The Fundamentals of Payroll Accounting
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Merrill Vogel, Deloitte Tax LLP
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Introduction
Accounting basics – Laying a foundation
Payroll accounting entries – Unseen and often unknown
What do payroll accounting entries look like?
Advanced payroll accounting
Introduction
Learning objectives

Upon completion of this course you will be able to:

• Reference basic accounting principles

• Understand and discuss the fundamentals of accounting

• Understand & discuss the typical accounting entries made when a payroll cycle closes

• Provide your payroll teams with general guidance with respect to the general ledger

• Identify and discuss the accounting considerations of preparing and recording payroll earnings & deductions
Accounting basics – Laying the foundation
Accounting basics - Laying the foundation

Generally Accepted Accounting Principles

**Business (or Economic) Entity Concept:** Personal transactions should be kept separate from business transactions

**Going Concern Concept:** On-going business with assets valued at cost or other basis prescribed by U.S. GAAP, not a business for sale with assets valued at FMV or assets and liabilities valued on a liquidation basis

**Time Period Concept:** Fiscal Year may, or may not, coincide with Calendar Year

**Cost Principle:** Long-lived assets valued at cost minus depreciation (nominal monetary units – e.g. USD), since this is an on-going business concern

**Objectivity Principle:** Assets are valued without bias, or respect to personal opinions or emotions

**Conservatism Principle:** Take uncertainty & risk into account when making accounting estimates.

**Matching Principle:** Expenses and revenue are recorded in the period in which they are incurred or earned (requiring the accrual basis of accounting)

**Realization Principle:** Revenue is recognized (or realized), and reported when earned

**Consistency Principle:** Transactions must be recorded in a consistent manner (i.e. applies to principles, procedures & practices)

**Materiality Principle:** An entity may be able to violate another principle if amount is deemed to be insignificant (i.e. to investor’s decisions).
Accounting basics - Laying the foundation
Types of accounts

**Assets** – property of the company or what the company owns, providing economic benefit or value to the company over time.

**Liabilities** – what the company owes to others. These are debts to be paid in the future and represent a claim against the company assets.

**Equity** – what the sole proprietor, partners, or shareholders can claim as theirs; contributed capital (from the owners) and retained earnings (i.e. Which is equal to Revenue – Expenses – Income Distributed).

**Revenue** – what the company earns from sales of goods or services for the owner(s).

**Expenses** – the cost to the owner(s) to make the goods or provide the services.
Accounting basics - Laying the foundation

Accounting equations *

1. **Assets – Liabilities = Equity** (Provides the basis for the Balance Sheet).

2. **Revenue – Expenses = Net Income** (Provides the basis for the Income Statement).

3. **Net Income (Revenue less Expenses) – Income Distributed + Contributed Capital = Equity** (Provides the basis for the Statement of Retained Earnings and is made up of):

   A. **Net Income - Income Distributed = Retained Earnings**

   B. **Retained Earnings + Contributed Capital = Equity**

* For simplicity, the U.S. GAAP concept of comprehensive income, which includes other gains & losses in addition to those included in net income, is ignored in this discussion.
Accounting basics - Laying the foundation

Account balances

<table>
<thead>
<tr>
<th>Type of account</th>
<th>Normal balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>Debit</td>
</tr>
<tr>
<td>Liability</td>
<td>Credit</td>
</tr>
<tr>
<td>Equity</td>
<td>Credit</td>
</tr>
<tr>
<td>Revenue</td>
<td>Credit</td>
</tr>
<tr>
<td>Expense</td>
<td>Debit</td>
</tr>
<tr>
<td>Income distributed</td>
<td>Debit</td>
</tr>
<tr>
<td>Contributed capital</td>
<td>Credit</td>
</tr>
</tbody>
</table>
A Global Payroll Scenario

When Foreign Earnings (e.g. Housing costs) are collected from the foreign locations and entered into the USD Payroll system for W-2 purposes as “Add to Pay” (i.e. no net pay – paid to landlord in the host location, or General Ledger (G/L) impact – these already took place in the foreign location), the U.S. G/L impact is as follows:

A. All the Foreign Earnings and tax gross-ups on the foreign earnings should flow into the expense accounts.

B. Only the tax gross-ups on the foreign earnings should flow into the expense accounts.

C. Only the Foreign Earnings should flow into the expense accounts.

D. The Foreign Earnings are “Intercompany Transferred” back to the foreign locations, and recorded in the location’s General Ledger.

E. The Foreign Earnings are only reported to the U.S. and should not be recorded on the G/L anywhere.
What do payroll accounting entries look like?
Accounting basics - Laying the foundation
Payroll accounting entries – Unseen & often unknown

**Payroll accounting entries are:**

1. Usually not taught in university accounting courses.

2. Automatically recorded in the G/L after the payroll cycle closes, and all the payroll data flows to the G/L.

3. Unknown as a result of entries being automated, and many accountants are not familiar with the accounting entries.

4. Unseen & unknown by many payroll practitioners, of which many are not versed in accounting, or regarding the impact to the G/L.

5. Usually discovered when problems in the G/L arise and detailed analysis must be performed.

6. Interface with the general ledger via an elaborate (automated) “Map” (i.e. Each payroll earnings & deduction code is “assigned” to a G/L Account).
What do payroll accounting entries look like?

Case study

In June, 2016, the O’Donnell Rib Palace (ORP) had a bi-weekly gross payroll of $10,000 with the following deductions:

- **Federal Income Tax**: $2,000
- **State Income Tax**: $500
- **Social Security Tax**: $620
- **Medicare Tax**: $145
- **Health Insurance premiums**: $300

ORP must also pay the following Employment taxes based on the above Payroll:

- **Social Security Tax**: $620
- **Medicare Tax**: $145
- **Federal Unemployment Tax**: $60
- **State Unemployment Tax**: $540
What do payroll accounting entries look like?

Case study

**Recording of the earnings:**

<table>
<thead>
<tr>
<th>Account description</th>
<th>Debit</th>
<th>Credit</th>
<th>Account type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary expense</td>
<td>$10,000</td>
<td></td>
<td>Expense</td>
</tr>
<tr>
<td>Salary/wages payable</td>
<td></td>
<td>$10,000</td>
<td>Liability</td>
</tr>
</tbody>
</table>

Question #1: Why is the Salary / Wage Payable a liability and not just a reduction to a cash account?

Question #2: If we also had a foreign service premium, a COLA, a Housing Deduction and Hypothetical Tax (in lieu of Federal income and possibly other U.S. tax withholdings) *, netting to $1,000, do you think the accounting entry would likely be the same or different? If different, then why?

*Hypo tax commences and the Federal Income Tax (FIT), and possibly other U.S. tax withholdings are discontinued, when the assignees are eligible for certain exclusions & a credit against their FIT on Foreign Earned Income. Said another way, the FIT liability may be reduced or eliminated due to the Foreign Earned Income Exclusion, housing exclusions, foreign tax credits, etc.
What do payroll accounting entries look like?
Case study

**Recording the deductions:**

<table>
<thead>
<tr>
<th>Account description</th>
<th>Debit</th>
<th>Credit</th>
<th>Account type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary / Wages Payable</td>
<td>$3,565</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Federal Income Tax W/H</td>
<td></td>
<td>$2,000</td>
<td>Liability</td>
</tr>
<tr>
<td>State Income Tax W/H</td>
<td>$ 500</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Social Security Tax W/H</td>
<td>$ 620</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Medicare Tax W/H</td>
<td>$ 145</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Health Insurance Premiums</td>
<td>$ 300</td>
<td></td>
<td>Liability</td>
</tr>
</tbody>
</table>
What do payroll accounting entries look like?

Case study

**What happens on payday?**

<table>
<thead>
<tr>
<th>Account description</th>
<th>Debit</th>
<th>Credit</th>
<th>Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary / Wage Payable</td>
<td>$6,435</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Payroll Checking (Cash) Account</td>
<td></td>
<td>$6,435</td>
<td>Asset</td>
</tr>
</tbody>
</table>

**What happens when the employee taxes are due?**

<table>
<thead>
<tr>
<th>Account description</th>
<th>Debit</th>
<th>Credit</th>
<th>Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Income Tax W/H</td>
<td>$2,000</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>State Income Tax W/H</td>
<td>$  500</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
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<td>$  620</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Medicare Tax W/H</td>
<td>$  145</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Health Insurance Premiums</td>
<td>$  300</td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Payroll Checking (Cash) Account</td>
<td></td>
<td>$3,565</td>
<td>Asset</td>
</tr>
</tbody>
</table>
What about the employer taxes?

<table>
<thead>
<tr>
<th>Account description type</th>
<th>Debit</th>
<th>Credit</th>
<th>Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll Tax Expense</td>
<td>$1,365</td>
<td></td>
<td>Expense</td>
</tr>
<tr>
<td>Social Security Tax Payable</td>
<td></td>
<td>$620</td>
<td>Liability</td>
</tr>
<tr>
<td>Medicare Tax Payable</td>
<td></td>
<td>$145</td>
<td>Liability</td>
</tr>
<tr>
<td>FUTA Tax Payable</td>
<td></td>
<td>$60</td>
<td>Liability</td>
</tr>
<tr>
<td>SUTA Tax Payable</td>
<td></td>
<td>$540</td>
<td>Liability</td>
</tr>
</tbody>
</table>

What happens when the employer taxes are due?

The 4 payable accounts are reversed (i.e. with a debit), and the payroll checking (cash) account is credited.
What do payroll accounting entries look like?

Case study

Conclusions so far:

1. When a Payroll cycle closes, salary, taxes withheld and taxes / benefits payable are considered as Liabilities until payday, or until the taxes or benefits are due.

2. The total expenses that will impact the Income Statement are:
   A. $10,000
   B. $ 6,435
   C. $ 3,565
   D. $11,365

3. How much came out of the Company’s Cash Account?

4. What is the balance in the liability accounts after everything is paid?
What do payroll accounting entries look like?
Payroll accruals & reversals – the “Matching Principle” in action:

A few points regarding accruals:

1. As the last day of a payroll period and the last day of an accounting period do not occur on the same day, an accrual must be recorded for payroll expenses through the end of the accounting period.

2. The accrual is established to implement the Matching Principle, where revenues, liabilities & expenses must be matched to the accounting period in which they were earned or incurred.

3. The accrual is an estimate generally based on daily payroll expenses & liabilities.

4. As the accrual is an estimate, it must be reversed during the next accounting period when actual expenses & liabilities are recorded.

5. If an accrual is not recorded, then expenses & liabilities would be understated in the current accounting period, and overstated in the following accounting period.
What do payroll accounting entries look like?

Recording the accruals:

<table>
<thead>
<tr>
<th>Account description</th>
<th>Debit</th>
<th>Credit</th>
<th>Account type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued payroll expense</td>
<td>$8,000</td>
<td></td>
<td>Expense</td>
</tr>
<tr>
<td>Accrued payroll liability</td>
<td></td>
<td>$8,000</td>
<td>Liability</td>
</tr>
<tr>
<td>Accrued payroll tax expense</td>
<td></td>
<td>$1,092</td>
<td>Expense</td>
</tr>
<tr>
<td>Accrued Soc. Sec. tax payable</td>
<td></td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Accrued Medicare tax payable</td>
<td></td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Accrued FUTRA tax payable</td>
<td></td>
<td></td>
<td>Liability</td>
</tr>
<tr>
<td>Accrued SUTA tax payable</td>
<td></td>
<td></td>
<td>Liability</td>
</tr>
</tbody>
</table>

To record the estimated salaries due for time worked from September 20th through September 30th. The entry will be reversed in the next accounting period when actual payroll for the period including those days is recorded.

To record the estimated Employer tax expenses on wages from September 20th through September 30th. The entry will be reversed in the next accounting period when the actual amounts are recorded.
What do payroll accounting entries look like?

Case study

Accrual Conclusions:

Why aren’t the employee withholding taxes accrued?

1. The total expenses that will impact the income statement based on the accrual entries are:
   
   A. $8,000  
   B. $10,000  
   C. $1,092  
   D. $9,092

3. How much came out of the company’s cash account?

4. What is the balance in the liability accounts after everything is paid?

5. Vacation Accruals: Based on the company policy, these accruals are recorded each accounting period to accurately record the vacation expenses earned during the period. When employees use vacation time, the liability is reduced by the payment to the employee (unlike the estimated payroll liability, which is reversed in the next accounting period).
What do payroll accounting entries look like?

Advanced payroll accounting – including global payroll considerations:

Accounting entries for:

1. Recording a shadow payroll in the U.S. (with & without totalization agreements)

2. Recording hypothetical taxes,

3. Tax Equalization* payment with gross-ups,

4. Tax Equalization* refund with gross-downs,

5. Split payrolls, where a part of the payroll is paid in the U.S. and another part in the foreign location.

*An internal company policy to ensure that the assignee will be no better off or worse off from a tax standpoint while on a foreign assignment, than if he/she never left their home country.
Questions?

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