**Chapter Three**

**The Payroll System in Ethiopia**

1. **The Importance of Payroll Accounting**

The concept payroll is often referred to the total amount paid to employees of a firm as a compensation for the service rendered to a firm in a given period of time. The payroll accounting of a firm has to be given emphases of significance for the following reasons (as stated in the book entitled “Accounting Principles” by Fees and Warren, Page 297).

1. Employees are sensitive to payroll errors and irregularities, and maintaining good employees 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 is unquestionable.

Moreover, since the payroll related payment is highly subject to certain fraudulent activities it is imperative that businesses need to properly design their payroll system so that it safeguards the company’s assets against unauthorized payments of payroll and the accuracy as well as reliability of the accounting records is assured pertaining to payroll. Some of the possible frauds that can be made on the payroll system are the following:

* Adding fictitious employees to the payroll
* Listing terminated employees on the payroll
* Using unauthorized pay rates
* Overstating working hours
* Issuing duplicate payroll checks
* Not deducting employees’ absent time
* Making incorrect totals on the payroll register

Thus, separation of duties on the functions of payroll activities is essential for strong internal control over payrolls in order to protect the above-mentioned methods of stealing money from company. Payroll activities involve four functions: hiring employees, timekeeping, preparing the payroll, and paying the payroll. For an internal control system to work effectively these four functions should be assigned to different departments or individuals.

1. ***Hiring (Personnel) Department:*** The work of the employment or personnel department begins with interviewing and hiring job applicants. When a new employee is hired, the personnel department prepares records showing the date of employment, the authorized rate of pay, and payroll deductions. The personnel department sends a written notice to the payroll department records to place the new employee on the payroll. Changes in pay rates and termination of employees will be recorded in personnel department records. When a person’s employment is terminated, the personnel department should notify the payroll department to remove the employee’s name from the payroll.
2. ***Timekeeping:*** Another area in which internal control is important is timekeeping. Hourly employees are usually required to record time worked by “punching" a time clock. The time of arrival and departure are automatically recorded by the employee when he or she inserts a time card into the clock. Time clock procedures are often monitored by a supervisor or security guard to make sure an employee punches only one card. At the end of the pay period, the employee’s supervisor is generally required to approve the hours shown by signing the time card. When overtime hours are involved, approval by a supervisor should be mandatory to guard against unauthorized overtime. The approved time card is then sent to the payroll department. For salaried employees, a manually prepared weekly or monthly time report kept by a supervisor may be used to record time worked.
3. ***Preparing the payroll:*** The input of information to the payroll department consists of hours reported by the timekeeping department, and authorized names, pay rates and payroll deductions received from the personnel department. The output of the payroll department includes preparing (but not signing) payroll checks, maintaining individual employee records of earnings and deductions, as well as making regular reports to the government showing employees earnings and taxes withheld.
4. ***Paying the Payroll:*** The payroll is paid by the treasure’s department. Payment by check minimizes the risk of loss from theft, and the endorsed check provides proof of payment. For good internal control, payroll checks should be pre numbered, and all checks should be accounted for. All checks must be signed by the treasurer (or a designated agent) and their distribution to employees should be controlled by the treasure’s department. Checks may be distributed by the treasurer or paymaster. The distribution of paychecks by the paymaster provides assurance that paychecks will not continue to be issued to fictitious employees who have been terminated. The paymaster should not, however, have responsibility for hiring or firing employees, timekeeping, or preparation of the payroll. If the payroll is paid in currency, it is customary to have a second person count the cash in each pay envelope and for the paymaster to obtain a signed receipt from the employee upon payment.

The separation of duties among the payroll related activities that are described above makes very difficult for employees to commit a payroll fraud. The people in personnel have no authority to prepare payrolls or write checks. Those in accounting cannot increase or decrease payroll deductions on individual employees, nor can they sign the payroll checks. The treasurers can write checks, but only those authorized, and he or she cannot record entries in the general ledger. It is worth noting that such system is essential for large companies, but not for small companies where the owner knows all the few employees.

1. **Definition 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 weekly. 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:***

The length of time covered by each payroll payment is the pay period. Pay period for wage workers are usually made on weekly or biweekly. On the other hand, salaried employees’ pay periods are monthly or semimonthly.

***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 payday.

Basic records of a payroll accounting system includes:

1. A payroll register (or sheet)
2. Individual employees’ earnings records, and
3. Pay checks.

These records are generated from a payroll system that is operated manually or using computers.

***A Payroll Register (Sheet):*** 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.

***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 summarize and file tax returns.

***Pay Check***: 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 net pay.

***Gross Earnings***: The total pay to an employee before deductions for the pay period.

***Payroll Taxes***: 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 employees of an organization and withheld by the employer per the regulations of the concerned government.

It is the deduction of taxes from an employee’s salary.

***Payroll Deductions***: 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. An employee sometimes knows it as take home pay, the amount collected on the payday.

1. **Possible Components of a Payroll Register**
2. **Employee number**: Numbers assigned to employees for identification purpose when a relatively large number of employees are included in the payroll register.
3. **Name of employees**: List of the names of employees
4. **Earnings**: money earned by an employee(s) of a firm from various sources. It may include:
5. ***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.
6. ***Allowances***: Money paid monthly to an employee for special reasons, which may include.
	1. **Position Allowance**: A monthly sum paid to an employee for bearing a particular office responsibility, head of a particular department or division.
	2. **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.
	3. **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.
	4. **Desert Allowance**: A monthly allowance given to an employee because of assignment to a relatively hot region.
	5. **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.
7. ***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 or proclamation no. 64/1975 the following is stated about payment for overtime work.

* A worker shall be entitled to be paid at a rate of one and one quarter (1 ¼) 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 ½) 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.)
* 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 ½) 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.

According to the amended income tax proclamation the tax on income from employment over six hundred (Br 600) shall be charged, levied and collected according to the following income tax rates.

**Schedule “A”: Table for income tax**

|  |  |  |
| --- | --- | --- |
| No | Taxable monthly income (In Birr) | Tax Rate (%) on every additional Income |
| 1 | Over 600 but not exceeding 1650 (600<E<1650) | 10% |
| 2 | Over 1650 but not exceeding 3200 (1650<E<3200) | 15% |
| 3 | Over 3200 but not exceeding 5,250 (3200<E<5,250) | 20% |
| 4 | Over 5,250 but not exceeding 7,800 (5,250<E<7,800) | 25% |
| 5 | Over 7,800 but not exceeding 10,900 (7,800<E<10,900) | 30% |
| 6 | Exceeding 10,900 | 35% |

**Schedule “B” Table for income tax computation (effective on July, 2008 E.C.)**

|  |  |  |
| --- | --- | --- |
| **Taxable Monthly** | **Rates of Tax (%) on every additional Income** | **Deductible Amount** |
| ≤ 600 | Exempt | 0 |
| 601-1650 | 10% | 60 |
| 1651-3200 | 15% | 142.5 |
| 3201-5250 | 20% | 302.5 |
| 5251-7800 | 25% | 565 |
| 7801-10900 | 30% | 955 |
| >10900 | 35% | 1500 |

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

However, according to income tax amendment proclamation no. 30/1992 issued on October 12, 1992 stated that the following categories of payments in cash or benefits in kind are exempted from taxation.

* Medical costs incurred by employer for treatment of employees.
* Transportation allowances paid by employer to its employees.
* Reimbursement by employer of traveling expenses incurred on duty by employees.
* Traveling expenses paid to transport employees from elsewhere to place of employment and to return them upon completion of employment.
1. **Pension Contributions**

Permanent employees of an organization, the employees of which 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 11% of the basic salary of every *permanent* employee of it. It is this total amount we called earlier as payroll taxes expense to the employer organization (i.e., 11% of the total basic salary of all permanent employee).

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 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 towards this fund monthly. Ultimately, when as employee retired or drawn out of work a lump sum amount is given at once.

1. **Other 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 organization; 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 given the total deductions from the gross earnings of an employee.

1. **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 grand total deductions made from the earnings of employees.

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 the name of employees.

**Illustration**

**Ethiopia for Better**, a governmental organization pays salary of its employees according to the Ethiopian calendar month. The following data relates the month of Tahsas, 2009 E.C.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **S.No.** | **Name of Employee** | **Basic Salary** | **OT hours Worked** | **Duration of OT work** | **Monthly Allowance** | **Basic Salary Per Hour** |
| 1 | Senait Bahru | 1600 | 10 | Weekly rest days | 400 | 10 |
| 2 | Petros Chala | 2080 | 7 | Public holiday | --- | 13 |
| 3 | Abdu Mohammed | 3680  | 9 | 10 P.m. –6 A.m | 1200 | 23 |
| 4 | Leila Jemal | 5440 | --- |  --- | --- | 34 |
| 5 | Kirkos Woldie | 8320 | 12 | Up to 10 P.m | 2100 | 52 |

**Additional Information**:

Note that management of the agency usually expects a worker to work 40 hours in a week and during Tahsas, 2009 all workers have done as they have been expected. Besides, all workers of this agency are permanent employees except Petros Chala; the monthly allowance of Kirkos Woldie is not taxable; Abdu Mohammed agreed to have a monthly Br. 200 be deducted and paid to the credit association of the agency as a monthly saving.

**Instructions: Based on the above Information**

1. Prepare a payroll register (or sheet) for the organization for the month of Tahsas, 2009 E.C.
2. Record the payment of salary and the accrued liabilities as of Tahsas 30, 2009 E.C. using check no. 03391
3. Record the payroll taxes expense for the month of Tahsas, 2009
4. Record the payment of the claim of the credit association of the company, and other payroll related liabilities to the concerned authorities (withholding taxes, and payroll taxes) that arouse from Tahsas’s payroll assuming that the payment was made on Tir 1, 2009 via Ck. no.03395

**Solution**

$$Regular Rate/hour =\frac{Basic Salary}{Monthly Regular Time}$$

**For example: Senait’s** $Regular Rate/hour =\frac{1600}{40 hr x 4 weeks}$

= 1600/160 = Br. 10 per hour

Computation of earnings, deductions, and net pay are as follows:

**Earnings:**

1. **Overtime Earnings**
2. Senait Bahru

= 10 x (10 x 2)

= Br. 200

1. Petros Chala

= 13 x (7 x 2.5)

= 227.5

1. Abdu Mohammed

= 23 x (9 x 1½)

= 310.5

1. Leila Jemal

= 34 x (0 x 0)

=0

1. Kirkos Woldie

= 52 x (12 x 1¼)

= 780

1. **Gross Earnings**

 ***= Basic Salary + Allowances + Overtime***

1. Senait Bahru

= 1600 + 400 + 200

= **2200**

1. Petros Chala

=2080 + 0+ 227.5

=2307.5

1. Abdu Mohammed

= 3680 + 1200 + 310.5

= **5190.5**

1. Leila Jemal

= 5440 + 0 + 0

= **5440**

1. Kirkos Woldie

= 8320 + 2100 + 780

= **11200**

1. **Deductions**

**Senait Bahru**

1. ***Income tax***

 = (2200 x 15%) – 142.5 = **Br. 187.5**

1. **Pension Contribution** = 7% x Basic salary

 = 1600 x 0.07 = **112**

Total deductions = **187.5**+ **112**

 = **299.5**

1. **Net Pay**

= Gross Earnings – Total deductions

 = 2200 – 299.5

 = **1900.5**

**Petros Chala**

1. **Income tax** = (2307.5 x .15%) – 142.5 = 203.625

Note:- No pension Contribution, because Petros Chala **is not a permanent employee**.

1. **Net Pay** = Gross Earnings – Total deductions

 = 2307.5– 203.625= **2103.875**

**Abdu Mohammed**

1. **Income tax** = (5190.5 x 20%) -302.5

 = **735.6**

1. **Pension contribution** = 7% x Basic salary

 = 3680x 0.07 = **257.6**

1. **Credit Association payment**

= **200**

Total deductions = **735.6**+ **257.6**+ 200

 = **1193.2**

1. **Net Pay** = Gross Earnings – Total deductions

 = 5190.5 – **1193.2**= **3997.3**

**Leila Jemal**

1. **Income tax** = (5440 x 25%) -565

= **795**

1. **Pension contribution** = 7% x Basic salary

 = 5440 x 0.07

 = **380.8**

Total deductions = **795**+ **380.8**

 = **1175.8**

1. **Net Pay** = Gross Earnings – Total deductions

 = 5440 – **1175.8** = **4264.2**

**Kirkos Woldie**

1. **Income Tax** = (11200 – 2100) x 30% - 955

 = **1775**

1. **Pension Contribution** = 7% x Basic salary

 = 8320 x 0.07

 = **582.4**

Total deductions = **1775**+ **582.4**

 = **2357.4**

1. **Net Pay** = Gross Earnings – Total deductions

 = 11200 – 2357.4 = **8842.6**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| S. No | **Employee Name** | **Earnings** | **Deductions** | **Net pay** |
| **Basic Salary** | **Allowances** | **Overtime** | **Gross Earnings** | **Income Tax** | **Pension Contribution** | **Other** | **Total Deductions** |
| 1 | Senait Bahru | 1600 | 400 | 200 | 2200 | 187.5 | 112 | - | 299.5 | 1900.5 |
| 2 | Petros Chala | 2080 | - | 227.5 | 2307.5 | 203.625 | - | - | 203.625 | 2103.87 |
| 3 | Abdu Mohammed | 3680 | 1200 | 310.5 | 5190.5 | 735.6 | 257.6 | 200 | 1193.2 | 3997.3 |
| 4 | Leila Jemal | 5440 | - | - | 5440 | 795 | 380.8 | - | 1175.8 | 4264.2 |
| 5 | Kirkos Woldie | 8320 | 2100 | 780 | 11200 | 1775 | 582.4 | - | 2357.4 | 8842.6 |
|  |  |  |  |  |  |  |  |  |  |  |
| **Total** |  |  |  | **26338** | **3696.275** | **1332.8** | **200** | **5229.525** | **21108.47** |

1. **Payroll Sheet**

**Journal Entries**

1. To record payment of salary

Salary Expense **26338**

Cash **21108.47**

 Employee Income tax payable **3696.275**

 Payable to Pension trust fund **1332.8**

 Payable to Credit Association 200

1. To record payroll tax expense

= 11% of total basic salary of permanent employees

= the total basic salary excluding Petros Chala’s salary of 2080

= 19040 x 0.11

= 2094.4

 Payroll Tax Expense 2094.4

 Payable to Pension trust fund 2094.4

1. To record payment to credit association

Payable to Credit Association 200

 Cash 200

1. **To record payment of withholding and payroll tax to the government**

Employee Income tax payable **3696.275**

Payable to Pension trust fund **1332.8**

 Cash 5028.275