PAYCHEX INC
Form 10-Q
September 26, 2006

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**
**FORM 10-Q**
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended ended August 31, 2006**
**Commission file number 0-11330**

**PAYCHEX, INC.**
911 Panorama Trail South
Rochester, New York 14625-2396
(585) 385-6666
A Delaware Corporation
*IRS Employer Identification Number: 16-1124166*

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No þ.

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

| | |
|---|---|
| Common Stock, $0.01 Par Value | 380,430,009 Shares |
| CLASS | OUTSTANDING AT AUGUST 31, 2006 |

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

**PAYCHEX, INC.**
**CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**
In thousands, except per share amounts

| | For the three months ended | |
|---|---|---|
| | **August 31, 2006** | **August 31, 2005** |
| **Revenue:** | | |
| Service revenue | $ 429,543 | $ 384,415 |
| Interest on funds held for clients | 29,831 | 19,300 |
| **Total revenue** | **459,374** | **403,715** |
| **Expenses:** | | |
| Operating expenses | 148,084 | 133,421 |
| Selling, general and administrative expenses | 124,936 | 107,474 |
| **Total expenses** | **273,020** | **240,895** |
| **Operating income** | **186,354** | **162,820** |
| Investment income, net | 9,416 | 4,859 |
| **Income before income taxes** | **195,770** | **167,679** |
| Income taxes | 60,689 | 52,651 |
| **Net income** | **$ 135,081** | **$ 115,028** |
| **Basic earnings per share** | **$ 0.36** | **$ 0.30** |
| **Diluted earnings per share** | **$ 0.35** | **$ 0.30** |
| **Weighted-average common shares outstanding** | **380,360** | **378,810** |
| **Weighted-average common shares outstanding, assuming dilution** | **381,876** | **380,180** |
| **Cash dividends per common share** | **$ 0.16** | **$ 0.13** |

See Notes to Consolidated Financial Statements.

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**PAYCHEX, INC.**
**CONSOLIDATED BALANCE SHEETS (UNAUDITED)**
In thousands, except per share amounts

| | August 31, 2006 | May 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 343,911 | $ 137,423 |
| Corporate investments | 309,322 | 440,007 |
| Interest receivable | 25,934 | 38,139 |
| Accounts receivable, net of allowance for doubtful accounts | 194,891 | 189,835 |
| Deferred income taxes | 13,396 | 18,314 |
| Prepaid income taxes | | 7,574 |
| Prepaid expenses and other current assets | 25,891 | 21,398 |
| **Current assets before funds held for clients** | **913,345** | **852,690** |
| Funds held for clients | 3,797,904 | 3,591,611 |
| **Total current assets** | **4,711,249** | **4,444,301** |
| Long-term corporate investments | 430,793 | 384,481 |
| Property and equipment, net of accumulated depreciation | 237,131 | 234,664 |
| Intangible assets, net of accumulated amortization | 59,973 | 60,704 |
| Goodwill | 405,842 | 405,842 |
| Deferred income taxes | 12,199 | 12,783 |
| Other long-term assets | 7,553 | 6,527 |
| **Total assets** | **$ 5,864,740** | **$ 5,549,302** |
| **LIABILITIES** | | |
| Accounts payable | $ 47,067 | $ 46,668 |
| Accrued compensation and related items | 97,215 | 130,069 |
| Deferred revenue | 5,748 | 5,809 |
| Accrued income taxes | 51,619 | |
| Legal reserve | 20,307 | 15,625 |
| Other current liabilities | 37,091 | 34,008 |
| **Current liabilities before client fund deposits** | **259,047** | **232,179** |
| Client fund deposits | 3,805,798 | 3,606,193 |
| **Total current liabilities** | **4,064,845** | **3,838,372** |
| Deferred income taxes | 14,215 | 15,481 |
| Other long-term liabilities | 40,106 | 40,606 |
| **Total liabilities** | **4,119,166** | **3,894,459** |

**COMMITMENTS AND CONTINGENCIES    NOTE I**

| | | |
|---|---|---|
| **STOCKHOLDERS EQUITY** | | |
| Common stock, $0.01 par value; Authorized: 600,000 shares; Issued and outstanding: 380,430 shares at August 31, 2006 and 380,303 shares at May 31, 2006, respectively | 3,804 | 3,803 |
| Additional paid-in capital | 294,149 | 284,395 |
| Retained earnings | 1,455,176 | 1,380,971 |
| Accumulated other comprehensive loss | (7,555) | (14,326) |
| **Total stockholders equity** | **1,745,574** | **1,654,843** |
| **Total liabilities and stockholders equity** | **$ 5,864,740** | **$ 5,549,302** |

See Notes to Consolidated Financial Statements.

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

| | For the three months ended August 31, 2006 | August 31, 2005 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income | $ 135,081 | $ 115,028 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization on property and equipment and intangible assets | 16,869 | 16,015 |
| Amortization of premiums and discounts on available-for-sale securities | 6,341 | 6,348 |
| Stock-based compensation costs | 6,527 | |
| Provision/(benefit) for deferred income taxes | 567 | (2,847) |
| Tax benefit related to exercise of stock options | | 2,456 |
| Provision for allowance for doubtful accounts | 733 | 554 |
| Net realized gains on sales of available-for-sale securities | (236) | (112) |
| Changes in operating assets and liabilities: | | |
| Interest receivable | 12,205 | 11,607 |
| Accounts receivable | (5,935) | (28,022) |
| Prepaid expenses and other current assets | 3,081 | (1,382) |
| Accounts payable and other current liabilities | 26,868 | 38,695 |
| Net change in other assets and liabilities | (2,186) | 2,991 |
| **Net cash provided by operating activities** | **199,915** | **161,331** |
| **INVESTING ACTIVITIES** | | |
| Purchases of available-for-sale securities | (23,348,338) | (18,161,206) |
| Proceeds from sales and maturities of available-for-sale securities | 24,536,781 | 19,519,734 |
| Net change in funds held for clients money market securities and other cash equivalents | (1,305,123) | (941,953) |
| Net change in client fund deposits | 199,605 | (390,680) |
| Purchases of property and equipment | (16,165) | (20,584) |
| Proceeds from sales of property and equipment | 111 | 18 |
| Acquisition of businesses, net of cash acquired | | (406) |
| Purchases of other assets | (2,650) | (647) |
| **Net cash provided by investing activities** | **64,221** | **4,276** |
| **FINANCING ACTIVITIES** | | |
| Dividends paid | (60,876) | (49,262) |
| Proceeds from exercise of stock options | 2,926 | 5,359 |
| Excess tax benefit related to exercise of stock options | 302 | |
| **Net cash used in financing activities** | **(57,648)** | **(43,903)** |

| | | | | |
|---|---|---|---|---|
| **Increase in cash and cash equivalents** | | **206,488** | | **121,704** |
| Cash and cash equivalents, beginning of period | | 137,423 | | 77,669 |
| **Cash and cash equivalents, end of period** | **$** | **343,911** | **$** | **199,373** |

See Notes to Consolidated Financial Statements.

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**PAYCHEX, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**
**August 31, 2006**

**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 comprehensive payroll and integrated 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 one segment based upon the provisions of Statement of Financial Accounting Standard ( SFAS ) No. 131, Disclosures about Segments of an Enterprise and Related Information. Substantially all of the Company s revenue is generated within the U.S. Revenue is also generated in Germany, which was less than one percent of total revenue for the three months ended August 31, 2006. Long-lived assets in Germany are insignificant to the total of long-lived assets for the Company as of August 31, 2006.

***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, 2006 ( fiscal 2006 ). Operating results and cash flows for the three months ended August 31, 2006 are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year ending May 31, 2007 ( fiscal 2007 ).

***PEO revenue recognition:*** Professional Employer Organization ( PEO ) revenue is included in service revenue and is reported net of direct costs billed and incurred for PEO worksite employees, which include wages, taxes, benefit premiums, and workers compensation costs and claims of PEO worksite employees. Direct costs billed and incurred for PEO worksite employees were $629.6 million and $582.9 million for the three months ended August 31, 2006 and 2005, 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. Claims are paid as incurred and the Company s maximum individual claims liability is $750,000 under both the fiscal 2007 and fiscal 2006 policies.

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

The Company has recorded the following amounts on its Consolidated Balance Sheets for workers compensation claims:

| In thousands | August 31, 2006 | May 31, 2006 |
|---|---|---|
| Prepaid expense | $ 3,129 | $ 3,150 |
| Current liability | $ 5,738 | $ 7,061 |
| Long-term liability | $ 17,075 | $ 18,374 |

The amount included in prepaid expense on the Consolidated Balance Sheets primarily relates to the policy for the fiscal year ended May 31, 2004, which was a pre-funded policy.

Estimated losses under the workers compensation policies, based on historical loss experience and independent actuarial loss projections, are subject to change based on changes in claims experience trends and other factors that management monitors on a regular basis. Any adjustment to previously established reserves is reflected in the operating results of 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:*** Effective June 1, 2006, the Company adopted SFAS No. 123 (revised 2004) ( SFAS No.123(R) ), Share-Based Payment, which replaces SFAS No. 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees. This statement requires that all stock-based awards to employees, including grants of employee stock options, be recognized as compensation costs in the Consolidated Financial Statements based on their fair values as measured at 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. The Company adopted this standard using the modified-prospective transition method, and accordingly, results for prior periods have not been restated. See Note B of the Notes to Consolidated Financial Statements for further discussion of the Company s stock-based compensation plans.

***Income taxes:*** The Company accounts for deferred taxes by recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the Consolidated Financial Statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. With the adoption of SFAS No.123(R), the Company records a deferred tax asset related to the stock-based compensation costs recognized for certain stock-based awards. At the time of exercise of non-qualified stock options or vesting of restricted stock awards, the Company accounts for the resulting tax deduction by reducing its accrued income tax liability with an offset to the deferred tax asset and any excess tax benefit increasing additional paid-in capital. The Company currently has a sufficient pool of excess tax benefits in additional paid-in capital to absorb any deficient tax benefits related to stock-based awards.

***Newly issued accounting pronouncements:*** In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, to create a

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

single model to address accounting for uncertainty in tax positions. FIN 48 clarified the accounting for income tax by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the Consolidated Financial Statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN 48 as of June 1, 2007, as required. The Company has not determined the effect, if any, the adoption of FIN 48 will have on its results of operations or financial position.

In April 2006, the FASB issued FASB Staff Position ( FSP ) FIN 46(R)-6, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R). This FSP provides additional guidance on the determination of and accounting for variable interests under FASB Interpretation No. 46(R). This FSP is effective for reporting periods beginning after June 15, 2006, and the Company will implement its guidance beginning in the second quarter of fiscal 2007. The adoption of this FSP is not expected to have a material effect on the Company s results of operations or financial position.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, the adoption of this statement will have on its results of operations or financial position.

***Reclassifications:*** Certain prior period amounts have been reclassified to conform to the current period presentation and had no effect on reported consolidated earnings.

Variable rate demand notes ( VRDNs ) were reclassified from cash equivalents to available-for-sale securities. VRDNs are variable rate securities where the interest rate is periodically reset, as established at the time of the notes issuance, and is often tied to short-term interest rates. However, the contractual maturity on these notes is typically 20 to 30 years. The Company invests in these securities to provide near-term liquidity, as it can tender the notes at par to a remarketing agent either daily or within five business days. Although VRDNs are issued as long-term securities, they are priced and traded as short-term instruments because of the liquidity provided through the tender feature. The Company had historically classified these securities as cash equivalents.

Purchases of available-for-sale securities, Proceeds from sales and maturities of available-for-sale securities, Net change in funds held for clients money market securities and other cash equivalents, and Amortization of premiums and discounts on available-for-sale securities included in the accompanying Consolidated Statements of Cash Flows have been revised to reflect the purchase and sale of VRDNs during the periods presented.

**Note B: Stock-Based Compensation Plans**

As noted in Note A to the Notes to Consolidated Financial Statements, effective June 1, 2006 (the adoption date ), Paychex adopted SFAS No. 123(R), Share-Based Payment. This statement requires that all stock-based awards to employees, including grants of employee stock options, be recognized as compensation costs in the Consolidated Financial Statements based on their fair values as measured at 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.

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**Note B: Stock-Based Compensation Plans** *continued*

The Company has adopted this standard using the modified-prospective transition method, and accordingly, results for prior periods have not been restated. Under this transition method, the Company has recognized for the three months ended August 31, 2006 compensation costs for (1) stock-based awards granted after the adoption date based on grant date fair value in accordance with the provisions of SFAS No. 123(R); and (2) the unvested portion of any grants issued prior to the adoption date based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123.

Prior to the adoption date, the Company accounted for stock-based compensation arrangements under the intrinsic value method described in APB 25 and related interpretations, as permitted by SFAS No. 123. Accordingly, no compensation costs were recognized for stock option grants because the exercise price of the stock options was equal to the market price of the underlying stock on the date of the grant.

Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits from the exercise of stock options as cash flows from operating activities in the Consolidated Statements of Cash Flows. SFAS No. 123(R) requires tax benefits in excess of compensation costs recognized in the Consolidated Financial Statements ( excess tax benefits ) to be presented as cash flows from financing activities. In accordance with SFAS No. 123(R), excess tax benefits recognized in periods after the adoption date have been properly classified as cash flows from financing activities. Total tax benefits recognized in periods prior to the adoption date remain classified as cash flows from operating activities.

As a result of adopting SFAS No. 123(R), the Company has recognized $6.5 million in stock-based compensation costs and $2.0 million in income tax benefits on its Consolidated Statement of Income for the three months ended August 31, 2006. Capitalized stock-based compensation costs related to the development of internal use software for the three months ended August 31, 2006 were not significant.

The following table illustrates the impact of the adoption of SFAS No. 123(R) on the Company s results of operations:

| **In thousands, except per share amounts** | | **For the three months ended August 31, 2006** |
|---|---|---|
| Operating expenses | $ | 1,886 |
| Selling, general and administrative expenses | | 4,641 |
| Total expenses | | 6,527 |
| Income before income taxes | | (6,527) |
| Income taxes | | (1,998) |
| Net income | $ | (4,529) |
| Basic earnings per share | $ | (0.01) |
| Diluted earnings per share | $ | (0.01) |
| Net cash provided by financing activities | $ | 302 |

**Note B: Stock-Based Compensation Plans** *continued*

The following table illustrates the previously disclosed pro-forma effect on net income and earnings per share as if the Company had applied the fair value recognition provision of SFAS No. 123 to stock-based compensation.

| In thousands, except per share amounts | | For the three months ended August 31, 2005 |
|---|---|---|
| Net income, as reported | $ | 115,028 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | | 4,295 |
| Pro-forma net income | $ | 110,733 |
| Earnings per share: | | |
| Basic as reported | $ | 0.30 |
| Basic pro forma | $ | 0.29 |
| Diluted as reported | $ | 0.30 |
| Diluted pro forma | $ | 0.29 |

Stock-based compensation costs for any awards granted subsequent to the adoption date are recognized on a straight-line basis over the requisite service period to better align the costs with the employee services provided. Compensation costs for stock-based awards granted prior to the adoption date will continue to be recognized according to an accelerated amortization schedule, as they were for the pro-forma disclosures above.

The Company s 2002 Stock Incentive Plan, as amended and restated effective October 12, 2005 (the 2002 Plan ), authorizes the granting of stock-based awards for up to 29.1 million underlying shares of the Company s common stock. Outstanding stock-based awards under the 2002 Plan as of August 31, 2006 consisted primarily of grants of stock options. In July 2006, restricted stock awards were issued under the 2002 Plan to officers and outside directors of the Company.

As of August 31, 2006, the total unrecognized compensation costs related to all stock-based awards were $68.3 million and are expected to be recognized over a weighted-average period of 3.0 years.

***Stock option grants:*** Stock option grants entitle the holder to purchase, at the end of the vesting term, a specified number of shares of Paychex common stock at an exercise price per share set equal to the market price of the common stock on the date of grant. Stock option grants have a ten-year contractual term and the vesting schedule is established by the Board of Directors (the Board ). Stock options granted during the three months ended August 31, 2006 and 2005 vest ratably over periods ranging from three to five years. The Company issues new shares of common stock to satisfy stock option exercises.

**Note B: Stock-Based Compensation Plans** ***continued***

The following table summarizes stock option activity for the three months ended August 31, 2006:

| | Shares subject to options (thousands) | Weighted-average exercise price | Weighted-average remaining contractual term (years) | Aggregate intrinsic value [(1)] (thousands) |
|---|---|---|---|---|
| Outstanding at May 31, 2006 | 13,510 | $ 31.61 | | |
| Granted | 3,442 | $ 36.87 | | |
| Exercised | (127) | $ 23.10 | | |
| Forfeited | (271) | $ 36.85 | | |
| Expired | (34) | $ 36.47 | | |
| Outstanding at August 31, 2006 | 16,520 | $ 32.67 | 7.2 | $ 68,387 |
| Vested or expected to vest[(2)] at August 31, 2006 | 15,676 | $ 32.47 | 7.2 | $ 68,140 |
| Exercisable at August 31, 2006 | 7,191 | $ 30.07 | 5.1 | $ 51,055 |

(1) Market price of the underlying stock at August 31, 2006 less the exercise price.

(2) The number of options expected to vest takes into account an estimate of expected forfeitures.

Other information pertaining to stock option grants is as follows:

| **In thousands** | **For the three months ended August 31, 2006** | **August 31, 2005** |
|---|---|---|
| Weighted-average grant-date fair value of stock options granted (per share) | $ 12.88 | $ 11.02 |
| Total intrinsic value of stock options exercised | $ 1,694 | $ 6,776 |
| Total fair value of stock options vested | $ 18,156 | $ 9,321 |

The fair value of stock option grants was estimated at the date of grant using a Black-Scholes option pricing model for grants prior to and subsequent to the adoption date. The weighted-average assumptions used for valuation under the Black-Scholes model for the three months ended August 31, 2006 (under SFAS No. 123(R)) and for the three months ended August 31, 2005 (pro-forma impact under SFAS No. 123) are as follows:

| | For the three months ended | |
|---|---|---|
| | **August 31, 2006** | **August 31, 2005** |
| Risk-free interest rate | 5.1% | 4.0% |
| Dividend yield | 1.7% | 1.5% |
| Volatility factor | .32 | .31 |
| Expected option life in years | 6.5 | 6.5 |

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**Note B: Stock-Based Compensation Plans** *continued*

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 calculated using weekly stock prices and implied market volatility, both over a period equal to the expected option life. Prior to the adoption date, the Company had used historical volatility using monthly stock prices. The expected option life is determined using historical exercise patterns.

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-based compensation. 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.

***Restricted stock awards:*** In July 2006, the Board approved a grant of restricted stock awards to the Company s officers and outside directors in accordance with the 2002 Plan. All shares underlying awards of restricted stock are restricted in that they are not transferable until they vest. The recipients of the restricted stock have voting rights and earn dividends, which are paid to the recipient at the time of vesting of the awards. If the recipient leaves Paychex prior to the vesting date for any reason, the shares of restricted stock and the dividends accrued on those shares will be forfeited and returned to Paychex.

For restricted stock awards granted to officers, the shares vest upon the fifth anniversary of the grant date provided the recipient is still an employee of the Company on that date. These awards have a provision for the acceleration of vesting based on achievement of performance targets established by the Board. If the established targets are met for a fiscal year, one-third of the award will vest. For directors, the shares vest on the third anniversary of the grant date.

The fair value of restricted stock awards is based on the market price of the underlying common stock as of the date of grant and is expensed over the requisite service period on a straight-line basis.

The following table summarizes the Company s restricted stock activity for the three months ended August 31, 2006:

| **In thousands, except per share amounts** | **Restricted shares** | **Weighted-average grant-date fair value** |
|---|---|---|
| Nonvested at May 31, 2006 | | $ 0.00 |
| Granted | 106 | $ 36.87 |
| Vested | | $ 0.00 |
| Forfeited | | $ 0.00 |
| Nonvested at August 31, 2006 | 106 | $ 36.87 |

***Employee Stock Purchase Plan***: The Company offers an Employee Stock Purchase Plan to all employees under which the Company s common stock can be purchased through a payroll deduction with no discount to the market price. The plan has been deemed non-compensatory subject to the provisions of SFAS No. 123(R) and, therefore, no stock-based compensation costs have been recognized for the three months ended August 31, 2006.

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**Note C: Basic and Diluted Earnings Per Share**
Basic and diluted earnings per share were calculated as follows:

| | For the three months ended | |
|---|---|---|
| **In thousands, except per share amounts** | **August 31, 2006** | **August 31, 2005** |
| **Basic earnings per share:** | | |
| Net income | $ 135,081 | $ 115,028 |
| Weighted-average common shares outstanding | 380,360 | 378,810 |
| Basic earnings per share | $ 0.36 | $ 0.30 |
| **Diluted earnings per share:** | | |
| Net income | $ 135,081 | $ 115,028 |
| Weighted-average common shares outstanding | 380,360 | 378,810 |
| Effect of common share equivalents at average market price | 1,516 | 1,370 |
| Weighted-average common shares outstanding, assuming dilution | 381,876 | 380,180 |
| Diluted earnings per share | $ 0.35 | $ 0.30 |
| Weighted-average anti-dilutive common share equivalents | 7,970 | 5,688 |

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 August 31, 2006, stock options were exercised for 0.1 million shares of the Company s common stock compared with 0.4 million shares for the three months ended August 31, 2005.

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**Note D: Funds Held for Clients and Corporate Investments**
Funds held for clients and corporate investments consisted of the following:

| | August 31, 2006 | | | |
|---|---|---|---|---|
| **In thousands** | **Cost** | **Gross unrealized gains** | **Gross unrealized losses** | **Market value** |
| **Type of issue:** | | | | |
| Money market securities and other cash equivalents | $ 1,862,198 | $ | $ | $ 1,862,198 |
| Available-for-sale securities: | | | | |
| General obligation municipal bonds | 768,984 | 1,484 | (8,473) | 761,995 |
| Pre-refunded municipal bonds | 206,883 | 415 | (2,224) | 205,074 |
| Revenue municipal bonds | 436,685 | 558 | (4,283) | 432,960 |
| Auction rate securities and variable rate demand notes | 711,793 | 37 | | 711,830 |
| U.S. government securities | 555,541 | 1,458 | (625) | 556,374 |
| Other equity securities | 20 | 51 | | 71 |
| Total available-for-sale securities | 2,679,906 | 4,003 | (15,605) | 2,668,304 |
| Other | 7,023 | 514 | (20) | 7,517 |
| Total funds held for clients and corporate investments | $ 4,549,127 | $ 4,517 | $ (15,625) | $ 4,538,019 |

| | May 31, 2006 | | | |
|---|---|---|---|---|
| **In thousands** | **Cost** | **Gross unrealized gains** | **Gross unrealized loss** | **Market Value** |