

Income Statement Format

Operating Expenses and Internal Controls

Norm's Inc. Income Statement for the year ending 12/31/X1

| | |
|------------------------------|--------|
| Sales Revenues | \$ xxx |
| Less: Sales Discounts | (xxx) |
| Sales Returns and Allowances | (xxx) |
| Net Sales Revenues | xxx |
| Less: Cost of Goods Sold | (xxx) |
| Gross Margin | xxx |
| Less: Operating Expenses | |
| Salaries Expense | (xxx) |
| Payroll Tax Expense | (xxx) |
| Utility Expense | (xxx) |
| Property Tax Expense | (xxx) |
| Operating Income | xxx |
| Other Revenues and Expenses | |
| Interest Revenue | xxx |
| Interest Expense | (xxx) |
| Income before inc. tax | xxx |
| Income Tax Expense | (xxx) |
| Net Income/Loss | \$ xxx |
| Earnings Per Share | \$ xx |

Payroll Tax

One of the most common operating expenses is the cost of employee salaries and wages.

To date, in our examples we have simplified this accounting.

Example: We have accounted for the payment of any employee's wage of **\$1,000** by simply:

| | | |
|--------------|----|----|
| Wage Expense | xx | |
| Cash | | xx |

Unfortunately the true accounting for salaries and wages is much more complicated. The major complicating factor is payroll taxes. There are two kinds of payroll taxes that must be considered and accounted for:

- 1) Employee Payroll Tax Withholding
- 2) Employer's Payroll Taxes

Payroll Taxes

Employee Payroll Tax Withholdings:

- FICA Taxes (Social Security & Medicare)
- Federal Income Taxes
- State Income Taxes
- Union dues, contributions to retirement or investment plans, charitable contributions

Example: An employee's gross wage for the month is **\$1,000**, however, the employer withholds **\$70** of FICA taxes, **\$170** of federal income taxes and **\$60** of state income taxes before issuing a check to the employee for their net pay of **\$700**.

Journal entry to record:

| | | |
|-----------------------|-------|-----|
| Wage Expense | 1,000 | |
| Cash | | 700 |
| Employee FICA Payable | | 70 |
| Employee FIT Payable | | 170 |
| Employee SIT Payable | | 60 |

The second form of payroll tax is the:

Employer's Payroll Taxes:

- FICA Taxes (equal to employee amount)
- Federal Unemployment Insurance (FUI)
- State Unemployment Insurance (SUI)

Example: The employer records the employer's payroll tax liability arising from the **\$1,000** employee payroll in the previous example. Assume FUI and SUI amount to **\$10** and **\$5**, respectively.

| | | |
|-------------------------|----|----|
| Payroll Tax Expense | 85 | |
| Employer's FICA Payable | | 70 |
| Employer's FUI Payable | | 10 |
| Employer's SUI Payable | | 5 |

Employer's Have Two Payroll-Related Costs

1. Employee salary/wage expense
2. Employer's payroll tax expense

State Sales Taxes

Example: Joe's Burgers sells a burger to a customer for **\$0.99** but collects **\$1.05** including state sales tax of **\$0.06**. Prepare the journal entry.

| | | |
|-------------------|------|-----|
| Cash | 1.05 | |
| Sales Revenue | | .99 |
| Sales Tax Payable | | .06 |

Upon remittance of the sales tax to the state, the entry would be:

| | | |
|-------------------|-----|-----|
| Sales Tax Payable | .06 | |
| Cash | | .06 |

Whose revenue is the sales tax?

State Government

Whose expense is the sales tax?

Customer's Expense

Problem: Payroll Taxes

Prepare the **12/31/X2** journal entries required given the following information for the December **20X2** payroll assuming the actual payment of December wages and payroll taxes will not be made until January, **20X3**:

Employee Withholding:

| Employees | Gross Wage | FICA Rate | FIT Rate | SIT Rate |
|-------------|------------|-----------|----------|----------|
| Jim Gordon | \$2,000 | 7.65% | 20% | 7% |
| Frank James | \$1,500 | 7.65% | 15% | 5% |
| Al Smith | \$1,200 | 7.65% | 15% | 5% |

Employer federal and state unemployment insurance rates are **2%** and **3%** of the gross wages, respectively.

Payroll Tax

Solution: Payroll Taxes

| Employee Withholdings: | | FICA Withholding | | FIT Withholding | | SIT Withholding | | Net Pay |
|------------------------|------------|------------------|----------|-----------------|-------|-----------------|-------|-------------|
| Employee | Gross Wage | Rate | \$ | Rate | \$ | Rate | \$ | \$ |
| Gordon | \$2,000 | .0765 | \$153.00 | .20 | \$400 | .07 | \$140 | \$ 1,307.00 |
| James | \$1,500 | .0765 | \$114.75 | .15 | \$225 | .05 | \$ 75 | \$ 1,085.25 |
| Smith | \$1,200 | .0765 | \$ 91.80 | .15 | \$180 | .05 | \$ 60 | \$ 868.20 |
| Totals | \$4,700 | | \$359.55 | | \$805 | | \$275 | \$ 3,260.45 |

| | | |
|-----------------------|----------|----------|
| Wage Expense | 4,700.00 | |
| Employee FICA Payable | | 359.55 |
| Employee FIT Payable | | 805.00 |
| Employee SIT Payable | | 275.00 |
| Wage Payable | | 3,260.45 |

| Employer Payroll Tax: | | FUI | | SUI | | |
|-----------------------|--------|------|------|------|-------|----------|
| Gross Wage | FICA | Rate | \$ | Rate | \$ | TOTAL |
| \$4,700 | 359.55 | .02 | \$94 | .03 | \$141 | \$594.55 |

| | | |
|-----------------------|--------|--------|
| Payroll Tax Expense | 594.55 | |
| Employer FICA Payable | | 359.55 |
| Employer FUI Payable | | 94.00 |
| Employer SUI Payable | | 141.00 |

The **matching principle** has to do with timing of expenses and seeks to record expenses in the period in which those costs of doing business contribute to the production of revenues, not necessarily when those costs are paid in cash.

Example: Assume property taxes amounting to **\$3,600** are prepaid on **11/1/X1** for the year through **10/31/X2**.

11/1/X1 Entry:

| | | |
|------------------------------|---------|---------|
| Prepaid Property Tax Expense | \$3,600 | |
| Cash | | \$3,600 |

12/31/X1 Adjusting Entry:

| | | |
|----------------------|---------|---------|
| Property Tax Expense | \$3,600 | |
| Prepaid Property Tax | | \$3,600 |

Other Operating Expenses

The **matching principle** has to do with timing of expenses and seeks to record expenses in the period in which those costs of doing business contribute to the production of revenues, not necessarily when those costs are paid in cash.

Example: Assume property taxes amounting to **\$3,600** are prepaid on **11/1/X1** for the year through **10/31/X2**.

11/1/X1 Entry:

| | | |
|------------------------------|----------------|----------------|
| Prepaid Property Tax Expense | \$3,600 | |
| Cash | | \$3,600 |

12/31/X1 Adjusting Entry:

| | | |
|----------------------|----------------|----------------|
| Property Tax Expense | \$3,600 | |
| Prepaid Property Tax | | \$3,600 |

Example: At **12/31/X1**, the utility bill for December has not yet been received or recorded. Based on the previous month's utility bill, utility costs for the month of December are estimated at **\$1,500**.

12/31/X1 Adjusting Entry:

| | | |
|-------------------|----------------|----------------|
| Utilities Expense | \$1,500 | |
| Utilities Payable | | \$1,500 |

Example: Payment of December's rent amounting to **\$1,000** paid in cash on **12/31/X1**.

Assuming this obligation had not been previously recorded, the entry upon payment would be:

| | | |
|--------------|----------------|----------------|
| Rent Expense | \$1,000 | |
| Cash | | \$1,000 |

Internal Controls

Internal Controls

Policies and procedures implemented by a business that are designed to safeguard assets and ensure accurate accounting records.

Examples: - Fencing around inventory and supplies
- Computer passwords
- Shoplifting detection procedures

- The risks of employee theft and fraud. Honest people are susceptible.

- **Key internal controls in safeguarding cash**
 1. Separation of duties
 2. Authorization procedures
 3. Adequate documentation and records
 4. Independent checks on performance (bank reconciliation)
- **CPA expertise in the area of internal controls**
- **Management's fiduciary responsibility and Management's Report.**

Management's Report on Financial Information

Management of **Sara Lee Corporation** is responsible for the preparation and integrity of the financial information included in this annual report. The financial statements have been prepared in accordance with generally accepted accounting principles and, where required, reflect our best estimates and judgments.

It is the corporation's policy to maintain a control-conscious environment through an effective system of internal accounting controls supported by formal policies and procedures communicated throughout the corporation. These controls are adequate to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and to produce the records necessary for the preparation of financial information. There are limits inherent in all systems of internal control based on the recognition that the costs of such systems should be related to the benefits to be derived. We believe the corporation's systems provide this appropriate balance.

The control environment is complemented by the corporation's internal auditors, who perform extensive audits and evaluate the adequacy of and adherence to these controls, policies, and procedures. In addition, the corporation's independent public accountants have developed an understanding of our accounting and financial controls, and have conducted such tests as they consider necessary to support their report below.

The board of directors pursues its oversight role for the financial statements through the Audit Committee, which is composed solely of outside directors. The Audit Committee meets regularly with management, the corporate internal auditors and Arthur Andersen LLP, jointly and separately, to receive reports on management's process of implementation and administration of internal accounting controls, as well as auditing and financial reporting matters. Both Arthur Andersen LLP and the internal auditors have unrestricted access to the Audit Committee.

The corporation maintains high standards in selecting, training and developing personnel to help ensure that management's objectives of maintaining strong, effective internal controls and unbiased, uniform reporting standards are attained. We believe it is essential for the corporation to conduct its business affairs in accordance with the highest ethical standards as expressed in Sara Lee Corporation's Code of Conduct.

John H. Bryan
Chairman of the Board
and Chief Executive Officer

Judith A. Sprieser
Senior Vice President
and Chief Financial Officer

Problem: Internal Controls

1. What are internal controls?
2. Who is ultimately responsible for the quality of and implementation of a business' internal controls?
3. What are some of the key internal controls associated with safeguarding a business' cash?
4. Identify some internal controls you might see at a local grocery store.

Solution: Internal Controls

1. Policies and procedures implemented by a business that are designed to safeguard assets and insure accurate accounting records.
2. It is management's responsibility; the people who are actually operating and running the company.
3.
 - a. separation of duties
 - b. proper authorization for transactions
 - c. adequate documentation and records
 - d. independent checks on performance
4.
 - customers enter and exit store through designated areas
 - large checks need management approval to protect business from bad checks
 - credit card devices; eliminates risk of bad checks
 - security personnel
 - rotation of vegetables