Payroll Procedures and Control

Essential Procedures for Completing the Payroll Process

Gregory Mostyn, CPA

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Table of Contents

Payroll

Overview of Payroll

What Is Payroll?

The term ***payroll*** generally refers to the process of identifying employees, calculating the pay and payroll taxes, recording the payroll transactions, making the payments, and completing required federal and state payroll tax forms. The diagram on the next page shows you an overview of the process.

Legal Rules

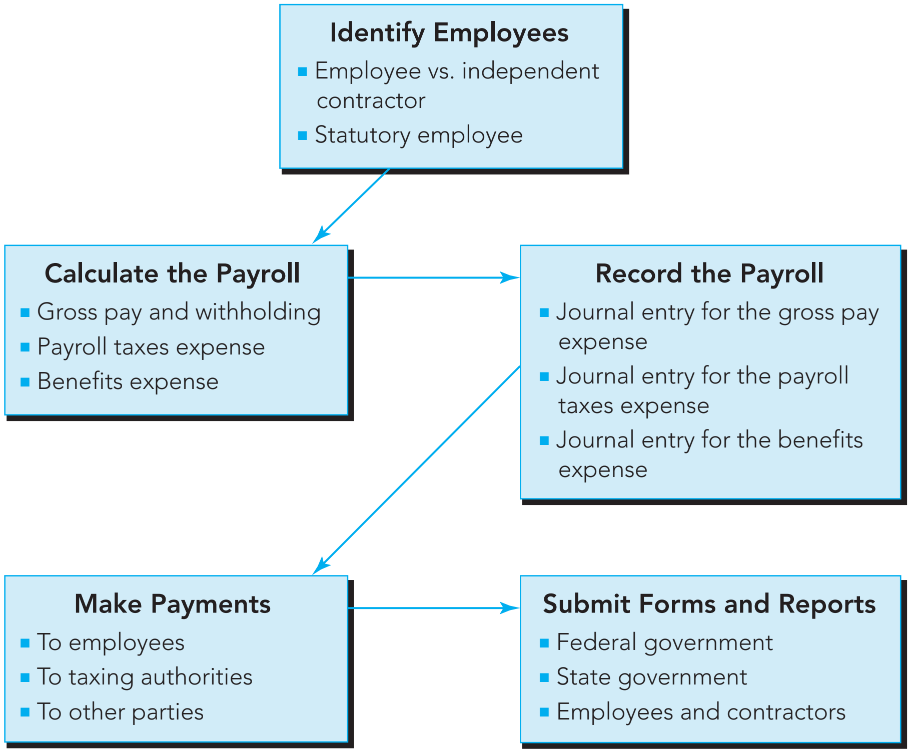
Payroll is unique from other basic accounting topics because payroll involves many federal (and state) payroll tax and income tax withholding laws, and pay rate calculation rules. Each of these legal rules imposes different requirements. So, to understand the payroll process, you will find yourself learning more than just how to properly analyze and record transactions. You will also learn about payroll laws and what is required to comply with these laws. Because each state has its own payroll laws, we focus on federal payroll requirements.

Getting Help

This material provides a general description of the payroll process. If you need to understand more about federal and state payroll laws and compliance requirements, or to calculate a payroll, you will need more help. Here are some suggestions for where to find more detailed information:

- **Circular E:** (Publication 15) This is a comprehensive employer resource for federal payroll rules. You can find it at the Internal Revenue Service website (www.irs.gov and ftp.irs.gov for ftp users) and you can also order it from the Internal Revenue Service Forms and Publications department by calling a local Internal Revenue Service office.
- **State Information:** With access to the Internet, you can quickly find state payroll references in several ways, including: (1) You can do an Internet search for "state of (name of state) payroll tax." (2) As of this writing, some useful websites are www.taxsites.com and the American Payroll Association site. (3) Use the reference section of a library.
- **Professional Help:** If you are in business or going into business, you *must* obtain expert professional help, because rates change and laws change and can be complex to apply. Find a CPA or an attorney who already has clients in the same type of business that you are in and who is familiar with your type of payroll and business issues. Interview several prospects, get client references, and double-check with state licensing boards.

The Payroll Process



Identify Employees

Employees

Overview

Not all people who perform duties for a business are employees. It is very important to accurately identify which workers qualify as employees because the law imposes different requirements for workers who are employees and those who are not. Every business must comply with the requirements of these laws. Proper identification also reduces fraud and waste.

"Employee" Defined

The general rule (called *common law*) is that any person who performs services for a business is an ***employee*** if *the business controls*:

- *what* will be done, *and*
- *how* it will done

This definition must be applied to each individual. It makes no difference what job title or name is used, how the individual is paid, or whether the work is full time or part time.

> *Note:* A business can submit Form SS-8 to have the Internal Revenue Service determine employee status. Contact state employment offices for state rules.

Example of an Employee

Jane is a secretary at Smith Company and is given word-processing tasks to perform that include preparing management reports. Jane is expected to be at the business during certain hours and allow her manager to review and make changes in her work. She must use the business office and the computer equipment and word-processing software used by the business. Jane is an employee because the Smith Company supervises and controls *how the job is done.*

Not an Employee

Mary also performs the same type of services for Smith Company. Mary is given a management report to complete, and she completes the job from her own office, which is not at the Smith Company location. Mary uses her own equipment and software, and she completes the job during her own hours without review from Smith managers. Mary is not an employee because Smith Company does not supervise or control *how the job is done.*

continued ►

Employees, *continued*

Business Owners

- Proprietorships: A sole proprietor is never an employee of the business.
- Partnership: A partner performing duties as a partner is never an employee of the partnership.
- Corporations: Owners (shareholders) of a corporation who work in the business are employees of the corporation.

Independent Contractors

Overview

It is important to identify independent contractors, because *an independent contractor is not an employee*, even though the independent contractor may do the same kind of work as an employee. The documentation and compliance rules that a business must follow for independent contractors are very different than for employees, so the distinction is significant. Only employees are considered to be part of a business "payroll."

Definition

An ***independent contractor*** is an individual who is in business to offer services to the public and who is in full control of the way in which the services are performed.

Examples

- People who are in business for themselves, such as doctors, lawyers, and construction contractors, are independent contractors.
- In the example on the previous page, Mary is an independent contractor.

Guidelines

Determining exactly who is an independent contractor and who is an employee can sometimes be complicated, and an employer should seek professional help. The IRS, the Department of Labor, and the individual states all have their own guidelines in this matter. Here are some key (but not all) indicators of an independent contractor:

- The person doing the work determines how the job is to be done.
- All or a significant amount of the work can be performed offsite.
- The person doing the work also offers his/her services to others.
- The person doing the work operates as a business making a profit or loss.
- There is a contract for the services to be performed.
- Payment is not by paycheck, but rather when invoices are submitted.
- The person doing the work sets his/her own working hours or schedule.

Statutory Employees

Overview

A *statute* is a law that has been enacted and recorded. In some specific cases, laws have been enacted that require workers who would normally be considered independent contractors to be treated in a manner similar to employees for certain types of tax withholding. The specific occupations that qualify people as statutory employees are identified in the statutes.

Definition

A ***statutory employee*** is someone who is not an employee under common law but who is designated as an employee by statute for the purposes of payroll tax withholding and employer payroll taxes.

Example

By statute, a homeworker who works by following the guidelines of the person for whom the work is being done, with materials furnished by and returned to that person, is a statutory employee. Therefore, such a home worker must be treated as an employee for the purpose of tax withholding. Other examples of independent contractors who might qualify as statutory employees include: corporate officers, certain sales people, and certain types of delivery drivers. Consult an employment attorney for guidance.

Employee Identification and Internal Control

Overview

Internal control refers to all the policies and procedures that a business uses to safeguard its assets. Employee identification must include internal control procedures that help prevent loss.

Potential Losses

- Payments to fictitious ("ghost") employees: These payroll checks will be cashed by people who use false identification.
- Misclassification of employees as independent contractors: An employer has liability to government taxing authorities for all amounts that should have been withheld (plus penalties) from the pay of workers who should be classified as employees. Moreover, owners, corporate officers, and even bookkeepers and accountants can be held *personally liable* for these amounts. If no form 1099 was issued to the worker, some of the amounts can be doubled.
- Employers can be subject to lawsuits for failure to pay the gross pay, any overtime pay, and benefits that would have been payable to a person that should have been classified as an employee.

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Employee Identification and Internal Control, *continued*

Personnel Department (Human Resources)

The mandatory use of a separate personnel department (also called the *human resources* department) acts as an internal control device to reduce the potential frauds and errors described above. In a small business that cannot afford a separate personnel office, the owner(s) should perform most or all of these functions. An outside employee search firm or consultant can be used to assist the employer and to perform background checks of job applicants.

Employee Identification in the Personnel Department

Summary Table

The table below summarizes the functions and procedures used for employee identification that should be done *only* by the personnel department.

Function	Procedure	Purpose
Hiring	Review job description	▪ Determine if the worker will act as employee or as independent contractor ▪ Clarify job requirements and duties
	Advertise, screen, and interview	▪ Find qualified applicants. This also helps screen out "ghost" and unneeded employees. ▪ Perform background checks
Authorizing	Complete forms that authorize employment and send forms to payroll department	▪ Prevent "ghost" employees from being placed on the payroll list ▪ Remove terminated employees from the payroll
	Issue employee badges	▪ Permit access and identification
Obtaining Data Required by Law	Obtain tax information form W-4	▪ Provide payroll withholding information
	Obtain work eligibility form I-9	▪ Identify undocumented immigrant workers

Check Your Understanding

Write the completed sentences on a separate piece of paper. The answers are below.

A person is an employee if the person or company they work for controls what work will be done and ········ it will be done. Proprietors and partners performing their duties ········ (are/are not) employees, whereas shareholders of a corporation who work for the business ········ (are/are not) employees.

An ········ ········ is an individual who is in business to offer services to the public as a business. A ········ ········ is someone who performs a particular occupation that is legally specified as an employee occupation.

"Ghost employees" and misclassification of employees ········ (is/is not) a potentially serious internal control problem for many businesses. A key internal control device for payroll procedures is the use of a ········ department. In a small business, the ········ performs these duties.

Answers

A person is an employee if the person or company they work for controls what work will be done and how it will be done. Proprietors and partners performing their duties are not (are/are not) employees, whereas shareholders of a corporation who work for the business are (are/are not) employees.

An independent contractor is an individual who is in business to offer services to the public as a business. A statutory employee is someone who performs a particular occupation that is legally specified as an employee occupation.

"Ghost employees" and misclassification of employees is (is/is not) a potentially serious internal control problem for many businesses. A key internal control device for payroll procedures is the use of a personnel department. In a small business, the owner performs these duties.

Calculate the Payroll

Overview

Introduction

To *calculate a payroll* means to make a calculation for a specific time period of total employee expense and then to determine the payments required.

Total Expense

The total employee expense includes three basic elements:

- Gross pay expense
- Payroll taxes expense
- Benefits expense

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Overview, *continued*

Payment Allocation

As each expense is calculated, the allocation of the payment for that expense is determined. The most detailed part of the payment calculation is determining how much of the gross pay will be withheld from the employee and then paid to various government taxing authorities and other third parties. Additionally, the payments required for other payroll taxes and benefits are calculated.

Not Part of Payroll

Remember that independent contractors are not employees and therefore are not part of the payroll calculation. Payments to independent contractors are recorded as separate categories of operating expenses.

Gross Pay

Identifying and Calculating Gross Pay

Definition

The term ***gross pay*** (sometimes called *gross earnings* or *gross wages*) means the total amount of compensation earned by an employee. This usually results in the employee receiving a paycheck. The amount earned could be for:

- ***Salary:*** The term *salary* generally refers to a fixed amount per period (such as annually) that is not determined by hours worked. Salaries are earned by managers, administrators, supervisors, and other professional staff.
- ***Wage:*** The term *wage* usually means an amount that is determined by hours worked or units of product completed (called *piecework*). Usually wages are earned by clerks and by skilled and unskilled labor.
- ***Commission:*** Commissions are earnings based on a percentage of sales.
- ***Bonus:*** Bonus earnings are extra amounts given as reward for achievement or meeting performance goals.
- ***In kind:*** Payment in some form of property or services (rather than money) are called *in kind* and are part of gross pay unless specifically exempted by law.

Examples of Not Gross Pay

Some examples that are *not* gross pay are:

- Amounts earned by independent contractors (because independent contractors are not employees)
- Employee business expense reimbursements under an approved plan (because approved reimbursements are exempt—they are not compensation)

Identifying and Calculating Gross Pay, *continued*

Overtime

Overtime is gross pay calculated at a higher rate per hour for those hours worked in excess of a standard daily amount of 8 hours or a weekly amount of 40 hours. Overtime is generally paid to hourly workers and workers earning less than a specified annual minimum who are not exempt from overtime. (Examples of exempt workers are top-level managers, corporate officers, and other specified jobs.) It does not matter when or how often the worker is paid. For most workers, the minimum overtime rate is 1-1/2 times the regular pay rate per hour for time exceeding 8 hours per day or 40 hours per week. Some companies add extra overtime pay rates for work such as on Sundays or holidays, or for activities designated by union contracts.

Overtime (and minimum wage) is regulated by the federal ***Fair Labor Standards Act (FLSA)***, by U.S. Department of Labor regulations and by state laws that may impose additional requirements.

Overtime Example

Dave is a wage-earning employee, and his regular rate is \$18 per hour. He worked 45 hours this week, Monday through Friday. He also worked 3 hours on Saturday. His company pays twice the regular rate for weekend and holiday work. Dave's gross pay is:

40 hours × \$18.00 =	\$720	regular
5 hours × \$27.00 =	135	overtime (\$18 × 1.5 = \$27)
3 hours × \$36.00 =	108	overtime (\$18 × 2 = \$36)
	\$963	total gross pay for the week

Withholding

Overview

Introduction

Payroll withholding means that an employer withholds (deducts) amounts from an employee's gross pay. These amounts are then paid by the employer to taxing authorities and other third parties. The amounts withheld from an employee's pay are called ***payroll deductions***. The remaining amount that the employee actually receives is called ***net pay***. Payroll deductions are not a tax on the employer; the employer is simply acting as a collection agent. The two categories of payroll deductions are:

- Deductions required by law
- Voluntary deductions by agreement

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