**Chapter Three**

**Accounting Systems for Payroll and Payroll Taxes in Ethiopian Context**

* 1. **Meaning of Payroll**

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

* 1. **The Importance of Payroll Accounting**

The payroll accounting of a firm has to be given emphasis of significance 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.

* 1. **Definitions of Payroll Related Terms**
* **Salary or 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.

* **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.

* **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.

* **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 (or the take home 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.

* **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.

* **Gross Earnings:**

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

* **Payroll Taxes**:

They are taxes levied against the employer on the payroll of a firm. It is an additional payroll related expense to an employer.

* **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.

* **Payroll Deductions**:

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

* **Net Pay**:

The gross earnings after subtracting all the deductions, it is sometimes known as take home pay - the amount collected by an employee on the pay day.

* 1. **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:
4. **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.
5. **Allowances:** money paid monthly to an employee for special reason, which may include:
6. ***Position Allowance:*** monthly sum paid to an employee for bearing a particular office responsibility, e.g. Head of a particular department or division.
7. ***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.
8. ***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.
9. ***Desert Allowance:*** a monthly allowance given to an employee because of assignment to a relatively hot region.
10. ***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.
11. **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.

1. 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).
2. 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 six o’clock in the morning (6 a.m).
3. Overtime work performed on the weekly rest days shall be paid at a rate of two (2) times the ordinary hourly rate of payment.
4. 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.

1. **Deductions**

These are subtractions made from the earnings of employees that is because it is required by government or permitted by the employee himself.In our country, Ethiopia, some of the deductions against the earnings of employees are:

1. **Employee Income Tax:**

In Ethiopia every citizen is required to pay something in the form of income tax from his/her earnings 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 save the first 150 Birr. According to proclamation No.286/1994 given below exempts the first Birr 150 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.**

The income tax proclamation effected since Hamle 1, 1994 states the following about employment income tax and its computations:

1. The first one hundred fifty Birr (Birr 150) income from employment shall be exempt from payment of income tax in all cases.
2. The tax on income from employment over one hundred fifty birr (Birr 150) shall be charged, levied and collected monthly according to the following schedule.

**Schedule “A”**

|  |  |  |
| --- | --- | --- |
|  | **Taxable Monthly Income**  **(In Birr)** | **Rates of Tax (%)**  **on Every**  **Additional Income** |
| 1 | Over 150 but not exceeding 650 on the next 500 | 10% |
| 2 | Over 650 not exceeding 1,400 on the next 750 | 15% |
| 3 | Over 1,400 but not exceeding 2,350 on the next 950 | 20% |
| 4 | Over 2,350 but not exceeding 3,550 on the next 1,200 | 25% |
| 5 | Over 3,550 but not exceeding 5,000 on the next 1,450 | 30% |
| 6 | Exceeding 5,000 | 35% |

**Generally,** taxable income from employment includes salaries, wages, allowances, director’s fee and other personal emoluments, all payments in cash and benefits in kind.

**However,** there are some income items, which are exempted/free from taxation.

The following income items are exempted from 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 Basic Salary of the employee or an amount that does not exceed 800 birr 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 600 birr 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)

1. **Pension Contributions**

Permanent employees of an organization, employees who are governed by the existing regulations of the Ethiopian public servants, are expected to pay or contribute 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 9% of the basic salary of every permanent employee of it. It is this total amount that we called earlier as payroll tax expense to the employer organization (i.e.7% of the total basic salary of all permanent employees)

Consequently, the total contribution to the pension trust fund of the Ethiopian government is equal to 16% of the total basic salary of all permanent employees of an organization (i.e. 7% comes from employees and the 9% 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-Government Organizations are also using this kind of scheme to benefit their employees with some modifications. This is made in some NGO’s by keeping a fund known as **Provident Fund**. Both the employees and the employer contribute toward this fund monthly. Ultimately, when an employee is retired or drawn out of work a **lump-sum** is given at once.

1. **Other Deductions**

Apart from the above two kinds of deductions from employees earnings, employees may individually authorize additional 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.

Ultimately, the sum of the employees’ income tax, pension contributions, and other deductions gives the total deductions from the gross earnings of an employee.

1. **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 payee.

1. **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 names of employees.

* 1. **Major Activities Involved in Accounting for Payroll**
* Gathering the necessary data. All the relevant information about every employee should be gathered. This requires reviewing various documents such as attendance sheets and doing some arithmetic work.
* Entering the names of employees along with the gathered data such as earnings, deductions and net pays in the appropriate columns of the payroll register.
* 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 payroll register.
* The accuracy and authenticity of the information summarized in the payroll should be verified by a different person from the one who prepared it.
* The payroll should be approved by an authorized personnel (individual)
* 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.
* Recording the payment of the payroll and recognition of the withholding tax liabilities.
* Recording the payroll tax expense of the employer.
* Paying and recording withholding and payroll tax liablities to the concerned authority, in our case to Inland Revenue Administration, on time.

**Illustration:**

**Ethiopia Pharmaceutical Company**, a wholly government owned company, pays salary to its employees according to the Ethiopian calendar month and submit income tax withheld from employees to the Federal Inland Revenue Authority (FIRA) on a monthly basis. The forth - coming data relates to the Month of Ginbot 2004.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **S.No.** | **Name** | **Basic Salary** | **Transportation Allowance** | **OT**  **Hours Worked** | **Duration of OT Work** | **Basic Salary Per Hour** |
| 01 | Meron | 4,800 | 900 | 10 | Up to 10 P.M | 30 |
| 02 | Haile | 1,920 | - | 8 | 10 P.M to 5 A.M | 12 |
| 03 | Dawit | 2,400 | - | 6 | Weekly rest days | 15 |
| 04 | Emnet | 2,160 | 600 | - | - | 13.50 |
| 05 | Getu | 1,440 | 100 | 10 | Public Holidays | 9 |

**N.B** The management of the company usually expects a worker to work 40 hours in a week and during Ginbot 2004 all workers have done as they are expected. Besides, all workers of the Company are permanent except Haile. Dawit agreed to have a monthly Birr 300 be deducted and paid to the Credit Association of the Company as a monthly saving.

**Required:** Based on the above information

* Prepare a **Payroll Register (or Sheet)** for the Company for the month of Ginbot 2004

**Solutions:**

1. **Preparation of Payroll Register (Sheet)**

**Step 1: Calculate OT Earnings of Employees**

**OT Earnings = OT hrs. Worked \* Ordinary hourly rate \* OT rate**

* **Meron**

OT Earnings = 10 Hrs \* 30 \* 1.25 = Birr 375

* **Haile**

OT Earnings = 8 Hrs \* 12 \* 1.50 = Birr 144

* **Dawit**

OT Earnings = 6 Hrs \* 15 \* 2.00 = Birr 180

* **Getu**

OT Earnings = 10 Hrs \* 9 \* 2.50 = Birr 225

**Step 2: Calculate the Gross Earnings and Taxable Earnings of employees**

**Gross Earnings = Basic Salary + Allowances + OT Earning**

* **Meron**

**Gross Earnings** = Birr 4800 + 900 + 375 = Birr 6,075

**Taxable Earnings** = Birr 6,075 – Birr 800 = Birr 5,275. The tax law says that the transportation allowance exempted from the payment of tax for Federal Government Organizations[Ethiopia Pharmaceutical Company is a Federal Public Enterpise] is the lower of what the employee get or 25% of the employee basic salary, if what the employee gets is less than Birr 800. What she gets is Birr 900 which is greater than Birr 800. So, the exempted allowance is the lower of Birr 800 or 25% of Birr 4800 which is Birr 1200. By applying the tax rule the exempted transportation allowanse will be Birr 800 only.

* **Haile**

**Gross Earnings** = Birr 1920 + 0 + 144 = Birr 2,064. The taxable earning of Haile is equal to his gross earnings because he doesn’t get transportation allowance, which could have been tax exempt.

* **Dawit**

**Gross Earnings** = Birr 2400 + 0 + 180 = Birr 2,580 the taxable earning of Dawit is equal to his gross earnings because he don’t get transportation allowance, which could have been tax exempt.

* **Emnet**

**Gross Earnings** = Birr 2160 + 600 + 0 = Birr 2760

**Taxable Earnings** = Birr 2760 – Birr 540 = Birr 2220. Non taxable transportation allowance for Emnet should be the lower of Birr 600 or 25% of her Basic salary because what she gets is less than Birr 800. 25% of Birr 2160 is Birr 540. So, the exempted transportation allowance will be Birr 540.

* **Getu**

**Gross Earnings** = Birr 1440 + 100 + 225 = Birr 1765

**Taxable Earnings** = Birr 1765 – Birr 100 = Birr 1665. Non taxable transportation allowance for Getu should be the lower of Birr 600 or 25% of his Basic salary because what he gets is less than Birr 800. 25% of Birr 1440 is Birr 360. So, the exempted transportation allowance will be Birr 100.

**Step 3: Go to the Calculation of Income Taxes and Pension**

* **Meron**

**Income Tax** = (Birr 5,275 \* 0.35) – 662.5 = **Birr 1,183.75**

**Pension** = 7% \* Birr 4800 = **Birr 336**

* **Haile**

**Income Tax** = (Birr 2,064 \* 0.2) – 117.5 = **Birr 295.30**

**Pension** for Haile is Zero because he is not a permanent worker.

* **Dawit**

**Income Tax** = (Birr 2,580 \* 0.25) – 235 = **Birr 410**

**Pension** = 7% \* Birr 2400 = **Birr 168**

* **Emnet**

**Income Tax** = (Birr 2,220 \* 0.20) – 117.5 = **Birr 326.5**

**Pension** = 7% \* Birr 2160 = **Birr 151.2**

* **Getu**

**Income Tax** = (Birr 1,165 \* 0.20) – 117.5 = **Birr 215.5**

**Pension** = 7% \* Birr 1440= **Birr 100.8**

**Step 4: Completion of payroll register (Sheet)**

**Ethiopia Pharmaceutical Company**

**Payroll Register (or Sheet)**

**For the Month of Ginbot 2004**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **S. No.** | **Name** | **Earnings** | | | **Gross**  **Earnings** | **Deductions** | | | **Total Deductions** | **Net Pay** |
| **Basic Salary** | **Transport**  **Allowance** | **Over**  **Time** | **Income**  **Tax** | **Pension** | **Other**  **Deductions** |
| 01 | Meron | 4,800 | 900 | 375 | 6,075 | 1183.75 | 240 | - | 1423.75 | 4651.25 |
| 02 | Haile | 1,920 | - | 144 | 2,064 | 295.30 | - | - | 295.30 | 1768.70 |
| 03 | Dawit | 2,400 | - | 180 | 2,580 | 410 | 120 | 300 | 830 | 1750 |
| 04 | Emnet | 2,160 | 600 | - | 2,760 | 326.5 | 108 | - | 434.5 | 2325.5 |
| 05 | Getu | 1,440 | 100 | 225 | 1,765 | 215.5 | 72 | - | 287.5 | 1477.5 |
| **Total** | | **12,720** | **1,600** | **924** | **15,244** | **2,431.05** | **540** | **300** | **3,271.05** | **11,972.95** |