

PAYCHEX INC  
Form 10-Q  
December 20, 2010



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**PAYCHEX, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**

In millions, except per share amounts

	<b>For the three months ended November 30,</b>		<b>For the six months ended November 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Revenue:</b>				
Total service revenue	\$ 500.0	\$ 483.0	\$ 1,006.2	\$ 969.5
Interest on funds held for clients	12.0	13.6	24.1	27.3
<b>Total revenue</b>	<b>512.0</b>	<b>496.6</b>	<b>1,030.3</b>	<b>996.8</b>
<b>Expenses:</b>				
Operating expenses	159.0	162.6	319.2	326.0
Selling, general and administrative expenses	149.1	140.9	306.4	287.9
<b>Total expenses</b>	<b>308.1</b>	<b>303.5</b>	<b>625.6</b>	<b>613.9</b>
<b>Operating income</b>	<b>203.9</b>	<b>193.1</b>	<b>404.7</b>	<b>382.9</b>
Investment income, net	1.5	1.1	2.9	2.1
<b>Income before income taxes</b>	<b>205.4</b>	<b>194.2</b>	<b>407.6</b>	<b>385.0</b>
Income taxes	71.5	68.4	141.8	135.5
<b>Net income</b>	<b>\$ 133.9</b>	<b>\$ 125.8</b>	<b>\$ 265.8</b>	<b>\$ 249.5</b>
<b>Basic earnings per share</b>	<b>\$ 0.37</b>	<b>\$ 0.35</b>	<b>\$ 0.73</b>	<b>\$ 0.69</b>
<b>Diluted earnings per share</b>	<b>\$ 0.37</b>	<b>\$ 0.35</b>	<b>\$ 0.73</b>	<b>\$ 0.69</b>
<b>Weighted-average common shares outstanding</b>	<b>361.7</b>	<b>361.4</b>	<b>361.6</b>	<b>361.3</b>
<b>Weighted-average common shares outstanding, assuming dilution</b>	<b>362.1</b>	<b>361.7</b>	<b>362.0</b>	<b>361.5</b>
<b>Cash dividends per common share</b>	<b>\$ 0.31</b>	<b>\$ 0.31</b>	<b>\$ 0.62</b>	<b>\$ 0.62</b>

See Notes to Consolidated Financial Statements.



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**PAYCHEX, INC.**  
**CONSOLIDATED BALANCE SHEETS (UNAUDITED)**

In millions, except per share amount

	<b>November 30, 2010</b>	<b>May 31, 2010</b>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 233.2	\$ 284.3
Corporate investments	230.3	82.5
Interest receivable	28.2	28.7
Accounts receivable, net of allowance for doubtful accounts	224.6	186.6
Deferred income taxes		3.8
Prepaid income taxes	5.1	6.7
Prepaid expenses and other current assets	32.1	25.5
<b>Current assets before funds held for clients</b>	<b>753.5</b>	<b>618.1</b>
Funds held for clients	3,260.4	3,541.0
<b>Total current assets</b>	<b>4,013.9</b>	<b>4,159.1</b>
Long-term corporate investments	226.4	290.1
Property and equipment, net of accumulated depreciation	279.5	267.6
Intangible assets, net of accumulated amortization	54.2	63.3
Goodwill	421.6	421.6
Deferred income taxes	23.3	21.1
Other long-term assets	3.8	3.5
<b>Total assets</b>	<b>\$ 5,022.7</b>	<b>\$ 5,226.3</b>
<b>LIABILITIES</b>		
Accounts payable	\$ 33.8	\$ 37.3
Accrued compensation and related items	183.2	163.2
Deferred revenue	2.7	3.5
Deferred income taxes	23.1	17.0
Other current liabilities	38.0	41.2
<b>Current liabilities before client fund obligations</b>	<b>280.8</b>	<b>262.2</b>
Client fund obligations	3,204.9	3,480.0
<b>Total current liabilities</b>	<b>3,485.7</b>	<b>3,742.2</b>
Accrued income taxes	28.1	27.4
Deferred income taxes	9.2	7.8
Other long-term liabilities	50.2	46.9
<b>Total liabilities</b>	<b>3,573.2</b>	<b>3,824.3</b>

**COMMITMENTS AND CONTINGENCIES NOTE H**

**STOCKHOLDERS EQUITY**

Common stock, \$0.01 par value; Authorized: 600.0 shares; Issued and outstanding: 361.7 shares as of November 30, 2010 and 361.5 shares as of May 31, 2010, respectively.	3.6	3.6
Additional paid-in capital	512.3	499.7
Retained earnings	894.5	856.3
Accumulated other comprehensive income	39.1	42.4
<b>Total stockholders equity</b>	<b>1,449.5</b>	<b>1,402.0</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 5,022.7</b>	<b>\$ 5,226.3</b>

See Notes to Consolidated Financial Statements.

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**PAYCHEX, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**  
 In millions

	<b>For the six months ended November 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 265.8	\$ 249.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	41.5	43.3
Amortization of premiums and discounts on available-for-sale securities	19.0	16.8
Stock-based compensation costs	13.5	13.3
Provision for deferred income taxes	9.7	4.3
Provision for allowance for doubtful accounts	0.6	1.9
Net realized gains on sales of available-for-sale securities	(0.3)	(1.0)
Changes in operating assets and liabilities:		
Interest receivable	0.4	(1.4)
Accounts receivable	(39.8)	(44.7)
Prepaid expenses and other current assets	(5.0)	1.7
Accounts payable and other current liabilities	10.4	(1.4)
Net change in other assets and liabilities	3.4	(3.2)
<b>Net cash provided by operating activities</b>	<b>319.2</b>	<b>279.1</b>
<b>INVESTING ACTIVITIES</b>		
Purchases of available-for-sale securities	(3,913.5)	(756.8)
Proceeds from sales and maturities of available-for-sale securities	3,429.8	284.1
Net change in funds held for clients money market securities and other cash equivalents	657.4	697.6
Purchases of property and equipment	(44.1)	(23.1)
Proceeds from sale of business		13.1
Purchases of other assets	(1.0)	(9.2)
<b>Net cash provided by investing activities</b>	<b>128.6</b>	<b>205.7</b>
<b>FINANCING ACTIVITIES</b>		
Net change in client fund obligations	(275.1)	(514.7)
Dividends paid	(224.2)	(224.2)
Proceeds from exercise and excess tax benefit related to stock-based awards	0.4	6.6
<b>Net cash used in financing activities</b>	<b>(498.9)</b>	<b>(732.3)</b>
<b>Decrease in cash and cash equivalents</b>	<b>(51.1)</b>	<b>(247.5)</b>
Cash and cash equivalents, beginning of period	284.3	472.8



<b>Cash and cash equivalents, end of period</b>	<b>\$ 233.2</b>	<b>\$ 225.3</b>
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See Notes to Consolidated Financial Statements.

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**PAYCHEX, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**November 30, 2010**

**Note A: Description of Business and Significant Accounting Policies**

**Description of business:** Paychex, Inc. and its wholly owned subsidiaries (collectively, the Company or Paychex ) is a leading provider of payroll, human resource, and employee benefits outsourcing solutions for small- to medium-sized businesses in the United States ( U.S. ). The Company also has a subsidiary in Germany.

Paychex, a Delaware corporation formed in 1979, reports as one segment. Substantially all of the Company s revenue is generated within the U.S. The Company also generates revenue within Germany, which was less than one percent of its total revenue for the six months ended November 30, 2010 and 2009. Long-lived assets in Germany are insignificant in relation to total long-lived assets of the Company as of November 30, 2010 and May 31, 2010.

**Basis of presentation:** The accompanying Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statement presentation. The Consolidated Financial Statements include the consolidated accounts of the Company with all significant intercompany transactions eliminated. In the opinion of management, the information furnished herein reflects all adjustments (consisting of items of a normal recurring nature), which are necessary for a fair presentation of the results for the interim period. These financial statements should be read in conjunction with the Company s Consolidated Financial Statements and related Notes to Consolidated Financial Statements presented in the Company s Annual Report on Form 10-K as of and for the year ended May 31, 2010 ( fiscal 2010 ). Operating results and cash flows for the six months ended November 30, 2010 are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year ending May 31, 2011 ( fiscal 2011 ). The Company has evaluated subsequent events for potential recognition and/or disclosure through the date of issuance of these financial statements.

**PEO revenue recognition:** Professional Employer Organization ( PEO ) revenue is included in service revenue and is reported net of direct costs billed and incurred which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred were \$1.0 billion and \$730.7 million for the three months ended November 30, 2010 and 2009, respectively, and \$2.0 billion and \$1.4 billion for the six months ended November 30, 2010 and 2009, respectively.

**PEO workers compensation insurance:** Workers compensation insurance for PEO worksite employees is provided under a deductible workers compensation policy with a national insurance company. Reserves are established to provide for the estimated costs of paying claims underwritten by the Company. The Company s maximum individual claims liability is \$1.0 million under both its fiscal 2011 and fiscal 2010 policies. As of November 30, 2010 and May 31, 2010, the Company had current liabilities of \$8.1 million and \$5.8 million, respectively, and long-term liabilities of \$19.6 million and \$20.1 million, respectively, on its Consolidated Balance Sheets for PEO workers compensation costs.

**Table of Contents****Note A: Description of Business and Significant Accounting Policies - continued**

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and actuarial loss projections, and is subject to change due to multiple factors, including economic trends, changes in legal liability law, and damage awards, all of which could materially impact the reserves as reported. Adjustments to previously established reserves are reflected in the results of operations for the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

**Stock-based compensation costs:** The Company has issued stock-based awards to employees and directors consisting of stock options, restricted stock awards, restricted stock units ( RSUs ), and performance shares. The Company accounts for all stock-based awards to employees and directors as compensation costs in the consolidated financial statements based on the fair value measured as of the date of grant. These costs are recognized as an expense in the Consolidated Statements of Income over the requisite service period and increase additional paid-in capital.

Stock-based compensation costs recognized were \$6.4 million and \$13.5 million for the three and six months ended November 30, 2010, as compared with \$6.6 million and \$13.3 million for the respective prior year periods. As of November 30, 2010, the total unrecognized compensation cost related to all unvested stock-based awards was \$50.0 million and is expected to be recognized over a weighted-average period of 2.9 years.

The fair value of restricted stock awards is equal to the closing market price of the underlying common stock as of the date of grant. The fair value of RSUs is equal to the closing market price of the underlying common stock as of the date of grant, adjusted for the present value of expected dividends over the vesting period, as these awards do not earn dividend equivalents. The fair value of performance shares is equal to the closing market price as of the measurement date, adjusted for the present value of the expected dividends over the performance period.

The fair value of stock option grants is estimated as of the date of grant using a Black-Scholes option pricing model. The weighted-average assumptions used for valuation under the Black-Scholes model were as follows:

	<b>For the six months ended</b>	
	<b>November 30,</b>	
	<b>2010</b>	<b>2009</b>
Risk-free interest rate	2.2%	3.0%
Dividend yield	4.2%	4.5%
Volatility factor	.25	.28
Expected option life in years	6.5	6.3

Risk-free interest rates are yields for zero-coupon U.S. Treasury notes maturing approximately at the end of the expected option life. The estimated volatility factor is based on a combination of historical volatility, using weekly stock prices over a period equal to the expected option life, and implied market volatility. The expected option life is based on historical exercise behavior.

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**Note A: Description of Business and Significant Accounting Policies - *continued***

The Company has determined that the Black-Scholes option pricing model, as well as the underlying assumptions used in its application, is appropriate in estimating the fair value of its stock option grants. The Company periodically assesses its assumptions as well as its choice of valuation model, and will reconsider use of this model if additional information becomes available in the future indicating that another model would provide a more accurate estimate of fair value, or if characteristics of future grants would warrant such a change.

***Recently adopted accounting pronouncements:*** Effective June 1, 2010, the Company adopted the following Financial Accounting Standards Board ( FASB ) authoritative guidance, neither of which had a material impact on its consolidated financial statements:

Guidance amending the accounting and reporting standards for transfers and servicing of financial assets, including the removal of the concept of a qualifying special purpose entity; and

Guidance to require a qualitative analysis rather than a quantitative-based risks and rewards calculation to determine the primary beneficiary of a variable interest entity ( VIE ) for consolidation purposes. This qualitative approach focuses on identifying which entity has the power to direct the activities of a VIE with the most significant impact on the VIE 's economic performance.

***Recently issued accounting pronouncements:*** Recent authoritative guidance issued by the FASB (including technical corrections to the FASB Accounting Standards Codification), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not, or are not expected to have a material effect on the Company 's consolidated financial statements.

**Table of Contents****Note B: Basic and Diluted Earnings Per Share**

Basic and diluted earnings per share were calculated as follows:

<b>In millions, except per share amounts</b>	<b>For the three months ended November 30,</b>		<b>For the six months ended November 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Basic earnings per share:</b>				
Net income	\$ 133.9	\$ 125.8	\$ 265.8	\$ 249.5
Weighted-average common shares outstanding	361.7	361.4	361.6	361.3
Basic earnings per share	\$ 0.37	\$ 0.35	\$ 0.73	\$ 0.69
<b>Diluted earnings per share:</b>				
Net income	\$ 133.9	\$ 125.8	\$ 265.8	\$ 249.5
Weighted-average common shares outstanding	361.7	361.4	361.6	361.3
Dilutive effect of common share equivalents at average market price	0.4	0.3	0.4	0.2
Weighted-average common shares outstanding, assuming dilution	362.1	361.7	362.0	361.5
Diluted earnings per share	\$ 0.37	\$ 0.35	\$ 0.73	\$ 0.69
Weighted-average anti-dilutive common share equivalents	13.4	13.5	13.8	14.0

Weighted-average common share equivalents that have an anti-dilutive impact are excluded from the computation of diluted earnings per share.

For the three months ended November 30, 2010 and 2009, minimal shares of the Company's common stock were issued. For the six months ended November 30, 2010 and 2009, 0.2 million shares and 0.5 million shares, respectively, of the Company's common stock were issued related to exercises or vesting of stock-based awards.

**Table of Contents****Note C: Funds Held for Clients and Corporate Investments**

Funds held for clients and corporate investments consisted of the following:

In millions	Amortized cost	November 30, 2010		Fair value
		Gross unrealized gains	Gross unrealized losses	
<b>Type of issue:</b>				
Money market securities and other cash equivalents	\$ 1,097.1	\$	\$	\$ 1,097.1
Available-for-sale securities:				
General obligation municipal bonds	995.9	32.6	(0.7)	1,027.8
Pre-refunded municipal bonds <sup>(1)</sup>	509.6	17.5		527.1
Revenue municipal bonds	344.8	12.1	(0.1)	356.8
Variable rate demand notes	700.0			700.0
Total available-for-sale securities	2,550.3	62.2	(0.8)	2,611.7
Other	8.1	0.2		8.3
Total funds held for clients and corporate investments	\$ 3,655.5	\$ 62.4	\$ (0.8)	\$ 3,717.1

In millions	Amortized cost	May 31, 2010		Fair Value
		Gross unrealized gains	Gross unrealized losses	
<b>Type of issue:</b>				
Money market securities and other cash equivalents	\$ 1,754.5	\$	\$	\$ 1,754.5
Available-for-sale securities:				
General obligation municipal bonds	951.1	33.7	(0.3)	984.5
Pre-refunded municipal bonds <sup>(1)</sup>	539.8	19.5		559.3
Revenue municipal bonds	368.0	13.8	(0.1)	381.7
Variable rate demand notes	226.3			226.3
Total available-for-sale securities	2,085.2	67.0	(0.4)	2,151.8
Other	7.5		(0.2)	7.3
Total funds held for clients and corporate investments	\$ 3,847.2	\$ 67.0	\$ (0.6)	\$ 3,913.6

<sup>(1)</sup> Pre-refunded municipal bonds are secured by an escrow fund of U.S. government obligations.

**Table of Contents****Note C: Funds Held for Clients and Corporate Investments - *continued***

Included in money market securities and other cash equivalents as of November 30, 2010 and May 31, 2010 are U.S. agency discount notes, government money market funds, and bank demand deposit accounts.

Classification of investments on the Consolidated Balance Sheets is as follows:

<b>In millions</b>	<b>November 30, 2010</b>	<b>May 31, 2010</b>
Funds held for clients	\$3,260.4	\$3,541.0
Corporate investments	230.3	82.5
Long-term corporate investments	226.4	290.1
Total funds held for clients and corporate investments	\$3,717.1	\$3,913.6

The Company is exposed to credit risk in connection with these investments through the possible inability of borrowers to meet the terms of their bonds. In addition, the Company is exposed to interest rate risk, as rate volatility will cause fluctuations in the fair value of held investments and in the earnings potential of future investments. The Company follows a conservative investment strategy of optimizing liquidity and protecting principal. The Company invests primarily in high credit quality securities with AAA and AA ratings and short-term securities with A-1/P-1 ratings. The Company limits the amounts that can be invested in any single issuer and invests in short- to intermediate-term instruments whose fair value is less sensitive to interest rate changes. All the investments held as of November 30, 2010 are traded in active markets. The Company has not and does not utilize derivative financial instruments to manage interest rate risk.

The Company's available-for-sale securities reflected a net unrealized gain of \$61.4 million as of November 30, 2010 compared with a net unrealized gain of \$66.6 million as of May 31, 2010. Included in the net unrealized gain as of November 30, 2010 and May 31, 2010, there were, respectively, 36 and 23 available-for-sale securities in an unrealized loss position. The securities in an unrealized loss position were as follows:

<b>In millions</b>	<b>November 30, 2010</b>		<b>More than 12</b>		<b>Total</b>	
	<b>Less than 12 months</b>	<b>months</b>	<b>Gross</b>	<b>Fair</b>	<b>Gross</b>	<b>Fair</b>
	<b>unrealized</b>	<b>Fair</b>	<b>unrealized</b>	<b>value</b>	<b>unrealized</b>	<b>value</b>
	<b>loss</b>	<b>value</b>	<b>loss</b>	<b>value</b>	<b>loss</b>	<b>value</b>
<b>Type of issue:</b>						
General obligation municipal bonds	\$(0.7)	\$ 85.5	\$	\$	\$(0.7)	\$ 85.5
Pre-refunded municipal bonds						
Revenue municipal bonds	(0.1)	25.9			(0.1)	25.9
Total	\$(0.8)	\$111.4	\$	\$	\$(0.8)	\$111.4

**Table of Contents****Note C: Funds Held for Clients and Corporate Investments - *continued***

In millions	Less than 12 months		May 31, 2010 More than 12 months		Total	
	Gross unrealized loss	Fair value	Gross unrealized loss	Fair value	Gross unrealized loss	Fair value
<b>Type of issue:</b>						
General obligation municipal bonds	\$(0.3)	\$44.0	\$	\$	\$(0.3)	\$44.0
Pre-refunded municipal bonds		4.1				4.1
Revenue municipal bonds	(0.1)	25.5			(0.1)	25.5
Total	\$(0.4)	\$73.6	\$	\$	\$(0.4)	\$73.6

The Company regularly reviews its investment portfolios to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns. The Company believes that the investments it held as of November 30, 2010 were not other-than-temporarily impaired. While \$111.4 million of available-for-sale securities held had fair values that were below amortized cost, the Company believes that it is probable that the principal and interest will be collected in accordance with the contractual terms, and that the unrealized loss on these securities of \$0.8 million was due to changes in interest rates and was not due to increased credit risk or other valuation concerns. All of the securities in an unrealized loss position as of November 30, 2010 and May 31, 2010 held an AA rating or better. The Company intends to hold these investments until the recovery of their amortized costs basis or maturity, and further believes that it is more-likely-than-not that it will not be required to sell these investments prior to that time. The Company's assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in the Company's strategies or assumptions related to any particular investment.

Realized gains and losses on the sales of securities are determined by specific identification of the amortized cost basis of each security. On the Consolidated Statements of Income, realized gains and losses from funds held for clients are included in interest on funds held for clients and realized gains and losses from corporate investments are included in investment income, net. Realized gains and losses were as follows:

In millions	For the three months ended		For the six months ended	
	November 30, 2010	2009	November 30, 2010	2009
Gross realized gains	\$ 0.2	\$ 0.7	\$0.3	\$ 1.0
Gr				