

**Fundamentals of Payroll Accounting**

Tanya Johnson, AVP Financial Accounting & Payroll

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### Agenda

- Accounting Basics
- Financial Statements
- Account Balances
- Chart of Accounts
- Journal Entries
- Account Reconciliations
- Internal Control
- Questions
- Case Study

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### Definition of Accounting

- Accounting is the action or process of keeping financial accounts.
  - What does this mean?
- Accounting is the recording of financial transactions plus storing, sorting, retrieving, summarizing and presenting the information in various reports and analyses

REPORT			
1234,76	736,47	1627,23	1779,49
3458,23	2291,34	5405,57	5559,39
234,28	36,83	127,11	78,68
1276,12	765,39	1807,51	1849,8
745,14	114,36	115,5	267,14
1576,08	975,15	2207,23	2359,74
772,74	413,39	842,15	994,09
832,11	454,9	943,01	1094,9
2345,23	1513,09	3014,42	2667,9
=====			
12074,81	8316,92	20047,73	20207,73
=====			
1627,23	1779,49	1234,76	736,47
5405,57	5559,39	2458,23	36,83
127,11	78,68	234,28	1234,76
1697,51	1849,8	1276,12	765,39
115,5	267,14	1845,14	114,36
2207,23	2359,74	1576,08	975,15
842,15	994,09	772,74	413,39
943,01	1094,9	832,11	454,9
2345,23	2667,9	3014,42	1513,09
=====			
17,73	20207,58	12074,81	8316,92

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### GAAP

- GAAP stands for Generally Accepted Accounting Principles
- GAAP is a common set of accepted accounting principles, standards and procedures that companies must follow when compiling financial statements
- GAAP is determined by the Financial Accounting Standards Board (FASB)



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### Fundamental Accounting Equation

- $Assets - Liabilities = Equity$ 
  - Also known as the Balance Sheet equation
- For every transaction

# Debits = Credits

- All entries must balance
- One account is increased and another account is decreased

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### Financial Statements

- Basic components of Financial Statements
  - Balance Sheet
  - Income Statement
  - Statement of Cash Flows
  - Statement of Changes in Equity



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### Balance Sheet

- Shows a Company's Financial Position at a single point in time
  - An "as of" Date
  - Typically is the last day of the month, but companies can utilize several different accounting period calendar structures



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### Types of Balance Sheet Accounts

- ASSETS**
  - Provides a benefit or value to the Company over time
- LIABILITY**
  - Company debts that must be paid in the future
  - Divided into either Current (paid within a year) or long term (paid after one year)
- EQUITY**
  - Funds invested in a Company by its owners

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### Examples of Balance Sheet Accounts

- ASSETS**
  - Cash
  - Receivable
- LIABILITY**
  - Accrued Payroll
  - Accrued Payroll Taxes
- EQUITY**
  - Net Income
  - Stockholder's Equity

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### Examples of Income Statement Accounts



**Revenue**

- Service sales
- Product sales



**Expenses**

- Wages paid to employees
- Employer paid benefit costs
- Employer share of payroll taxes

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## Income Statement Example

Example Corporation Income Statement For the year ended December 31, 2018	
Sales (all on credit)	\$500,000
Cost of goods sold	380,000
Gross profit	120,000
Operating expenses	
Selling expenses	35,000
Administrative expenses	45,000
Total operating expenses	80,000
Operating income	40,000
Interest expense	12,000
Income before taxes	28,000
Income tax expense	5,000
Net income after taxes	\$ 23,000
Earnings per share (based on 100,000 shares outstanding)	\$ 0.23

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### Audited Financial Statements

- Financial Statements are audited by independent certified public accountants who make a determination as to whether or not the statements adequately depict the company's financial condition
  - An auditor's independence helps guard against any possible conflicts of interest
- Auditors also have to form an opinion as to whether or not the company has internal controls in place to adequately safeguard its assets and record transactions properly



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### Normal Account Balances

- Accountants think in a world of debits (DR) and credits (CR)
- Each account type has a usual account balance, which is either a debit or credit balance

Type of Account	Normal Account Balance
Asset	Debit
Liability	Credit
Equity	Credit
Revenue	Credit
Expense	Debit

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### Normal Account Balances, Cont.

#### Any Asset or Expense Account

Debit	Credit
Increases	Decreases

#### Any Liability or Revenue Account

Debit	Credit
Decreases	Increases

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### Chart of Accounts

- Chart of Accounts lists each account by name and number
- Each Company's chart of accounts is a unique numbering scheme
- Large companies can have account numbers that are between 15 – 20 digits
  - The account number can designate division, department and location along with the type of account



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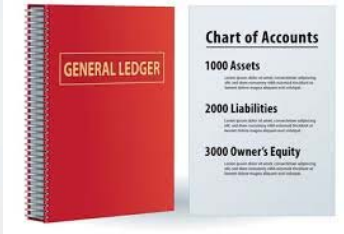
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### Chart of Accounts Cont.

- Generally the first digit of an account number signifies what kind of account it is
  - 0 – 1 = Asset accounts
  - 2 = Liability accounts
  - 3 = Equity accounts
  - 5 = Revenue accounts
  - 6 – 8 = Expense accounts



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### Chart of Accounts Example

- My Company normally uses a 17 digit account number with four unique divisions
- First division of account number is 5 digits and represents the business unit
  - Example: 68010 = salon number
- Second division of account number is 4 digits and represents the account number
  - Example: 6860 = travel expense
- Third division of account number is 3 digits and represents the sub-account
  - Example: 005 = business meals
- Fourth and final division of account number is 5 digits and represents the subledger
  - Example: 12345 = employee (John Doe)

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### Chart of Accounts Example, Cont.

- Total account number = 68010.6860.005.12345
  - Account number above = salon.travel expense.business meals.john doe
- Not all divisions of an account are used all of the time
- Not all accounts use subaccounts
- Subledger is generally only used to identify a specific person or project

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### Journal Entries

- Financial Statements are the accumulation of many journal entries
- Journal entries are the method used to record a Company's business transactions
  - Journal entries can be recorded manually or through system integrations (ex. Infinium payroll system)
- A journal entry shows both the debit and the credit to be entered into specific accounts

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### Payroll Journal Entries

- Payroll journal entries are generally recorded in detail into a subledger system
  - The subledger then passes aggregated information to the General Ledger
- Payroll expense journal entries are recorded as of the date of pay period end
- Payroll and tax payment journal entries are recorded as of the date of payment

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### Payroll Expense Journal Entry Example

From September 15 – 28, 2019, TLJ Enterprises had bi-weekly gross payroll of \$100,000. Employees were then paid on October 2, 2019.

Pay Period Sun – Sat	Pay Date	Record Expense in Month
9/1/19 – 9/14/19	9/18/19	September
9/15/19 – 9/28/19	10/2/19	September
9/29/19 – 10/12/19	10/16/19	September & October

9/28/19 Journal Entry

<u>Account Description</u>	<u>DR</u>	<u>CR</u>	<u>Account Type</u>
Payroll Expense	100,000		Expense
Accrued Payroll		100,000	Liability

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### Payroll Deduction Journal Entry Example

- Payroll deductions are amounts deducted from an employees' wages that must be paid to a third party
- The below deductions were associated with the September 15 – 28, 2019 payroll
  - Federal Income Tax 20,000
  - State Income Tax 5,000
  - Social Security Tax 6,200
  - Medicare Tax 1,450
  - Health Insurance Premiums 3,330

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### Payroll Deduction Journal Entry Example, Cont.

Pay Period Sun – Sat	Pay Date	Date of Liability	Record Liability in Month
9/1/19 – 9/14/19	9/18/19	9/18/19	September
9/15/19 – 9/28/19	10/2/19	10/2/19	October
9/29/19 – 10/12/19	10/16/19	10/16/19	October

10/2/19 Journal Entry

Account Description	DR	CR	Account Type
Accrued Payroll	35,980		Liability
Federal Income Tax Payable		20,000	Liability
State Income Tax Payable		5,000	Liability
Social Security Tax Payable		6,200	Liability
Medicare Tax Payable		1,450	Liability
Health Insurance Premiums		3,330	Liability

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### Employer Payroll Taxes Journal Entry Example

- Employers must also pay their share of social security and Medicare and federal and state unemployment taxes
  - Amounts due are based on amount of wages paid to employees that are subject to each type of tax
- Employer taxes are not deducted from employees' wages
  - Employer taxes represent an additional expense to the employer



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### Employer Payroll Taxes Journal Entry Example, Cont.

Pay Period Sun – Sat	Pay Date	Record Expense in Month
9/1/19 – 9/14/19	9/18/19	September
9/15/19 – 9/28/19	10/2/19	September
9/29/19 – 10/12/19	10/16/19	September & October

9/28/19 Journal Entry

Account Description	DR	CR	Account Type
Payroll Tax Expense	13,850		Expense
Social Security Tax Payable		6,200	Liability
Medicare Tax Payable		1,450	Liability
Federal Unemployment Tax Payable		600	Liability
State Unemployment Tax Payable		5,400	Liability

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### Payroll Paid Journal Entry Example

Pay Period Sun – Sat	Pay Date	Record Entry in Month
9/1/19 – 9/14/19	9/18/19	September
9/15/19 – 9/28/19	10/2/19	October
9/29/19 – 10/12/19	10/16/19	October

10/2/19 Journal Entry

Account Description	DR	CR	Account Type
Accrued Payroll	64,020		Liability
Cash		64,020	Asset

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### Payment of Payroll Liabilities



- Amounts deducted from employees' wages and the employer's share of payroll taxes are also recorded when the cash is remitted
- Entries booked are the same of type entry that is recorded when payroll is paid out to the employees
  - DR            Liability
  - CR            Cash
- The entries should leave zero balances in the liability accounts

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**Vacation Entry Example**

- If employees accrue vacation leave, which can be used at a later date, the employer incurs a liability as the vacation time is earned
  - DR Vacation Expense XXXX
  - CR Accrued Vacation XXXX
- When the employee uses vacation time, the liability is reduced
  - DR Accrued Vacation XXXX
  - CR Cash XXXX

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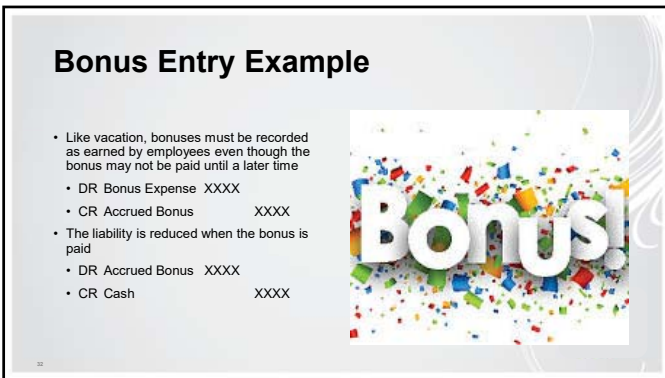
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**Bonus Entry Example**

- Like vacation, bonuses must be recorded as earned by employees even though the bonus may not be paid until a later time
  - DR Bonus Expense XXXX
  - CR Accrued Bonus XXXX
- The liability is reduced when the bonus is paid
  - DR Accrued Bonus XXXX
  - CR Cash XXXX

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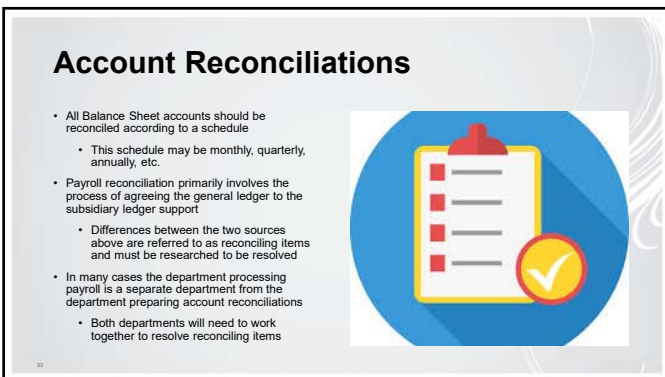
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**Account Reconciliations**

- All Balance Sheet accounts should be reconciled according to a schedule
  - This schedule may be monthly, quarterly, annually, etc.
- Payroll reconciliation primarily involves the process of agreeing the general ledger to the subsidiary ledger support
  - Differences between the two sources above are referred to as reconciling items and must be researched to be resolved
- In many cases the department processing payroll is a separate department from the department preparing account reconciliations
  - Both departments will need to work together to resolve reconciling items

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### Investigating Reconciling Items

- When the General Ledger and Subledger do not agree, reconciliation preparers need to investigate and determine why
- Was there a manual posting made to a General Ledger payroll account that was incorrect?
- Was the system General Ledger coding incorrect?
- Was there a system hiccup when the payroll system posted to the General Ledger?
  - Duplicate entry?
  - Only 1/2 of the system journal entry posted?



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### Explaining Financial Statement Variances



- Typically Finance has to explain financial statement variances to budget, forecast (if applicable) and prior year
- For example, if payroll expense is higher than expected, Finance will have to work with Payroll to determine the reason why
  - Was there a specific wage increase?
  - Was there more overtime worked than expected?
- Finance has to work with Payroll because generally Finance sees only the aggregation of payroll data in the General Ledger and not specifics

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### Internal Controls

- Internal Controls are a system of checks and balances applied within a Company to ensure the accuracy of its financial records and security of its assets
- Internal Auditors have the responsibility of reviewing the efficiency of the Company's internal control procedures and make recommendations on how they can be improved
- Management has the responsibility to ensure compliance with internal controls
- One of the most important components of internal controls is segregation of duties
  - The principle of segregation of duties is that critical job processes are not the total responsibility of one person or department
  - Failure to segregate job duties makes the Company vulnerable to theft and is a "red flag" for outside auditors and potential shareholders that a serious security problem exists

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### Internal Control Recommendations

- It is good practice to rotate employees into different positions periodically during the payroll processing cycle
  - Allows for cross training, which is critical at times of employee absences
  - If problematic, require employees to take vacation during a payroll processing cycle
- Paychecks and blank check stock should never be left in unlocked desks or file cabinets
- Payroll department should not reconcile the payroll cash account
- Timecards should be reviewed and approved by department supervisors before being sent to payroll for processing



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### SOX

- In 2002, the Public Company Accounting Reform and Investor Protection Act, also known as the Sarbanes-Oxley Act (SOX) was enacted in response to several large corporate finance scandals
- SOX was designed to restore investor and public confidence in corporate financial management by imposing various requirements on publicly held companies
- SOX requires a public company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to certify each quarterly and annual report filed with the Securities and Exchange Commission (SEC)
- A Company's annual report must contain an internal control report with a statement of management's responsibility for designing and maintaining adequate internal controls and its assessment of the effectiveness of these internal controls
  - The Company's external auditors must attest to and report on management's assessment

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# SOX

### SOX Compliance

- SOX requires a public company to have an internal audit department
- SOX requires public accounting firm partners to rotate every five years
- SOX prohibits a public accounting firm from providing both external auditing and most other non-auditing services to the same client
- Develop process and workflow maps that document each function for evidence of adequate internal controls

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## Service Organization Controls Report (SOC1)

- Outsourcing of all or part of the payroll process does not relieve a public company of its responsibility under SOX to have adequate internal controls
- SOC1 report shows that a service provider has had its control objectives and activities examined by an independent auditing firm
- Two types of SOC1 reports for service organizations
- Type 1 report is an attestation of controls at a service organization at a specific point in time
- Type 2 report is an attestation of controls at a service organization over a minimum six month period
  - In most cases, a Type 2 report is preferable
- SOC1 reports should be reviewed by management as they are ultimately responsible for certifying the adequacy of its internal controls even when those controls are supplied by an outside third party



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## Questions?



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## Case Study

- From October 13 – 26, 2109, CJL Industries had bi-weekly gross payroll of \$250,000. Employees were paid on November 1.
- Employee deductions were:
 

• Federal Income Tax	\$50,000
• State Income Tax	\$12,500
• Social Security Tax	\$15,500
• Medicare Tax	\$ 3,625
• Garnishment	\$ 5,000
- Employer taxes were:
 

• Social Security Tax	\$15,500
• Medicare Tax	\$ 3,625
• Federal Unemployment	\$ 1,500
• State Unemployment	\$13,500



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**Case Study, Cont.**

- 1) Record payroll expense journal entry
- 2) Record employee payroll deduction journal entry
- 3) Record employer payroll taxes journal entry
- 4) Record payment of net payroll
- 5) Record payment of employee payroll deductions
- 6) Record payment of employer payroll taxes

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