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SECTION 1

INDEPENDENT SERVICE AUDITOR'S REPORT

To the Board of Directors
The Payroll Department, Inc.
Durango, Colorado

We have examined the accompanying description of controls related to the tax depository payments application of The Payroll Department, Inc. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of The Payroll Department, Inc.'s controls that are relevant to tax depository payments and (2) the controls included in the description were suitably designed to achieve the control objective specified in the description, if those controls were complied with satisfactorily and user organizations applied the controls contemplated in the design of The Payroll Department, Inc., controls. The management of The Payroll Department, Inc. specified the control objective.

The accompanying description of controls includes only those controls relevant to the control objective related to tax depository payments. The description does not include control objectives related to other aspects of processing user organizations payroll data. Accordingly, the accompanying description is not intended to, and does not, present fairly, in all material respects, all aspects of The Payroll Department, Inc.'s controls that may be relevant to a user organization's internal control as it relates to an audit of user financial statements.

In our opinion, the accompanying description of the controls related to tax depository payments application of The Payroll Department, Inc. presents fairly, in all material respects, the relevant aspects of The Payroll Department Inc.'s controls that had been placed in operation as of July 3, 2008. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objective would be achieved if the described controls were complied with satisfactorily and user organizations applied the controls contemplated in the design of The Payroll Department, Inc.'s controls.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls to obtain evidence about their effectiveness in meeting the related control objective as of July 3, 2008. The specific controls, the related control objective, and the nature, timing, extent, and results of the tests are summarized on Section 3 of this report. Because our tests were as of a point in time, and not for a period of time, we can not, and do not, express an opinion as to whether the controls were operating with sufficient effectiveness.

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The description of controls at The Payroll Department, Inc. is as of July 3, 2008. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the service organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that (1) changes made to the system of controls, (2) changes in processing requirements, or (3) changes required because of the passage of time may alter the validity of such conclusions.

This report is intended solely for the use by the management of The Payroll Department, Inc. and its users.

FredrickZink & Associates, PC

FredrickZink & Associates, PC
October 14, 2008

SECTION 2

The Payroll Department, Inc.'s

DESCRIPTION OF THE SERVICE ORGANIZATION'S CONTROLS OVER THE TAX DEPOSITORY APPLICATION

The Payroll Department, Inc. (the Organization) is located in Durango, Colorado and provides payroll processing services to user organizations (hereinafter referred to as client) primarily located in the four corners area (Durango, Pagosa Springs, Cortez, Farmington and surrounding area). Currently the clients have payrolls in fifteen states.

This description pertains only to controls related to the Organization's processing of payroll taxes and reporting to third parties such as government agencies.

RELEVANT ASPECTS OF THE CONTROL ENVIRONMENT, RISK ASSESSMENT AND MONITORING

Operations are under the direction of the President, General Manager and Operations Manager who oversee the internal control function. The Organization employs seven people in the following areas:

- Data processing - This function coordinates and oversees the collection of payroll information.
- Operations - This function manages the daily computer operations and report production.
- Bagging and Wrap Up - This function coordinates collection of payroll report information to process for pick-up, courier, mailing or through the internet.
- Accounting - This function reviews and reconciles bank accounts in which the Organization holds client funds prior to submitting for payment to various government agencies.

The Organization's employees are not authorized to initiate or authorize client transactions that are submitted for processing except through appropriate approval from responsible personnel.

Once a week, currently on Thursday afternoon, the operations staff meets to discuss quality control issues including any errors made by staff in the previous week. Changes may be made to procedures at that time to prevent a repeat of an error. In addition, a weekly management meeting is held each Monday morning (more frequently if needed) to discuss operational and personnel issues.

All employees have job descriptions which are reviewed annually. All employees receive written evaluations at three months, twelve months and every twelve months thereafter to review performance within the job description. All employees in operations and management are required to have had a background check and each must sign a confidentially agreement which includes maintaining employer and employee confidentiality.

RISK ASSESSMENT

The Organization has performed risk analysis to identify and manage risk that could affect the ability of the Organization to perform the necessary operations. Each weekly manager's meeting has an agenda item to identify new or changed risks.

MONITORING

The Organization's President, General Manager and Operations Manager monitor the quality of the internal control performance as a routine part of their activities. To assist them in this monitoring, the Organization has implemented a series of management reports that measure the results of various processes involved in processing payroll related transactions initiated by clients. These include reports of actual daily counts of payrolls processed with the total number submitted by clients daily; summary, transmission and confirmation reports for all custodial tax depository payments handled by the Organization which have been authorized by clients, and a reconciliation of all tax depository payments to independent third party records. All exceptions to normal or scheduled processing related to hardware, software, or procedural problems are logged, reported, and resolved daily. Reports are viewed daily and weekly at staff meetings by appropriate levels of management, and action is taken as necessary.

INFORMATION AND COMMUNICATION

The Organization licenses a payroll processing system from "Paychoice", a software company located in Moorestown, New Jersey. Paychoice licenses approximately 125 service bureaus and its software processes approximately 100,000 companies in the payroll process.

The Organization receives tax table updates weekly from Paychoice. No less than quarterly government forms are modified for reporting purposes.

The Organization receives payroll information in several different forms. These include phone, submitting pre-printed forms by fax or in person, spreadsheets in a .csv format, through on-line time and attendance .asp format, email, and through the web through an online payroll processing system.

The Organization creates an Automated Clearing House (ACH) file of all direct deposit debits and credits which includes employee direct deposit pay, payroll tax calculated on the most current payroll processed, and invoices. Each day the Organization impounds tax dollars from its clients based on the check date of the payroll. These funds are impounded based on files created in Paychoice and then imported into various software (AllianceACH, Bank of Colorado and First National Bank of Durango) to initiate these debits and credits.

The Organization is a recognized "Batch Filer" with the IRS for processing tax payments on behalf of its clients. Files are submitted through this Batch Filer software no less than twice a week to initiate the processing of tax payments and are submitted 48 hours in advance of due date.

State tax payments are submitted and paid depending on the requirements of the individual state. Most are filed electronically although a few payments are submitted using a check.

COMMUNICATION

The Organization has implemented various methods of communication to ensure that all employees understand their individual roles and responsibilities over tax depository payments and external report generation processing and controls, and to ensure that significant events are communicated in a timely manner. These methods include orientation and training for newly hired employees, a monthly Organization newsletter that summarizes significant events and changes occurring during the month, other changes planned for the up-coming months, and the use of electronic mail messages to communicate time-sensitive messages and information. The Organization also holds weekly staff meetings. Every employee has a written job description and is encouraged to communicate significant issues and exceptions to management in a timely manner.

The Organization has implemented various methods of communication to ensure that clients understand the Organization's roles and responsibilities in processing their payroll transactions, to ensure that significant events are communicated to clients in a timely manner. These methods include the Organization's active participation in feedback from clients through the website, telephone, and the monthly newsletter, which summarizes the significant events and changes during the month and planned for upcoming months.

The Organization's President, General Manager, Operations Manager and staff provide customer support and ongoing communication with clients. They maintain records of problems reported by clients and monitor such items until they are resolved. They also communicate information regarding changes in processing schedules, systems enhancements, and other information to clients.

CONTROL OBJECTIVES AND RELATED CONTROLS

The Organization's control objectives and related controls over tax depository payments are included in Section 3 of this report, "Information Provided by the Service Auditor," to eliminate the redundancy that would result from listing them in this section and repeating them in Section 3. Although the control objectives and related controls are included in Section 3, they are, nevertheless, an integral part of the Organization's description of controls.

CLIENT CONTROL CONSIDERATIONS

The Organization's processing of payroll and related transactions authorized by the clients, and the controls over processing were designed with the assumption that certain controls would be placed in operation by the client. Below are described some of the controls that should be in operation at the client company.

- Instructions and information are provided to the Organization from its clients in accordance with pre-printed forms or through the applicable processing section of the Organization's website.
- Physical and logical access to the Organization's systems through workstations is limited to authorized individuals.
- Timely written notification of changes in the designation of individuals authorized to instruct the Organization regarding activities on behalf of the client is adequately communicated to the Organization.
- The client performs timely review of reports provided by the Organization of payroll-related information, and written and oral notice of discrepancies is communicated to the Organization for timely resolution.

The list of client control considerations presented above and those presented with certain control objectives do not represent a comprehensive set of all the controls that should be employed by the client. Other controls may be required by the client.

SECTION 3

INFORMATION PROVIDED BY THE SERVICE AUDITOR

CONTROL OBJECTIVES, RELATED CONTROLS, AND TESTS OF OPERATING EFFECTIVENESS OF THE TAX DEPOSITORY APPLICATION

This section presents the following information provided by the service auditor:

- A description of the testing performed by the service auditor to determine whether the Organization's controls were operating with sufficient effectiveness to achieve specified control objectives at a specified point in time. The service auditor determined the nature and extent of the testing performed.

- The results of the service auditor's tests of operating effectiveness.

Also included in this section is the following information provided by the Organization:

- The control objectives specified by the management of the Organization.

- The control objectives established and specified by the Organization to achieve the specified control objectives.

Control Objective:
Controls provide reasonable assurance that tax depository payments and direct deposits authorized by the Organization are accounted for and remitted in a timely manner.

Description of Controls:
The Paychoice payroll software, along with its interface with Tax Central reconciling software, tracks the collection and payment of payroll taxes allowing for daily reconciliation of the tax account residing at Bank of Colorado.

With each payroll, an ACH file is created which has up to three different elements: the employee direct deposit file, the tax impound or collection file and the file for the invoice of the service bureau. The employee direct deposit file debits directly against the client account with the resulting credits going to the employees' accounts. The tax file flows through the Bank of Colorado account and is tracked through the Tax Central software. The invoice file is sent to another bank account (the operating account).

Daily ACH Processing
Every week day, a payroll processor sends the Same Day direct deposits, which are clients with direct deposit employees with a check date of the next day. The payroll processor utilizes Paychoice and accesses the ACH Direct Deposit Menu where she tags clients with the check date of the next day. She also ensures that there are no clients with previous dates that have not been processed. A file is created of the clients that will be sent to the bank for processing.

In order to access online banking, each bank account that is used requires at least one password. Each Payroll Department employee has an individual password and log-on. All submitted files at each bank must be approved by another employee. In order for the process to not become routine, the payroll processors switch roles every other week.

After the payroll processor logs onto the appropriate bank, she uploads the ACH Direct Deposit report and then enters the manual entries from the direct deposit entry slips, if any. After the upload is complete, the payroll processor prints the ACH direct deposit report, writes the amount of the deposit at the top of the report and takes it to another payroll processor for review. Payroll processor #2 accesses the bank through on-line banking and verifies that the upload data ties to the ACH direct deposit report. Next, she chooses the effective date of the ACH deposits (the next business day) and then submits the file(s) to the bank. The bank provides confirmation numbers for each upload, which the payroll processor #2 prints and staples to the ACH direct deposit report and files them together.

<u>Submitting Alliance</u>

Each weekday, a payroll processor uses Paychoice to send the Alliance ACH (a third party ACH processor). Through Paychoice, the payroll processor tags the clients who have employee Direct Deposit files to submit in two business days and tags clients which have tax files to submit in one business day. The payroll processor also tags clients with tax file dates that were due prior to the following business day, as the client likely ran their payroll late. She also ensures that the clients with holds are not tagged. A file is created for both the employee and tax submissions, and they are both printed. Next, Alliance is accessed through the internet. Alliance ACH has password protection, but only requires one client to submit files. The payroll processor imports the tax and employee files, renames them to the appropriate date, and verifies that the totals match the printed reports. The paper reports are then filed.

<u>State Tax Payments</u>

No less than twice a week, state tax payment files are reviewed in Paychoice to determine whether any payments are due. State payments are made weekly, monthly or quarterly depending on the state for which the client is filing. The payroll processor tracks all due dates on a calendar.

The payroll processor tags the clients by date in Paychoice with ACH to process and creates a file for the dates selected. She signs onto the Bank of Colorado account. In order to access online banking, the Bank of Colorado requires specific PIN ID and password. After the ACH file is uploaded, the payroll processor verifies that the total matches the ACH report. Because the software automatically defaults to the date of the payroll check date, the payroll processor changes the period ending date on the files to the state's due date. She also changes the effective date, per the bank, to the date the payment needs to be posted. The file is saved as a NACHA file and another copy of the file is saved in the payroll processor's file.

The ACH printout is given to another payroll processor to authorize and submit. Payroll processor #2 accesses the Bank of Colorado through on-line banking, verifies that the upload data ties to the ACH direct deposit report and then submits the file(s) to the bank. The bank provides confirmation numbers for the upload, which the payroll processor #2 prints and staples to the ACH direct deposit report and files them together.

<u>Federal Tax Payments</u>

Each weekday, a payroll processor reviews federal tax files in Paychoice to determine whether any payments are due either on the next business day or two days out. Clients with federal taxes due are tagged and a file is created to be exported to EFTPS software, where the clients' tax payments are to be submitted. The payroll processor logs onto the software using her user name and password and imports the files. There are two types of tax clients: 1) Non-tax file and pay, and 2) Tax file and pay. The two types of tax clients have different pins and passwords. All payments that need to be made are selected and the total is written on and compared to the total from the ETPS report EOD created in Paychoice. Under the Payment Inquiry screen, the tax payments are synched, and upon success, the screen indicates the number of clients that were uploaded (inserted). Using the Send Payments screen, the payroll processor verifies that there are no duplicate uploads. Finally, using the Payment Inquiry screen, the settlement date is chosen and the confirmation numbers are given. The confirmation numbers are highlighted and exported back into Paychoice. The payroll processor ensures that the clients whose payments were posted are no longer listed as to be paid, and then prints the EPTS report – Payment Response Audit. One copy of this report is filed and the ETPS report EOD is given to the operations manager to assist in the account reconciliation process.

Account Reconciliation

Each morning the Operations Manager accesses the Bank of Colorado (Trust Fund) checking account through the internet. She prints out the previous day's business from the checking account, which includes the beginning balance, all credits, all debits and the ending balance. Next, she accesses the online REPO account and obtains the previous day's account ending balance. After obtaining the bank balances, the Operations Manager uses Paychoice to manually select the appropriate client(s) and then automatically brings all tax liabilities (collected amounts) and tax payments into Tax Central (tax reconciling software). This step creates the Tax Liability Summary report. Next, tax payments are imported by tagging the client who paid and the information is sent to Tax Central. This step creates the Payments Import Summary Report. Payments are dated in accordance with the date on the bank statement and liabilities are based on their due date. The Operations Manager ensures that all individual tax payments (collections and disbursements) per the bank detail were properly posted in Tax Central. After the bank account is reconciled to Tax Central, the Account Reconciliation Report is printed, which contains the beginning and ending balances and the cleared amounts.

Occasionally, discrepancies exist between the liability and payment amounts. These discrepancies typically consist of the amount the liability was calculated to be versus the amount that was actually paid. For example, amounts can be overpaid (money back), underpaid (collect $), or the client can decide to take FICA (pre-tax deduction) out when they are computing the check and the Payroll department isn't told to change the FICA percentage. These discrepancies are corrected quarterly by running balance statements (compiled on an Excel spreadsheet) and ensuring that no outstanding tax liabilities or over-collected amounts exist.

Tests of Operating Effectiveness:

For July 3, 2008, we obtained the Schedule of Cash Held for Clients and compared the reconciled balance of the bank accounts to confirmed cash balances as of that date. We matched outstanding deposits and payments from the reconciliation to Tax Central reports. We selected a sample of clients and performed the following:

1. We obtained the Tax Central Quarterly Balance Sheet Reports and matched amounts that were reported as held at July 3 to the Schedule of Cash Held for Clients.
2. We matched total liabilities from the Tax Central Quarterly Balance Sheet Reports to the Paychoice Tax Liability Report quarter to date tax liability amounts.
3. We obtained Paychoice Tax Liability Reports for each client and matched the total current tax amount due for total company (client) liabilities to a deposit on a bank transaction report, typically the date of the payroll run or the following day.
4. We matched current additional taxes due listed on the Paychoice Tax Liability Report to the payment on the bank transaction report.
5. We matched current Colorado State tax liabilities from Paychoice Tax Liability Reports to Paychoice ETPS reports, which contain the clients individual amount included in the lump payment of state taxes. We matched the lump payment of state taxes from the ETPS reports to the bank transaction report.

Results of tests: No exceptions noted.

In conclusion, the system of internal controls related to payroll processing, payroll tax and deduction payments, and external payroll reporting applications is adequately designed to provide reasonable assurance that the transactions are being recorded accurately and timely with the results of our tests of the internal controls found no exceptions to be reported.