



Bookkeeping 101: The Ceterus Way

Allocation payroll transactions is one of the most complex and oftentimes cumbersome tasks we handle at Ceterus. From the expense allocations that need to be made to the recording of benefits and miscellaneous withholdings like garnishments, payroll allocations tend to be complicated. Further complicating things, the dollar amounts payroll processors take to fund payroll do not match what you see hitting your profit and loss statement.

Let's walk through a typical example of how a payroll transaction is recorded in the books. Please keep in mind that every business is different and it is possible that the journal entry to record payroll may look different than what we are going to walk through.

Payroll Report Example

Description	Amount	Reconciliation
Gross Wages	25,688.71	A
TIPS Paid	3,215.55	B
Employee Payroll Taxes	5,018.07	C
Employer Payroll Taxes	1,937.50	D
Employee Benefit Deductions - Health	733.62	E
Net Pay - Direct Deposits	17,080.28	F
Net Pay - Checks	2,856.74	G

The information in the payroll report is transformed into a journal entry.

Account	Debit	Credit	Explanation
Payroll Expense	22,473.16		(A-B) Gross Pay from employer to employee (Gross wages minus Tips paid)
Payroll Taxes (employer portion)	1,937.50		(D) Employer payroll tax responsibilities (FICA, Federal Unemployment, State Unemployment)
Accrued Tips	3,215.55		(B) Tips paid to the employee
Benefits Expense - Health		733.62	(E) Employee contributions to health insurance
Payroll Clearing		19,937.02	(F+G) Net Pay - Direct Deposits + Checks
Payroll Clearing		6,955.57	(C+D) Employer and Employee taxes

Most of the time, the cash outflow will be posted on the same day as the payroll report. If not, it will post the next business day for all amounts the payroll processor is withholding. The journal entry to record the cash outflow would look like this.

Account	Debit	Credit	Explanation
Operating Account		19,937.02	Net Pay cash outflow
Operating Account		6,955.57	Payroll Tax cash outflow
Payroll Clearing	19,937.02		Net Pay clearing
Payroll Clearing	6,955.57		Payroll Tax clearing

The end result of the two journal entries is proper recording of payroll expense, payroll tax expense, various benefit related items, tips, and the cash outflow to fund these payroll activities. It is important to point out that the payroll clearing account acts as a passthrough account. This account has a zero balance expectation, meaning that if there is a balance in this account on an ongoing basis then there is likely something incorrect and investigation is required.

All that is great, but I still don't understand why payroll expenses don't match the dollar amounts leaving my bank account. Let's dig into this. It will be best to carve it up into bite size pieces.

1. Cash Outflow - Generally speaking when amounts to process payroll are pulled by the processor they are done so in two separate transactions.

One is for net pay (direct deposits and manual checks)

The second is for payroll taxes (employer and employee portion).

2. Payroll Expense - The amount recorded on the profit and loss statement includes Gross Wages. Gross Wages includes all monies earned by the employee, except for tips (see #4). It is not the net wages of the employee.

3. Payroll Tax Expense - Payroll tax expense on the profit and loss statement only includes the employer portion of payroll taxes. This is because the employee portion is included in gross wages, which we discussed in #2 above.

4. Tips - Tips paid to employees via payroll do not appear on the profit and loss statement. Instead they flow through the balance sheet. This is because tips collected are not considered revenue and tips paid to employees are not considered expenses.

5. Benefits - If the company offers a benefit plan, employee contributions to the plan are withheld. These withholdings end up being recorded as a credit or reduction to the company's benefit expenses. A retirement plan would be handled in a similar fashion.

I led with the fact that understanding how payroll is allocated is complex. I hope you have a better understanding of the mechanics of the journal entry and the accounts that are used to properly account for this significant part of your business.