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ACCOUNTING IMPLICATIONS OF MINIMUM-WAGE REGULATIONS

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ABSTRACT

This article addresses the ways in which minimum-wage regulations impact on the data and financial statements reported by accounting systems. Taking a user perspective, the effect of a change in minimum wage will be more readily apparent within managerial accounting systems than financial accounting systems under current standards promulgated by the Financial Accounting Standards Board.

In setting minimum-wage standards, policymakers consider a number of factors from both a societal and economic perspective. Changes in minimum wage can also have a significant impact on the financial statements a firm prepares for public dissemination. These financial statements are used by current stockholders, potential investors, lenders, and management to make decisions about the current status of the firm and its future prospects. Understanding how changes in minimum-wage regulations affect the quantitative information presented in the financial statements can help lead to better decisions by users of that information.

Accounting systems keep track of quantitative information for both internal reporting purposes (managerial accounting) and external reporting purposes (financial accounting). The data processed and generated by the accounting system provides a window into the financial condition of a firm and has utility for both internal and external users who make decisions that are often highly dependent on the numbers and trends represented in that information. An increase

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in minimum-wage standards would have an impact on the numbers reported by both managerial and financial accounting systems. Although both systems keep track of the impact of wages and associated payroll taxes on profitability and cash flows, the way these items are reported are very different, however.

Managerial accounting systems maintain detailed accounts related to wages and for the various payroll taxes. Therefore, it is typically easier for management to make informed judgments about the specific impact a change in minimum wage would have on the financial condition of the firm. Nonetheless, management is typically wary of any change that can potentially reduce the reported profitability of the firm, whether internally or externally, so understanding how an increase in minimum wage affects these individual accounts is important.

On the other hand, financial accounting systems generate statements prepared under generally accepted accounting standards promulgated by the Financial Accounting Standards Board (FASB). In order to enhance comparability across firms and safeguard proprietary information, current FASB standards only require firms to report broad categories of expenses or cash flows. In doing so, expenses and cash flows related to wages are combined into larger aggregate amounts rather than reported as separate line items. For example, wages and payroll tax expenses are only subset of a broad variety of expenses that are combined and reported as a single line item called “Selling, General, and Administrative Expenses.” Although, as noted, the motivation for using such a broad category is to increase comparability and safeguard proprietary information, it also makes it very difficult for external users to make informed decisions about how a change in minimum wage would impact on the firm’s current and future financial position.

Even if detailed wage and payroll tax information were reported as separate line items in external financial statements, however, there is another issue. The impact of a minimum-wage increase will not be systematic across firms as there are other factors that influence how the increase would affect the financial position of the firm. These factors are discussed in a later section. The next sections will provide a primer on the impact of wages and associated payroll taxes on the financial statements disseminated to external users under current FASB accounting standards.

IMPACT OF WAGES ON THE INCOME STATEMENT

An increase in minimum wages would clearly increase the amount of “Selling, General, and Administrative Expenses” reported in aggregate on the income statement, thereby reducing net income. Because management is typically adverse to changes that result in the profitability of their firm decreasing, it may take actions to bring expense back to its prior level. For example, to offset the increase in minimum wages, firms may attempt to increase the price of their products or lay off workers. The first option may not be available to a firm if they compete in a highly inelastic market. The latter option may cause the remaining workforce to become overwhelmed, thereby decreasing productivity. Firms also face the increased likelihood of fines and penalties if they do not adapt to the new minimum-wage level.

In addition to an increase in wages expense, a higher minimum wage would also cause a corresponding increase in associated employer payroll taxes that will create an additional tax burden for the firm. Specific taxes associated with wages are as follows [1].

Social Security Taxes

Social security taxes are the combination of contributions made by to the Old-Age, Survivors, Disability Insurance (OASDI) and Medicare Hospital Insurance (MDI). Both the employer and employee are required to pay into the OASDI tax pool with the firm matching the amount contributed by the employee. As of 2007, the amount of earnings subject to OASDI taxation for a given year is limited to a maximum amount of $97,500. All earnings up to $97,500 are taxed at a rate of 6.2 percent for a maximum annual contribution for both the employee and employer of $6,045 ($97,500 × 6.2 percent). After the maximum has been reached, the employee and employer no longer contribute to the program. The other component of social security taxes, MHI, is currently levied at 1.4 percent for employees and employers. Unlike OASDI contributions, the tax is applied to all earnings without a maximum taxable base.

Federal and State Unemployment Taxes

The Federal Unemployment Tax Act authorizes the Internal Revenue Service to collect a federal employer tax used to fund state workforce agencies. Only employers are subject to these taxes which are levied by the federal government in cooperation with state governments. In general, an employer must pay both state and federal unemployment taxes if 1) wages paid to employees exceed $1,500 in any quarter of a calendar year, or 2) they had at least one employee during any day of a week during 20 weeks in a calendar year, regardless of whether or not the weeks were consecutive. However, some state laws differ from the federal law. Therefore, employers should be cognizant that they should contact their state workforce agencies to learn the exact requirements and how it would impact on their firm's tax burden.

The federal unemployment tax rate is 6.2 percent of taxable wages, and the taxable wage base is the first $7,000 paid in wages to each employee during a calendar year. Employers paying their state unemployment taxes on a timely basis are eligible to receive a credit of up to 5.4 percent. Therefore, for most employers, the net federal tax rate is 0.8 percent (6.2 percent – 5.4 percent) which would result in a maximum of $56 ($7,000 × 0.8 percent) per employee per year. State unemployment tax rates are base on the requirements of each state's law.

Assessment of Income Statement Impact

Knowledgeable users of external financial statements will understand the general implications of a minimum-wage increase and associated payroll taxes on the income statement but will lack enough detailed information to make an accurate estimate of that impact. For example, external users would not have knowledge of how many employees of the firm would cap out at the maximum tax base of $97,500 for social security taxes or $7,000 for federal employment taxes. Thus, users attempting to compare the impact of a minimum-wage increase across different firms might find this particularly perplexing in making their judgments.

IMPACT OF WAGES ON THE BALANCE SHEET

Ceteris paribus, an increase in minimum wage will reduce cash and wage-related liabilities reported on the balance sheet. In addition to the social security and unemployment taxes noted in the preceding section, employers are also required to withhold income taxes on behalf of their employees. The tax is imposed on the employee, not the employer, so these income taxes do not affect the expenses of the firm. Because the firm is acting as an intermediary between the employee and the federal and state governments, however, a liability exists between the time the tax is withheld and the time the tax is remitted. An increase in minimum wages would thus lead to potentially higher liabilities being reported for all three types of taxes (social security, unemployment, and income taxes) and would also affect financial ratios that use liabilities as a component (e.g., current ratio).

Assessment of Balance Sheet Impact

As with the income statement, external users attempting to estimate the impact an increase in minimum wage on the balance sheet will find it difficult as the they are not privy to detailed information needed to make that assessment. With respect to income tax withholding, the amount of taxes withheld is computed using a tax table that takes into account such variables as taxable wages, marital status, and claimed dependents. Estimating the change in the payable related to withheld income taxes without detailed knowledge of each individual employee in a firm’s workforce is difficult at best.

IMPACT OF WAGES ON THE STATEMENT OF CASH FLOWS

Ceteris paribus, an increase in minimum wage will increase cash outflows for both wages and employer payroll taxes related to social security and unemployment. These outflows are reported as a component of the operating activities section of the statement of cash flows rather than financing or investing activities. External users typically focus on the operating activities section to make predictions about future cash flows as transactions reported in this section relate to the day-to-day activities of the firm.

Assessment of Impact on Statement of Cash Flows

Again, current accounting standards make it difficult for external users to determine the exact effect of a higher minimum wage on the statement of cash flows. FASB standards currently permit two ways of presenting the operating activities section on the statement of cash flows: the indirect method and direct method. The indirect method starts with net income and adjusts that accrual-based number to a cash-based amount. Under the indirect method, there is no separate reporting of cash outflows related to wages and wage-related taxes, as those transactions are included in the aggregate net income amount reported as a single-line item.

On the other hand, the direct method requires reporting of cash flows by operating activity (e.g., payments to supplies, cash received from customers). With the direct method, wages paid to employees and for payroll taxes would typically be reported as separate line items making it easier for external users to identify the effects of a minimum-wage increase on the cash flow prospects of the firm.

A vast majority of firms, however, use the indirect method as it is less costly to maintain. Therefore, detailed information that would aid external decision makers in evaluating the impact of a higher minimum wage is buried in net income under the indirect method. Currently, there is no evidence of a trend toward firms switching to the more helpful direct method.

OTHER FACTORS TO CONSIDER

Even if external users were presented with detailed wage-related information in the financial statements, predicting the impact of a minimum-wage increase across firms is confounded by other factors such as:

1. Automated versus Labor-Intensive Environment

An automated firm is less severely impacted by a minimum-wage increase than a firm that is highly dependent on a hourly workforce.

2. Large versus Small Businesses

Small businesses are disproportionately affected by increase in minimum wage. In response, the United States Senate is attaching "to its minimum-wage proposal a package of tax breaks worth $8 billion over 10 years. The relief package includes simplification of some accounting rules, increased deductibles and an extension of the Work Opportunity Tax Credit, an incentive that covers some of the costs of hiring disadvantaged workers such people transitioning off welfare, disabled veterans, and former convicts. To offset the cost of the breaks to small businesses, the Senate measure limits the amount of tax-deferred pay for corporate executives and raises some corporate taxes" [2].

3. Skilled versus Unskilled Workforce

A firm might already be paying well above the minimum wage to hire a dedicated or skilled workforce. Therefore, an increase in minimum wage would have less impact on that firm. However, having to pay unskilled workers a higher wage might trickle up if the skilled workforce demands to be given an corresponding increase in compensation.

4. Older Workforce versus Younger Workforce

Miller discusses the impact of minimum wage on expenses for firms with an older workforce (i.e., Continental Airlines) versus those with a younger workforce (i.e., JetBlue). The CEO of Continental, Gordan Bethune, believes his firm is disadvantaged by income statement effects of paying an older workforce and suggest, "In addition to the usual earnings reports, require firms to issue an "age-adjusted" income statement that shows what earnings would be if the company had, say, average-aged workers" [3].

SUMMARY

Understanding the impact of minimum wages on the quantitative information reported by an accounting system is dependent on whether that information is generated for internal purposes (managerial accounting) or external purposes (financial accounting). Management will have access to detailed information from the managerial accounting system (e.g., workforce composition) that will allow a relatively accurate assessment. External users, on the other hand, will not be privy to the detailed data produced by the managerial accounting system. Therefore, these users must rely on the statements produced by the financial accounting system under standards promulgated by the FASB. Current standards do not mandate the level of detail typically necessary to make informed decisions on how a higher minimum wage will specifically affect the current and future financial position of the firm.

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