

THEME: PAYROLL

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ACCOUNTING TERM: Payroll Clearing Account

A payroll clearing account is a general ledger account that is normally set up in the asset section of the balance sheet. The purpose it serves is to reconcile all the net payroll checks paid to employees during an accounting period with a general journal entry that summarizes the total of all the net payroll checks. If an discrepancy occurs, the difference will remain in the payroll clearing account. This difference can then be researched to find the cause of the discrepancy.

FEATURE ARTICLE: Recording Payroll On Your Books

If you are a business owner or manager, chances are you have had to deal with payroll and all of its complexities. If you haven't dealt with payroll yet, you may have to in the future. There are many parts to payroll. First you have to learn how to calculate withholding taxes for employees and understand all the federal and state rules associated with those taxes. If you don't stay on top of the rules, which can change from year to year, you risk miscalculating the taxes and/or missing reporting deadlines. The price for not conforming to the rules can be severe penalties.

Faced with these hurdles, many small businesses opt for a payroll tax service. This is usually a good idea, as these services tend to be inexpensive and can lift a heavy burden from the shoulders of an owner or manager. However, the information provided by the payroll service company has to be entered into the company's books. There is a simple way and a complicated way to do this, but first, you must have an understanding of what you are trying to accomplish.

It is imperative to understand the difference between "employee withholding taxes" and "employer payroll taxes". In the U. S., it works like this:

Employee Taxes

Federal:

FIT (Federal Income Tax)
FICA Tax (Social Security)
Medicare Tax

State:

SIT (State Income Tax)
SDI (State Disability Insurance)

Employer Taxes

Federal:

FICA Tax
Medicare Tax
FUTA Tax (Federal Unemployment)

State:

SUTA Tax (State Unemployment)

The state I use in the examples above is California. However, your state may not

have an income tax, etc. If you live outside the U.S., your country may have similar taxes but they may come under different names. Regardless, you will have to follow the same accounting procedures.

Many of the larger payroll service companies provide a ton of information in the form of payroll reports. Unfortunately, the payroll information you need for your general ledger is not often easily discernable. I have had a payroll service business in Santa Barbara for 20 years and even I have a hard time deciphering the large payroll service companies' reports.

The larger payroll companies insist that you pay your payroll taxes "the day" of payroll. Therefore, you must set up an agreement between your bank and the payroll company so that the payroll company can automatically withdraw funds from your account to their account. They pay the taxing agencies directly. Your taxes may not be due on that exact date, so the payroll company has use of your money until the time the taxes are paid. They make millions on the interest alone.

An advantage of using a smaller payroll service company or using your own payroll software program is that you have the use of your money until the taxes become due. This can be critical if you happen to be suffering from a cash flow shortage.

The challenge for you is to reconcile what you actually owe for each tax against what has been paid. It can be done, but it is a pain. Here's how I do it:

One of your reports should be a payroll history that lists each employee, his/ her gross wages, FIT, FICA, Medicare, SIT, SDI, and net wages. For instance:

| <u>Gross Wages</u> | <u>FIT</u> | <u>FICA</u> | <u>Medicare</u> | <u>SIT</u> | <u>SDI</u> | <u>Other</u> | <u>Net Wages</u> |
|--------------------|------------|-------------|-----------------|------------|------------|--------------|------------------|
| 10,000.00 | 2,600.00 | 620.00 | 145.00 | 400.00 | 80.00 | 20.00 | 6135.00 |

There should be another report that clearly shows the *employer* payroll taxes.

| <u>FICA</u> | <u>Medicare</u> | <u>FUTA</u> | <u>SUTA</u> |
|-------------|-----------------|-------------|-------------|
| 620.00 | 145.00 | 80.00 | 350.00 |

This is the information you need to write your payroll journal entry. Here is an example of a journal entry for the employee side:

| <u>DESCRIPTION</u> | <u>DEBIT</u> | <u>CREDIT</u> |
|---------------------|--------------|---------------|
| Gross Wages | 10,000.00 | |
| FIT, FICA, Medicare | | 3,365.00 |
| SIT, SDI | | 480.00 |
| Employee Advance | | 20.00 |

| | | |
|-----------------------------------|--|----------|
| Payroll Clearing | | 6,135.00 |
| To record payroll for xx/xx/xx | | |

Here is the example for employer payroll taxes:

| DESCRIPTION | DEBIT | CREDIT |
|---------------------------------------------------------------|----------|----------|
| Employer Payroll Tax | 1,195.00 | |
| Accrued Employer P/R Tax | | 1,195.00 |
| To record employer payroll taxes: FICA, Med, FUTA, SUTA | | |

Let's look now at what you have accomplished with these journal entries. In the first journal entry, you recorded your gross wages to the appropriate expense account. You set up the liability for the employee taxes payable. You recorded a credit in the employee advance account, assuming an employee was given a \$20.00 advance earlier. You recorded a credit to the Payroll Clearing account for the correct amount of net checks that were paid out. This amount should clear out all the individual checks posted to the Payroll Clearing account that were paid to employees via your cash disbursements system.

In the second journal entry, you recorded all the employer payroll taxes to the expense account and set up the liability for those payroll taxes. When the taxes are actually paid, the amount will be recorded as a debit to Accrued Employer Payroll Taxes and will zero out that account.

When you actually pay your payroll taxes usually it is for a combination of both employer and employee taxes. This means you have to allocate the payment into the proper general ledger accounts. The following is a journal entry representation of the transaction:

| DESCRIPTION | DEBIT | CREDIT |
|------------------------|----------|---------|
| Accrued Empl'r P/R Tax | 1,195.00 | |
| FIT, FICA, Medicare | 3,365.00 | |
| SIT, SDI | 480.00 | |
| Cash | | 5040.00 |

Whether you use an outside payroll service or buy your own payroll software, I would make sure that the reports you receive are simple to read and clearly display the critical information you need to record your payroll activity quickly and accurately. A payroll software program should post all the information automatically. However, you should be able to verify and prove that the information is correct. This requires good reports and a solid understanding of how payroll recording should work.

QUESTION: How Is An Employee Payroll Advance Recorded?

There will always be an employee who needs an advance on his/her paycheck. It's no big deal, as long as the employee has earned the money thus far. You simply write he/she a check out of your cash disbursements system and record the amount to a general ledger account called Employee Advance. For instance, using T-Accounts:

| | | | |
|--------------------------------|--|--------------------|-------|
| <u>Employee Advance</u> | | <u>Cash</u> | |
| 20.00 | | | 20.00 |

When the regular payday happens, instead of the employee receiving a full check, he/she would receive the full amount less \$20.00. The transaction is recorded like this:

| | | | | |
|-------|---------------------|--|--------------------------------|-------|
| | <u>Wages</u> | | <u>Employee Advance</u> | |
| 20.00 | | | | 20.00 |

The Employee Advance account should clear each pay period. If it doesn't and you find an amount remaining, then you should research to find out why. Sometimes, the owner/manager will give an advance but forget to tell the payroll company about it.

TIP: Using The Officer Advance Account To Capture Irregular Draws

You record an officer payroll advance just like the employee payroll advance, except that you use a general ledger account called Officer Advance. The tip is how to use the Officer Advance account when you have an officer, usually a 100% stockholder, such as a doctor or lawyer, who doesn't like to conform to a standard salary amount. These individuals are used to taking a draw whenever they like. The problem arises when they become incorporated because, as a corporate officer and working stockholder, they are required to take a salary via payroll.

I let them keep taking a draw by recording their withdrawals or personal expenses to the Officer Advance account. I set them up with a base salary that loosely correlates their net salary with the amount of their monthly withdrawals. For instance, let's say that Dr. Jones pulls out about \$6,000 a month in draws. After doing some tax planning, I would set him/her up with a \$10,000 gross salary per month because I know his/her net salary was \$6,000.

Using the T-Accounts again, let's see how it works:

| <u>Officer Advance</u> | <u>Cash</u> | <u>Officer Salary</u> |
|------------------------|-------------|-----------------------|
| (a) 2,200 6,000 (b) | 6,700 (a) | (b) 10,000 |
| (a) 3,000 | | |
| (a) 1,500 | | |
| 700 | | |

Payroll Taxes Payable
| 4,000 (b)

What transpired here? First were the cash withdrawals of \$6,700 (a) that were posted as debits to the Officer Advance Account and a credit to Cash. Second, was the recording of the gross salary \$10,000 (b) to the Officer Salary account as the debit. Following this, is the recording of the payroll tax liability of \$4,000 (b) as a credit, and then, instead of recording the doctor's net salary of \$6,000 (b) to Cash, it is posted to the Officer Advance account as a credit. This leaves a debit balance of \$700 in the Officer Advance account. In other words, he/she drew cash out that exceeded his/her prescribed net salary amount. The \$700 will be applied to the next month's draws.

Toward the end of the year, you should review this account and if the doctor has taken more draws than his/her salary permits, then you may want to consider giving him a bonus to clear out the remainder. If you leave the remainder in the account, there is a chance the IRS will declare it a dividend instead of salary.

This method offers flexibility to those non-conformist type individuals who like to do things their own way. However, you do have to keep your eye on things and be ready to adjust the salary up or down depending on the officer's withdrawal habits.

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