Chapter Three

Accounting for the Payroll System in an Ethiopian Context

3.1. Meaning of Payroll

What is Payroll and Payroll Accounting?

➢The term **Payroll** often refers to the document prepared to pay remuneration for the service rendered in a given period of time.

➢**Payroll Accounting** is an accounting that is concerned with preparation of payroll and recording and reporting of remunerations.

3.2. The Importance of Payroll Accounting

➢The payroll accounting of a firm has to be given **emphasis** for the following reasons.

1. Employees are **sensitive** to ***payroll errors*** and ***irregularities***, and maintaining good employee moral requires that the payroll be paid on a timely, accurate basis.
2. Payroll expenditures are subject to ***various government regulations.***
3. The payment for payroll and related taxes has ***significant effect on the net income*** of most business enterprises.

➢For the aforesaid reasons the need for accurate system of handling the payroll of a business is **unquestionable.**

3.3. Definitions of Payroll Related Terms

1) Salary Vs. Wages

- Salary and wages are usually used interchangeably.
- However, the term wages is more correctly used to refer to payments for manual labor that are paid based on the number of hours worked or the number of units produced. So, they are usually paid when a particular piece of work is completed or for a period less than a month.
- On the other hand, compensations to employees on monthly or annual basis are termed as salaries.
- It must be clear that when we say an employee, we refer to an individual who works primarily to an organization and whose activities are under the direction and supervision of the **employer.**
- Hence an **employee** is different from an **independent contractor**, a self-employed individual who works on a fee basis to a firm.

2) The Pay Period

- It is the length of time covered by each payroll payment.
- Pay periods for wage workers are usually made on weekly or bi-weekly.
- On the other hand, salaried employees pay periods are monthly or semi-monthly.

3) The Pay Day

- The day, on which wages or salaries are paid to employees, usually the last day of the pay period is known as the Pay Day.

4) A Payroll Register (Sheet)

- It is the entire list of employees of a business along with each employee's gross earnings, deductions, and net pay for a particular payroll period.
- The basis for the preparation of the payroll register can be the attendance sheets, punched (clock) cards or time cards.

Payroll Register

No	Name of Employee	Earnings			Gross Earning	Deductions			Total Deductions	Net Pay
		Basic Salary	Allow.	OT		Employee Income Tax	Pension Contributions	Other Deductions.		

5) Employee Earnings Record

- It is a summary of each employee's Earnings, Deductions, and Net Pay for each payroll period and of cumulative gross earnings during the year.
- It is a separate record kept for each employee.
- The individual employees' earnings record helps the employer organization to properly summaries and file **tax returns.**

6) Pay Check

- It is an instrument for paying salary if the firm makes payment via writing a check in the name of each employee for the net pay or a check for the total pay.

7) Gross Earnings

- It is the total pay to an employee before deduction for the pay period.

8) Payroll Taxes

- They are taxes levied against the employer on the payroll of a firm.
- It is the portion of pension or social security contribution made by the employer.
- It is an additional payroll related expense to an employer.

9) Withholding Taxes

- These are taxes levied against the earnings of the employees of an organization and **withheld** by the employer per the regulations of the concerned government.

10) Payroll Deductions

- Are all the reductions from the gross earnings of an employee such as withholding taxes, union dues, fines, credit association pays, etc.

11) Net Pay

- The gross earnings after subtracting all the deductions, it is sometimes known as **take home pay**.

- In the above definitions of payroll related terms, the three are considered the basic records of a payroll accounting system.
- **These are:** (1) A payroll sheet, (2) Individual employees' earnings records, and (3) Pay checks.
- These records are generated from a payroll system that is operated either manually or using computers

3.4. Possible Components of a Payroll Register

1) Employee Number

- Numbers assigned to employees for identification purpose when a relatively large number of employees are included in the payroll register.

2) Name of Employees

- List of the name of employees.

3) Earnings

- Money earned by an employee(s) of a firm from various sources. It may include:

A. The Basic Salary or Regular Earning

- A **flat** monthly salary of an employee that is paid for carrying out the normal work of employment and subject to change when the employee is **promoted**.

B. Allowances

- Money paid monthly to an employee for special reason, which may include:

i. Position Allowance

- Monthly sum paid to an employee for bearing a particular office responsibility, e.g. HoD.

ii. House Allowance

- A monthly allowance given to cover housing costs of the individual employee when the employment contract requires the employer to provide housing but fails to do so.

iii. Hardship Allowance

- A sum of money given to an employee to compensate for an inconvenient circumstance caused by the employer.
- For instance, unexpected transfer to a different and distant work area or location.
- It is sometimes known as **disturbance allowance**.

iv. Desert Allowance

- A monthly allowance given to an employee because of assignment to a relatively hot region.

v. Transportation (Fuel) Allowance

- A monthly allowance to an employee to cover cost of transportation up to the work place if the employer has committed itself to provide transportation service.

C. Overtime Earning

- Overtime work is the work performed by an employee beyond the regular working hours or days.
- **Overtime earning** is the amount payable to an employee for overtime work done.
- In Ethiopia, in this respect, according to Article 33 of proclamation No. 64/1975, the following is discussed about payment for overtime work.
- A worker shall be entitle to be paid at rate of one and one quarter(1 & 1/4) times his ordinary hourly rate for overtime work performed before 10 o'clock in the evening (10 p.m).
- A worker shall be paid at the rate of one and one half (1 & 1/2) times his ordinary hourly rate for overtime work performed between 10 O'clock in the evening (10 p.m) and 6 O'clock in the morning (6 a.m).

- Overtime work performed on the weekly rest days shall be paid at a rate of two (2) times the ordinary hourly rate of payment.
- A worker shall be paid at a rate of two and half (2 & 1/2) times the ordinary hourly rate for overtime work performed on a public holiday.
- Hence, the gross earnings of an employee may, therefore, include the **basic salary**, **allowances** and **overtime earnings**.
- You may find sometimes other form of earnings such as **Bonus** that is paid to employees for achieving results better than usual.

Exercise 1

- Mr. X is an employee of a governmental organization. He has a monthly basic salary of Birr 8,000. In a given month Mr. X has worked 12 hours during weekly rest days. In addition Mr. X has also worked 9 hours and 15 hours during the holidays and b/n 10 pm and 6 am respectively.
- Assuming a normal working hours of 160 per month determine the OTE of Mr. X.

4) Deductions

- These are amounts to be subtracted from the earnings of employee because they are required by the government **(mandatory deductions)** or permitted by the employee himself **(voluntary deductions)**.
- Mandatory deductions include ***employment income tax*** and ***pension contribution***.
- In our country, Ethiopia, some of the deductions against the earnings of employees are:

A. Employee Income Tax

- In Ethiopia every citizen is required to pay something in the form of ***income tax*** from his/her earning of employment.
- In this case, a ***progressive*** income tax system that charges higher rates for higher earnings is applied on the gross earnings of each employee.
- The new tax system/rate that has become in effect beginning Hamle 1, 2008 E.C. exempts the first **Birr 600** of the earnings of an employee from income tax.
- The money on which a person does not have to pay income tax is an **exemption**.
- According to the new tax system/rate, employee income tax has to be computed based on **Schedule "A"** as follows:

Schedule "A"

Tax Bracket	Employment Income in Birr (Per Month)	Additional Layer Income	Tax Rate	Adjustment /Deduction In Birr
1st	0 - 600	600	0%	0
2nd	601 - 1,650	1,050	10%	60
3rd	1,651 - 3,200	1,550	15%	142.5
4th	3,201 - 5,250	2,050	20%	302.5
5th	5,251 - 7,800	2,550	25%	565
6th	7,801 - 10,900	3,100	30%	955
7th	Over 10,900		35%	1,500

Cont'd

- Generally, taxable income from employment includes salaries, wages, allowances, director's fees and other personal emoluments, all payments in cash and benefits in kind.
- **However,** there are some income items, which are exempted/free from taxation.
- Accordingly, Article 13 of the proclamation No. 286/2002 declares the following categories of payments in cash or benefits in kind to be excluded from computation of employment income tax.

- Income from employment received by casual employees. Casual employees are workers who do not work for more than **one month** for the same employer in any **twelve-month period**.
- Pension contribution, provident fund and all forms of retirement benefit contributed by employers that **does not exceed 15%** of the monthly salary of employees.
- Subject to reciprocity, income from employment of **diplomatic** and **consular representatives.**
- Amounts paid by employer to cover the actual cost of **Medical treatment** of employees.
- Allowance in lieu of means of **transportation** granted to employees under contract of employment.
- However, the treatment of transportation allowance differs at **Federal** and **City administration level**.

- For example, at federal level only transportation allowances up to 25% of the BS of the employee or an amount that does not exceed Br. 800 is exempted from tax. Any amount in excess of this is subject to tax.
- In Addis Ababa & Dire Dawa City administrations, the exempted amount of transportation allowance is 15 % the Basic Salary of the employee or an amount that does not exceed Br. 600 is exempted from tax.
- Hardship Allowance
- Amounts paid to employees in reimbursement of travelling expenses incurred on duty.
- Allowances paid to members and secretaries of boards of public enterprises and public bodies as well as members and secretaries of study groups set up by federal and regional government.
- Income from persons employed for domestic duties (home servants)

Exercise 2

- Ato Kassahun the employee of government owned organizations has worked 8 hours, 6 hours and 10 hours during the holidays, after mid night working days and week end days respectively in a given month. For the year 2009 he has earned a regular monthly salary of Birr 3,500 as a result of working 160 regular hours. Then determine

  a) Over time earning (OTE) of Ato Kassahun

  b) Gross earning (GE)

  c) EIT based on the new income tax system

B. Pension Contribution

- Permanent employees of an organization, employees who are governed by the existing regulations of the Ethiopian public servants, are expected to pay or contribute certain percentage (7%) of their basic (monthly) salary to the government pension trust fund.
- This amount should be withheld by the employer from the basic salary of each employee on every payroll and later be paid to the respective government body.
- On the other hand, the employer is also expected to contribute towards the same fund 11% of the basic salary of every permanent employee of it. It is this total amount that we called earlier as payroll taxes expense to the employer organization
- Consequently, the total contribution to the pension trust fund of the Ethiopian government is equal to 18% of the total basic salary of all permanent employees of an organization (i.e. 7% comes from the employees and the 11% comes from the employer).

- This enables a permanent employee of an organization to be entitled to the pension pay given that the employee has satisfied the minimum requirements to enjoy this benefit when retired.
- Non-governmental organizations are also using this kind scheme to benefit their employees with some modifications.
- This is made in some NGO'S by keeping a fund known as **Provident Fund**.
- Both employees and the employer contribute towards this fund monthly.
- Ultimately, when an employee is retired or drawn out of work **a lump sum amount** is given at once.

Exercise 3: W/ro Kidist Mamo is a permanent employee of a government owned organization. The employer contributes Birr 550 for pension on behalf of W/ro Kidist Mamo for the month of Ginbot 2011. **Then determine,**

- The monthly basic salary of W/ro Kidist Mamo.
- The amount of pension contribution to be withheld from W/ro Kidist in the month Ginbot 2011 to pension trust fund.

C. Other Deductions (Voluntary Deductions)

- Apart from the above two kinds of deductions from employees earnings, employees may individually authorize additional deductions such as deductions to pay *health or life insurance premiums*; to repay *loans from the employer* or *credit association*; to pay for *donations to charitable organizations*; etc.
- Each of the major other deductions may be put in special column in the payroll register.
- Ultimately, the sum of the employees' income tax, pension contributions and other deductions gives the total deductions from the gross earnings of an employee.
- The column **"Total Deductions"** shows the total amount to be deducted from the earnings of employees.

5) The Net Pay

- This amount is held in one column of the payroll register representing the **excess** of ***gross earnings*** over the ***total deductions*** of an employee.
- The column **'Net Pay'** total tells the excess of grand total earnings over grand total deductions made from the earnings of employees.
- It is the grand total **take-home pay.**

6. Signature

- Unless some other document is used, the payroll sheet may be designed to allow a column for **signature** of the employees after collection of the net pay.
- In general, a payroll register should at least show the **earnings**, deductions and the **net pays** along with the **names of employees**.

3.5. Major Procedures Involved in Accounting for Payroll

1) Gathering the necessary data.

- All the relevant information about every employee should be gathered. This activity requires reviewing various documents and to do some arithmetic work.

2) Including the names of employees along with the gathered data such as earnings, deductions and NP's in the appropriate columns of the payroll register.

3) Totaling and proving the payroll register.

- It must be proved that the grand total earnings **equal** the **sum of** the grand totals of deductions and net pays in the register.

4. The accuracy/authenticity of the information summarized in the payroll should be verified by a different person from the one who compiles it.
5) The payroll is approved by the authorized personnel.
6) Paying the payroll either in cash (this may be after cashing a check issued for the total net pay of the payroll) or issuing a check for every individual employee for the net amount payable to each employee.
7) Recording the payment of the payroll and WHT liabilities.
8) Recording the payroll taxes expense of the employer.
9) Paying and recording withholding and payroll tax liabilities to the concerned authority, in our case to ERCA, on time.

3.6. Demonstration Problem

Ethio Relief Agency pays the salary of its employees according to the Ethiopian Calendar month. The forth coming data relates to the month of Nehassie 2008.

S.No.	Name Of Employee	Basic Salary	All.	OT Hrs Worked	Duration of OT Work	BS Per Hour
01	Senait Bahiru	9,600	100	10	6 AM to 10 PM	60
02	Petros Challa	1,600	__	8	10 PM to 6 AM	10
03	Abdu Mohammed	6,000	__	6	Weekly Rest Days	37.5
04	Leilla Jemal	4,000	50	__	__	25
05	Kirkos Wolde	12,000	500	10	Public Holidays	75

- **Additional Information:**

- Note that management of the agency usually expects an employee to work **40** hours in a week and during Nehassie 2008 all employees have worked as they have been expected. Besides, all workers of this agency are permanent employees except Petros Chala and the monthly allowance of Kirkos Wolde is not taxable; Abdu Mohammed agreed to have Birr 200 be deducted from his earning and paid to the Credit Association of the Agency as a monthly saving.

Instructions: Based on the above information:

A. Compute of earnings, deductions and net Pays.

B. Prepare a Payroll Register (or Sheet) for the agency for the month of Nehassie 2008.

C. Record the payment of salary as of Nehassie 2008 using Check No. 41 as a source document.

D. Record the payroll tax expense for the month of Nehassie 2008 . Memorandum No.006

E. Record the payment of the claim of the Credit Association of the agency that arose from Nehassie's payroll assuming that the payment was made on Meskerem 1, 2008.

F. Record the payments of withholding taxes and payroll taxes of the month of Nehassie, 2008 assuming that they have been paid on Meskerem 5, 2008 via Check No. 50

Solutions

A. Computation of earnings, deductions and net Pays.

***Overtime Earning*:**

Overtime Earning = OT Hrs Worked @ (Ordinary Hourly Rate @ OT Rate)

1. Senayit Bahiru
   - 10 Hrs @ (60 @ 1.25) = **Br 750**
2. Petros Challa
   - 8 Hrs @ (10 @ 1.5) = **Br 120**
3. Abdu Mohammed
   - 6 Hrs @ (37.5 @ 2) = **Br 450**
4. Kirkos Wolde
   - 10 Hrs @ (75 @ 2.5) = **Br 1,875**

A. Computation of earnings, deductions and net Pays.

Gross Earnings:

Gross Earnings = Basic Salary + Allowance + OT Earning

1. Senayit Bahiru
   - Br 9,600 + 100 + 750 = **Br 10,450**
2. Petros Challa
   - Br 1,600 + 0 + 120 = **Br 1,720**
3. Abdu Mohammed
   - Br 6,000+ 0 + 450 = **Br 6,450**
4. Leilla Jemal
   - Br 4,000 + 50 + 0 = **Br 4,050**
5. Kirkos Wolde
   - Br 12,000 + 500 + 1,875 = **Br 14,375**

A. Computation of earnings, deductions and net Pays.

DEDUCTIONS AND NET PAY:

1. ***Senayit Bahiru***

Gross Income (Gross Earning) = Br 10,450 and Taxable Income = Br 10,450

Deductions:

- Employee Income Tax: (10,450 x .3) - 955= **2,180**
- Pensions Contribution = Basic Salary @ 7% = Br 9,600 x .07% = **Br 672**

Net Pay:

Gross Taxable Income	Br 10,450.00
Less: Deductions	
Employee Income Tax.....	2,180
Pension Contribution	672
Voluntary Contribution	0.00
Total Deduction.....	2,852
Net Pay.....	**Br 7,598**

A. Computation of earnings, deductions and net Pays.

2. ***Petros Challa***

Gross Income = Br 1,720 and Taxable Income = Br 1,720

Deductions:

- Employee Income Tax: (1,720 x .15) -142.5 = 115.5
- Pensions Contribution = Br 0.00, he is a Contractual worker

Net Pay:

Gross Taxable Income		Br 1,720.00
Less: Deductions		
Employee Income Tax.....	115.5	
Pension Contribution	0.00	
Voluntary Contribution 0.00		
Total Deduction.....		115.5
Net Pay		**Br 1,604.5**

A. Computation of earnings, deductions and net Pays.

*3. **Abdu Mohammed***

Gross Income = Br 6,450 and Taxable Income = Br 6,450

Deductions:

- Employee Income Tax: (6,450 x .25) -565 = 1047.5
- Pensions Contribution = Br 6,000 x .07% = Br 420
- Voluntary Contribution = Br 200.00 payable to Credit Association

Net Pay:

Gross Taxable Income		Br 6,450.00
Less: Deductions		
Employee Income Tax.....	1047.5	
Pension Contribution	420.00	
Voluntary Contribution.....	200.00	
Total Deduction.....		1667.5
Net Pay		**Br 4,782.5**

A. Computation of earnings, deductions and net Pays.

4. ***Leilla Jemal***

Gross Income = Br 4,050 and Taxable Income = Br 4,050

Deductions:

- Employee Income Tax: (4,050 x .2) -302.5 = 507.5
- Pensions Contribution = Br 4,000 x 0.07% = Br 280

Net Pay:

Gross Taxable Income		Br 4,050.00
Less: Deductions		
Employee Income Tax	507.5	
Pension Contribution	280	
Voluntary Contribution	0.00	
Total Deduction.....		787.5
Net Pay		**Br 3,262.5**

A. Computation of earnings, deductions and net Pays.

5. ***Kirkos Wolde***

Gross Income = Br 14,375 and Taxable Income = Br 14,375 – 500 = Br 13,875

Deductions:

- Employee Income Tax = (13,875 x .35) – 1,500 = Br 3,356.25
- Pensions Contribution = Br 12,000 @ .07% =Br 840

Net Pay:

Gross Taxable Income		Br 13,875.00
Less: Deductions		
Employee Income Tax..	3,356.25	
Pension Contribution.....	840	
Voluntary Contribution	0.00	
Total Deduction.....		4,196.25
Net Pay		**Br 9,678.75**

B. Preparing A Payroll Register (Or Sheet)

ETHIO RELIEF AGENCY

Payroll Register (Sheet)

For Month of Nehassie 2008

		Earnings				Deductions				
Seri. No	Name of Employee	Basic Salary	Allow.	Over-time	Gross Earning	Income Tax	Pension Ded.	Other Ded.	Total Ded.	Net Pay
01	Senavet B.	9,600.00	100.00	750.00	10,450.00	2,180	672	—	2,852	7,598
02	Petros Ch.	1,600.00	—	120.00	1720.00	115.5	—	—	115.5	1,604.5
03	Abdu M.	6,000.00	—	450.00	6,450.00	1047.5	420	200	1667.5	4,782.5
04	Leila J.	4,000.00	50.00	—	4,050.00	507.5	280	—	787.5	3,262.5
05	Kirkos W.	12,000.00	500.00	1,875.00	14,375.00	3,356.25	840	—	4,196.25	10,178.75
	Totals	**33,200.00**	**650.00**	**3,195.00**	**37,045.00**	**7,206.75**	**2,212**	**200.00**	**9,618.75**	**27,426.25**

Cont'd

c. Record the payment of salary as of Nehassie 2008 using Check No. 41 as a source document.

Salary Expense	37,045.00	
Employee Income Tax Payable		7,206.75
Pension Contribution Payable.....		2,212
Credit Association Payable.....		200
Cash		27,426.25

Ck. No. 41

D. Record the payroll tax expense for the month of Nehassie 2008 . Memorandum No.006

Ethio-Relief Agency incurred payroll tax expense of **Br 3,476** during Nehassie, 2008. This is determined as the product of the basic salary of all permanent employees and 11%. This is because the agency has to contribute 11% of the basic salary of every permanent employee to the government pension trust fund. Thus,

- Payroll Tax Expense = Total Basic Salary of all permanent Employees @ 11%
- Payroll Tax Expense = (9,600 + 6,000 + 4,000 + 12,000) @ 11% = Br **3,476**

By the amount of Br 3,476 the agency's expense, payroll taxes expense, and pension contributions payable increase. Therefore, the following journal entry is made as of Nehassie, 30, 2008:

Payroll Tax Expense.....	3,476	
Pension Contribution Payable.....		3,476

Memorandum No. 006

The source document is an internal office memorandum that indicates the incurrence of this expense.

E. Record the payment of the claim of the Credit Association of the agency that arose from Nehassie's payroll assuming that the payment was made on Meskerem 1, 2008.

Credit Association Payable.....	200	
Cash.....		200

F. Record the payments of withholding taxes and payroll taxes of the month of Nehassie, 2008 assuming that they have been paid on Meskerem 5, 2008 via Check No. 50

Look at the account balances before payment:

Employee Income Tax Payable	
	7,206.75 (2)

Pension Contribution Payable	
	2,212 (2)
	3,476.00 (3)
	5,688

Cont'd

From the above accounts you can see that the agency has a total liability of Br ***12,894.75***. That is the sum of Br 7,206.75 Employee Income Tax payable and Br 5,688 Pension Contribution payable (7,206.75 + 5,688= ***12,894.75***). Note also that the total pension contribution payable is equal to 18% of the basic salary of all permanent employees. That is, Br 31,600 x 18% = Br 5,688. Then, the payment is recorded as follows:

Employee Income Tax Payable.....	7,206.75	
Pension Contribution Payable.....	5,688	
Cash		***12,894.75***

Ck. No. 50

After the payment of these liabilities have been posted, the above two accounts will have zero balances.