the gross receipts. The Tax Equity and Fiscal Responsibility Act (TEFRA) details the calculation of gross receipts and the types of establishments that are included in this reporting. If all the employees' tips reportings do not meet at least 8 percent of the gross receipts of the business, the employer needs to perform an allocation by either the gross receipts method or the hours worked method to allocate such shortfall to the appropriate employee.

- 4. Describe and record employer payroll taxes.** Employer payroll taxes consist of FICA, federal unemployment taxes, and state unemployment taxes. The taxes are usually accrued at the time the payroll is recorded by debiting Payroll Tax Expense and crediting separate liability accounts for each type of tax.



## GLOSSARY

- Bonus** Compensation to management personnel and other employees, based on factors such as increased sales or the amount of net income (p. 324).
- Employee earnings record** A cumulative record of each employee's gross earnings, deductions, and net pay during the year (p. 327).
- Employee's Withholding Allowance Certificate (Form W-4)** An Internal Revenue Service form on which the employee indicates the number of allowances claimed for withholding federal income taxes (p. 326).
- Fair Labor Standards Act (FLSA)** 1938 law, amended with additional provisions in 1977, commonly known as FLSA. It provides minimum standards for both wages and overtime entitlement, equal pay, and child labor and spells out administrative procedures by which covered work time must be compensated (p. 323).
- Federal Insurance Contribution Act (FICA) taxes** Taxes designed to provide workers with supplemental retirement, employment disability, and medical benefits (p. 325).
- Federal unemployment taxes** Taxes imposed on the employer that provide benefits for a limited time period to employees who lose their jobs through no fault of their own (p. 336).
- Fringe benefits** Any form of employee compensation except salary and wages. This may include life or medical insurance, retirement, bonus plans, or leaves (p. 336).
- Gross earnings** Total compensation earned by an employee (p. 324).
- Gross receipts method** A method of tip reporting under which all gross receipts of employees are totaled and then

multiplied by 8 percent to determine the amount of tips an employee should report (p. 331).

**Hours worked method** A method of tip reporting under which the total hours worked by all employees are used as the benchmark for tip calculation (p. 333).

**Net pay** Gross earnings less payroll deductions (p. 327).

**Payroll deductions** Deductions from gross earnings to determine the amount of a paycheck (p. 325).

**Payroll register** A payroll record that accumulates the gross earnings, deductions, and net pay by employee for each pay period (p. 328).

**Salaries** Specified amount per month or per year paid to executive and administrative personnel (p. 320).

**Statement of earnings** A document attached to a paycheck that indicates the employee's gross earnings, payroll deductions, and net pay to date (p. 329).

**State unemployment taxes** Taxes imposed on the employer that provide benefits to employees who lose their jobs (p. 337).

**Tax Equity and Fiscal Responsibility Act (TEFRA)** 1982 law that institutes regulations guiding food and beverage operations on tip reporting (p. 331).

**Wage and Tax Statement (Form W-2)** A form showing gross earnings, FICA taxes withheld, and income taxes withheld that is prepared annually by an employer for each employee (p. 338).

**Wages** Amounts paid to employees based on a rate per hour or per piece (p. 320).

## EXERCISES

Compute gross earnings and net pay.

(SO 2)

- 11-1** Sandy Teter's regular hourly wage rate is \$16, and she receives an hourly rate of \$24 for work in excess of 40 hours. During a January pay period, Sandy works 45 hours. Sandy's federal income tax withholding is \$95, and she has no voluntary deductions. Compute Sandy Teter's gross earnings and net pay for the pay period.

**11-2** Data for Sandy Teter are presented in 11-1. Prepare the journal entries to record (a) Sandy’s pay for the period and (b) the payment of Sandy’s wages. Use January 15 for the end of the pay period and the payment date.

*Record a payroll and the payment of wages.*  
(SO 2)

**11-3** In January, gross earnings in Yoon Company totaled \$90,000. All earnings are subject to 8% FICA taxes, 5.4% state unemployment taxes, and 0.8% federal unemployment taxes. Prepare the entry to record January payroll tax expense.

*Record employer payroll taxes.*  
(SO 3)

**11-4** Employee earnings records for Brantley Restaurants reveal the following gross earnings for four employees through the pay period of December 15:

*Compute maximum FICA deductions.*  
(SO 2)

C. Mays	\$83,500	D. Delgado	\$86,100
L. Jeter	\$85,600	T. Rolan	\$87,000

For the pay period ending December 31, each employee’s gross earnings is \$3,000. The FICA tax rate is 8 percent on gross earnings of \$87,900.

**Instructions**

Compute the FICA withholdings that should be made for each employee for the December 31 pay period. (Show computations.)

**11-5** Marissa’s Sushi has the following data for the weekly payroll ending January 31:

*Prepare payroll register, and record payroll and payroll tax expense.*  
(SO 2, 3)

Employee	Hours						Hourly Rate	Federal Income Tax Withholding	Health Insurance
	M	T	W	T	F	S			
M. Hindi	8	8	9	8	10	3	\$11	\$34	\$10
E. Benson	8	8	8	8	8	2	13	37	15
K. Estes	9	10	8	8	9	0	14	58	15

Employees are paid 1½ times the regular hourly rate for all hours worked in excess of 40 hours per week. FICA taxes are 8 percent on the first \$87,900 of gross earnings. Marissa’s Sushi is subject to 5.4 percent state unemployment taxes on the first \$9,800 and 0.8 percent federal unemployment taxes on the first \$7,000 of gross earnings.

**Instructions**

- (a) Prepare the payroll register for the weekly payroll.
- (b) Prepare the journal entries to record the payroll and Marissa’s payroll tax expense.

**11-6** The payroll procedures used by three different companies are:

*Identify internal control weaknesses and make recommendations for improvement.*  
(SO 1)

1. In Brewer Cafe, each employee is required to mark on a clock card the hours worked. At the end of each pay period, the employee must have this clock card approved by the department manager. The approved card is then given to the payroll department by the employee. Subsequently, the treasurer’s department pays the employee by check.
2. In Evan’s Steak House, clock cards and time clocks are used. At the end of each pay period, the department manager initials the cards, indicates the rates of pay, and sends them to payroll. A payroll register is prepared from the cards by the payroll department. Cash equal to the total net pay in each department is given to the department manager, who pays the employees in cash.
3. In Elien’s Noodles, employees are required to record hours worked by “punching” clock cards in a time clock. At the end of each pay period, the clock cards are collected by the department manager. The manager prepares a payroll register in duplicate and forwards the original to payroll. In payroll, the summaries are checked for mathematical accuracy, and a payroll supervisor pays each employee by check.

**Instructions**

- (a) Indicate the weakness(es) in internal control in each company.
- (b) For each weakness, describe the control procedure(s) that will provide effective internal control. Use the following format for your answer:

**(a) Weaknesses**                      **(b) Recommended Procedures**



Prepare payroll register and payroll entries.  
(SO 2, 3)

**11-7** Joe's Sandwich Shop has four employees who are paid on an hourly basis plus time-and-a-half for all hours worked in excess of 40 a week. Payroll data for the week ended February 15, 2010, are presented below:

<u>Employees</u>	<u>Hours Worked</u>	<u>Hourly Rate</u>	<u>Federal Income Tax Withholdings</u>	<u>United Fund</u>
L. Leiss	39	\$14.00	\$ ?	\$ —
S. Bjork	42	\$12.00	?	5.00
M. Cape	44	\$12.00	61	7.50
L. Wild	48	\$12.00	52	5.00

Leiss and Bjork are married. They claim two and four withholding allowances, respectively. The following tax rates are applicable: FICA 8 percent, state income taxes 3 percent, state unemployment taxes 5.4 percent, and federal unemployment taxes 0.8 percent. The first three employees are sales clerks (store wage expense). The fourth employee performs administrative duties (office wages expense).

**Instructions**

- Prepare a payroll register for the weekly payroll. (Use the wage-bracket withholding table in the text for federal income tax withholdings.)
- Journalize the payroll on February 15, 2010, and the accrual of employer payroll taxes.
- Journalize the payment of the payroll on February 16, 2010.
- Journalize the deposit in a Federal Reserve bank on February 28, 2010, of the FICA and federal income taxes payable to the government.

Journalize payroll transactions and adjusting entries.  
(SO 2, 3)

**11-8** The following payroll liability accounts are included in the ledger of Milton's Brewery and Grille on January 1, 2010:

FICA Taxes Payable	\$ 662.20
Federal Income Taxes Payable	1,254.60
State Income Taxes Payable	102.15
Federal Unemployment Taxes Payable	312.00
State Unemployment Taxes Payable	1,954.40
Union Dues Payable	250.00
U.S. Savings Bonds Payable	350.00

In January, the following transactions occurred:

- Jan. 10 Sent check for \$250.00 to union treasurer for union dues.
- 12 Deposited check for \$1,916.80 in Federal Reserve bank for FICA taxes and federal income taxes withheld.
- 15 Purchased U.S. Savings Bonds for employees by writing check for \$350.00.
- 17 Paid state income taxes withheld from employees.
- 20 Paid federal and state unemployment taxes.
- 31 Completed monthly payroll register, which shows office salaries \$17,600; store wages \$27,400; FICA taxes withheld \$3,600; federal income taxes payable \$1,770; state income taxes payable \$360; union dues payable \$400; United Fund contributions payable \$1,800; and net pay \$37,070.
- 31 Prepared payroll checks for the net pay, and distributed checks to employees.

On January 31, the company also makes the following accrual for employer payroll taxes: FICA taxes 8 percent, state unemployment taxes 5.4 percent, and federal unemployment taxes 0.8 percent.

**Instructions**

- Journalize the January transactions.
- Journalize the adjustments pertaining to employee compensation at January 31.

**11-9** For the year ended December 31, 2010, R. Visnak Company reports the following summary payroll data:

*Prepare entries for payroll and payroll taxes; prepare W-2 data.*  
(SO 2, 3)

Gross earnings	
Administrative salaries	\$180,000
Electricians' wages	320,000
Total	<u>\$500,000</u>
Deductions	
FICA taxes	\$35,200
Federal income taxes withheld	153,000
State income taxes withheld (2.6%)	13,000
United Fund contributions payable	25,000
*Hospital insurance premiums	15,800
Total	<u>\$242,000</u>

R. Visnak Company's payroll taxes are FICA 8 percent, state unemployment 2.5 percent (due to a stable employment record), and federal unemployment 0.8 percent. Gross earnings subject to FICA taxes total \$440,000, and unemployment taxes total \$110,000.

**Instructions**

- (a) Prepare a summary journal entry at December 31 for the full year's payroll.
- (b) Journalize the adjusting entry at December 31 to record the employer's payroll taxes.
- (c) The W-2 Wage and Tax Statement requires the following dollar data:

<u>Wages, Tips, Other Compensation</u>	<u>Federal Income Tax Withheld</u>	<u>State Income Tax Withheld</u>	<u>FICA Wages</u>	<u>FICA Tax Withheld</u>
--	--	--------------------------------------	-----------------------	------------------------------

Complete the required data for the following employees:

<u>Employee</u>	<u>Gross Earnings</u>	<u>Federal Income Tax Withheld</u>
R. Lopez	\$60,000	\$27,500
K. Kirk	27,000	11,000

**11-10** Nguyen's Vietnamese Sandwiches employs seven waitpersons with one busperson, with whom the waitpersons will share their tips. The information regarding their gross receipts, number of hours worked, and tips reported are detailed in the table below. The owner, Mrs. Trang Nguyen, is not sure that all the waitpersons report the required 8 percent of gross receipts. Using both the gross receipts and the hours worked methods, please help Mrs. Nguyen identify the tip amounts that need to be allocated to each employee, if any.

*Prepare entries for payroll and payroll taxes; prepare W-2 data.*  
(SO 3)

<u>Employee</u>	<u>Gross Receipts</u>	<u>Hours Worked</u>	<u>Tips Reported</u>
1	\$28,000	30	\$1,600
2	35,000	40	2,670
3	17,500	20	1,250
4	31,230	40	3,150
5	40,100	40	3,870
6	42,290	38	3,775
7	34,300	40	2,200

**EXPLORING THE WEB**

**11-11** The Internal Revenue Service provides considerable information over the Internet. The following demonstrates how useful one of its sites is in answering payroll tax questions faced by employers.

**Address:** [www.irs.ustreas.gov/formspubs/index.html](http://www.irs.ustreas.gov/formspubs/index.html), or go to [www.wiley.com/college/weygandt](http://www.wiley.com/college/weygandt)

**Steps**

1. Go to the sites shown on the previous page.
2. Choose **Publications Online**.
3. Choose **Publication 15, Circular E, Employer's Tax Guide**.

**Instructions**

Answer each of the following questions:

- (a) How does the government define “employees”?
- (b) What are the special rules for Social Security and Medicare regarding children who are employed by their parents?
- (c) How can an employee obtain a Social Security card if he or she doesn't have one?
- (d) Must employees report to their employer tips received from customers? If so, what is the process?
- (e) Where should the employer deposit Social Security taxes withheld or contributed?

**GROUP DECISION CASE**

**11-12** Kishwaukee Catering Company provides catering services for banquets, events, and other catering functions within a university community. The work is fairly steady throughout the year but peaks significantly in December and May as a result of holiday parties and graduation events.

Two years ago, the company attempted to meet the peak demand by hiring part-time help. However, this led to numerous errors and considerable customer dissatisfaction. A year ago, the company hired four experienced employees on a permanent basis instead of using part-time help. This proved to be much better in terms of productivity and customer satisfaction. But it has caused an increase in annual payroll costs and a significant decline in annual net income.

Recently, Valarie Flynn, a sales representative of Harrington Services, Inc., has made a proposal to the company. Under her plan, Harrington Services will provide up to four experienced workers at a daily rate of \$110 per person for an eight-hour workday. Harrington workers are not available on an hourly basis. Kishwaukee Catering would have to pay only the daily rate for the workers used.

The owner of Kishwaukee, Martha Bell, asks you, as the company's accountant, to prepare a report on the expenses that are pertinent to the decision. If the Harrington plan is adopted, Martha will terminate the employment of two permanent employees and will keep two permanent employees. At the moment, each employee earns an annual income of \$30,000. Kishwaukee pays 8 percent FICA taxes, 0.8 percent federal unemployment taxes, and 5.4 percent state unemployment taxes. The unemployment taxes apply to only the first \$7,000 of gross earnings. In addition, Kishwaukee Catering pays \$40 per month for each employee for medical and dental insurance.

Martha indicates that if the Harrington Services plan is accepted, Kishwaukee's needs for Harrington's workers will be as follows.

<u>Months</u>	<u>Number</u>	<u>Working Days per Month</u>
January–March	2	20
April–May	3	25
June–October	2	18
November–December	3	23

**Instructions**

With the class divided into groups, answer the following:

- (a) Prepare a report showing the comparative payroll expense of continuing to employ permanent workers compared to adopting the Harrington Services, Inc., plan.
- (b) What other factors should Martha consider before finalizing her decision?

**ETHICS CASE**

**11-13** Harry Smith owns and manages Harry's Restaurant, a twenty-four-hour restaurant near the city's medical complex. Harry employs nine full-time employees and sixteen part-time

employees. He pays all the full-time employees by check, the amounts of which are determined by Harry's public accountant, Pam Web. Harry pays all his part-time employees in cash. He computes their wages and withdraws the cash directly from his cash register.

Pam has repeatedly urged Harry to pay all employees by check. But, as Harry has told his competitor and friend, Steve Hill, who owns the Greasy Diner, "First of all, my part-time employees prefer the cash over a check; and second, I don't withhold or pay any taxes or workmen's compensation insurance on those wages because they go totally unrecorded and unnoticed."

**Instructions**

- (a) Who are the stakeholders in this situation?
- (b) What are the legal and ethical considerations regarding Harry's handling of his payroll?
- (c) Pam Web is aware of Harry's payment of the part-time payroll in cash. What are her ethical responsibilities in this case?
- (d) What internal control principle is violated in this payroll process?



Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.