

PAYCHEX INC  
Form 10-Q  
December 21, 2017  
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 November 30, 2017

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

---

Edgar Filing: PAYCHEX INC - Form 10-Q

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer	Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company Emerging growth company
-------------------------	-------------------	--	--

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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	359,185,462	Shares
CLASS	OUTSTANDING AS OF	November 30, 2017

PAYCHEX, INC.

Table of Contents

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	1
<u>Consolidated Statements of Income and Comprehensive Income</u>	1
<u>Consolidated Balance Sheets</u>	2
<u>Consolidated Statements of Cash Flows</u>	3
<u>Notes to Consolidated Financial Statements</u>	4
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
<u>Item 3. Quantitative and Qualitative Disclosures of Market Risk</u>	30
<u>Item 4. Controls and Procedures</u>	30
<u>PART II. OTHER INFORMATION</u>	30
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	30
<u>Item 6. Exhibits</u>	31
<u>Signatures</u>	32

---

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PAYCHEX, INC.

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

In millions, except per share amounts

	For the three months ended November 30,		For the six months ended November 30,	
	2017	2016	2017	2016
Revenue:				
Service revenue	\$ 812.5	\$ 760.0	\$ 1,615.6	\$ 1,533.5
Interest on funds held for clients	14.0	11.4	27.7	23.4
Total revenue	826.5	771.4	1,643.3	1,556.9
Expenses:				
Operating expenses	248.7	226.3	480.8	451.4
Selling, general and administrative expenses	245.6	234.0	485.3	471.4
Total expenses	494.3	460.3	966.1	922.8
Operating income	332.2	311.1	677.2	634.1
Investment income, net	1.7	0.9	3.8	2.4
Income before income taxes	333.9	312.0	681.0	636.5
Income taxes	116.9	109.9	236.2	217.0
Net income	\$ 217.0	\$ 202.1	\$ 444.8	\$ 419.5
Other comprehensive loss, net of tax:				
Unrealized losses on securities, net of tax	(33.6)	(56.0)	(29.2)	(46.0)
Total other comprehensive loss, net of tax	(33.6)	(56.0)	(29.2)	(46.0)
Comprehensive income	\$ 183.4	\$ 146.1	\$ 415.6	\$ 373.5
Basic earnings per share	\$ 0.60	\$ 0.56	\$ 1.24	\$ 1.16
Diluted earnings per share	\$ 0.60	\$ 0.56	\$ 1.23	\$ 1.16
Weighted-average common shares outstanding	359.1	360.2	359.0	360.4
Weighted-average common shares outstanding, assuming dilution	361.4	362.6	361.4	363.2
Cash dividends per common share	\$ 0.50	\$ 0.46	\$ 1.00	\$ 0.92

See Notes to Consolidated Financial Statements.

1

---

Table of Contents

PAYCHEX, INC.

## CONSOLIDATED BALANCE SHEETS (UNAUDITED)

In millions, except per share amount

	November 30, 2017	May 31, 2017
Assets		
Cash and cash equivalents	\$ 257.2	\$ 184.6
Corporate investments	81.4	138.8
Interest receivable	35.2	35.9
Accounts receivable, net of allowance for doubtful accounts	595.2	507.5
Prepaid income taxes	62.4	45.0
Prepaid expenses and other current assets	73.4	58.3
Current assets before funds held for clients	1,104.8	970.1
Funds held for clients	4,888.2	4,301.9
Total current assets	5,993.0	5,272.0
Long-term corporate investments	480.9	454.0
Property and equipment, net of accumulated depreciation	377.1	337.2
Intangible assets, net of accumulated amortization	77.4	57.6
Goodwill	698.1	657.1
Prepaid income taxes	24.9	24.9
Other long-term assets	33.2	30.9
Total assets	\$ 7,684.6	\$ 6,833.7
Liabilities		
Accounts payable	\$ 58.4	\$ 57.2
Accrued compensation and related items	281.2	280.5
Short-term borrowings	133.4	—
Deferred revenue	27.0	22.9
Other current liabilities	103.8	91.9
Current liabilities before client fund obligations	603.8	452.5
Client fund obligations	4,897.9	4,272.6
Total current liabilities	5,501.7	4,725.1
Accrued income taxes	50.1	45.6
Deferred income taxes	85.0	33.9
Other long-term liabilities	78.9	73.8
Total liabilities	5,715.7	4,878.4
Commitments and contingencies — Note L		
Stockholders' equity	3.6	3.6

Edgar Filing: PAYCHEX INC - Form 10-Q

Common stock, \$0.01 par value; Authorized: 600.0 shares;

Issued and outstanding: 359.2 shares as of November 30, 2017

and 359.4 shares as of May 31, 2017

Additional paid-in capital	1,093.5	1,030.0
Retained earnings	881.0	901.7
Accumulated other comprehensive (loss)/income	(9.2)	20.0
Total stockholders' equity	1,968.9	1,955.3
Total liabilities and stockholders' equity	\$ 7,684.6	\$ 6,833.7

See Notes to Consolidated Financial Statements.

2

---

Table of Contents

PAYCHEX, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

In millions

	For the six months ended November 30,	
	2017	2016
Operating activities		
Net income	\$ 444.8	\$ 419.5
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	65.7	59.7
Amortization of premiums and discounts on available-for-sale securities	33.8	37.0
Stock-based compensation costs	19.1	17.6
Provision for deferred income taxes	68.4	24.0
Provision for allowance for doubtful accounts	1.8	2.7
Net realized gains on sales of available-for-sale securities	—	(0.1)
Changes in operating assets and liabilities:		
Interest receivable	0.7	0.3
Accounts receivable	(56.5)	(123.0)
Prepaid expenses and other current assets	(25.8)	(46.4)
Accounts payable and other current liabilities	(34.3)	5.8
Net change in other long-term assets and liabilities	1.7	16.3
Net cash provided by operating activities	519.4	413.4
Investing activities		
Purchases of available-for-sale securities	(20,324.3)	(23,664.1)
Proceeds from sales and maturities of available-for-sale securities	20,708.7	24,198.5
Net change in funds held for clients' money market securities and other cash equivalents	(1,018.0)	214.9
Purchases of property and equipment	(95.5)	(46.8)
Acquisition of businesses, net of cash acquired	(17.9)	—
Purchases of other assets	(4.1)	(4.6)
Net cash (used in)/provided by investing activities	(751.1)	697.9
Financing activities		
Net change in client fund obligations	625.3	(693.6)
Net proceeds from short-term borrowings	133.4	103.1
Dividends paid	(358.9)	(331.5)
Repurchases of common shares	(94.1)	(166.2)



Edgar Filing: PAYCHEX INC - Form 10-Q

Activity related to equity-based plans	(1.4)	10.4
Net cash provided by/(used in) financing activities	304.3	(1,077.8)
Increase in cash and cash equivalents	72.6	33.5
Cash and cash equivalents, beginning of fiscal year	184.6	131.5
Cash and cash equivalents, end of period	\$ 257.2	\$ 165.0

See Notes to Consolidated Financial Statements.

3

---

Table of Contents

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

November 30, 2017

Note A: Description of Business, Basis of Presentation, and Significant Accounting Policies

Description of business: Paychex, Inc. and its wholly owned subsidiaries (collectively, the “Company” or “Paychex”) is a leading provider of integrated human capital management solutions for payroll, human resource (“HR”), retirement, and insurance services for small- to medium-sized businesses in the United States (“U.S.”). The Company also has operations 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 represented less than one percent of the Company’s total revenue for each of the six months ended November 30, 2017 and November 30, 2016. Long-lived assets in Germany are insignificant in relation to total long-lived assets of the Company as of November 30, 2017 and May 31, 2017.

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 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 statement 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 (“Form 10-K”) for the fiscal year ended May 31, 2017 (“fiscal 2017”). Operating results and cash flows for the six months ended November 30, 2017 are not necessarily indicative of the results that may be expected for other interim periods or for the fiscal year ending May 31, 2018 (“fiscal 2018”).

PEO insurance reserves: As part of the professional employer organization (“PEO”), the Company offers workers’ compensation insurance and health insurance to client companies for the benefit of client employees. For workers’ compensation insurance, reserves are established to provide for the estimated costs of paying claims up to per occurrence liability limits. The Company’s maximum individual claims liability is \$1.3 million under both its fiscal 2018 and fiscal 2017 workers’ compensation insurance policies.

Under the minimum premium insurance plan offering within the PEO, the Company's health benefits insurance reserves are established to provide for the payment of claims liability charges in accordance with its service contract with the insurance carrier. The Company's maximum individual claims liability is \$0.3 million under both its calendar 2017 and calendar 2016 minimum premium insurance plan policies.

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 in the consolidated financial statements. Accordingly, final claim settlements may vary from the present estimates, particularly with workers' compensation insurance where those payments may not occur until well into the future. The Company regularly reviews the adequacy of its estimated insurance reserves. Adjustments to previously established insurance reserves are reflected in the results of operations for the period in which such adjustments are identified. Such insurance reserve adjustments could be significant, reflecting any combination 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, performance shares, performance-based restricted stock, and performance stock options. The Company accounts for all stock-based awards to employees and directors as compensation costs in the consolidated financial statements based on their fair values measured as of the date of grant. These costs are recognized over the requisite service period. Stock-based compensation costs recognized were \$10.4 million and \$19.1 million for the three and six months ended November 30, 2017, respectively, as compared with \$8.5 million and \$17.6 million for the three and six months ended November 30, 2016, respectively. The methods and assumptions used in the determination of the fair value of stock-based awards are consistent with those described in the Company's fiscal 2017 Form 10-K.

Recently adopted accounting pronouncements: There were no recently adopted accounting pronouncements during the six months ended November 30, 2017.

Table of Contents

Recently issued accounting pronouncements: In February 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-02, “Leases (Topic 842).” ASU No. 2016-02 improves transparency and comparability among companies by recognizing lease assets and lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU No. 2016-02 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2018, with early application permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2019. The Company is in the preliminary stages of gathering data and assessing the impact of the new lease standard. However, the Company anticipates that the adoption of the new lease accounting standard will impact its Consolidated Balance Sheets.

In May 2014, the FASB issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” This guidance, as amended by subsequent ASUs on the topic, outlines a single comprehensive model for determining revenue recognition for contracts with customers, and supersedes current guidance on revenue recognition in Accounting Standards Codification (“ASC”) Topic 605, “Revenue Recognition.” Entities have the option to apply the new guidance under a full retrospective approach to each prior reporting period presented or a modified retrospective approach with a cumulative effect of initially applying the new guidance recognized at the date of initial application within the consolidated financial statements. This guidance will be effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods.

The Company did not elect to early-adopt the new standard, and will adopt the new standard in its fiscal year beginning June 1, 2018. The analysis of the new standard and its impact to the Company is nearly complete as the Company is in the process of finalizing its conclusions. Further, the Company currently anticipates applying the guidance under the full retrospective approach. The Company’s ability to adopt using the full retrospective method is dependent on system readiness and the completion of the analysis of information necessary to restate prior period consolidated financial statements. While the evaluation of the impact of the new revenue recognition standard on its consolidated financial statements has not yet been finalized, the Company anticipates the provisions to primarily impact the manner in which it treats certain costs to obtain contracts and costs to fulfill contracts. Generally, in relation to these items, the new standard will result in the Company deferring additional costs on the Consolidated Balance Sheets and subsequently amortizing them to the Consolidated Statements of Income and Comprehensive Income over the estimated average life of the client. The Company does not expect the provisions of the new standard will have a material impact on the timing or the amount of revenue it recognizes.

The Company has also not yet fully determined the impacts of the disclosure requirements under the new standard, and is evaluating the way it will disaggregate revenue into categories that show how economic factors affect the nature, timing, and uncertainty of revenue and cash flows generated from contracts with customers. Additionally, while the Company is in the process of assessing its accounting and forecasting considerations to ensure its ability to record, report, forecast, and analyze results under the new standard, it is not expecting significant changes in its business processes or systems.

Other recent authoritative guidance issued by the FASB (including technical corrections to the ASC), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission during the six months ended November 30, 2017 did not, or are not expected to, have a material effect on the Company’s consolidated financial statements.

## Note B: Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In millions, except per share amounts	For the three months ended		For the six months ended	
	November 30, 2017	2016	November 30, 2017	2016
Basic earnings per share:				
Net income	\$ 217.0	\$ 202.1	\$ 444.8	\$ 419.5
Weighted-average common shares outstanding	359.1	360.2	359.0	360.4
Basic earnings per share	\$ 0.60	\$ 0.56	\$ 1.24	\$ 1.16
Diluted earnings per share:				
Net income	\$ 217.0	\$ 202.1	\$ 444.8	\$ 419.5
Weighted-average common shares outstanding	359.1	360.2	359.0	360.4
Dilutive effect of common share equivalents	2.3	2.4	2.4	2.8
Weighted-average common shares outstanding, assuming dilution	361.4	362.6	361.4	363.2
Diluted earnings per share	\$ 0.60	\$ 0.56	\$ 1.23	\$ 1.16
Weighted-average anti-dilutive common share equivalents	1.2	0.7	1.1	0.6

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

Table of Contents

For the three months ended November 30, 2017 and November 30, 2016, 0.3 million and 0.1 million shares, respectively, of the Company's common stock were issued in connection with the exercise or vesting of stock-based awards. For the six months ended November 30, 2017 and November 30, 2016, 0.8 million and 1.4 million shares, respectively, of the Company's common stock were issued in connection with the exercise or vesting of stock-based awards. In addition, for the six months ended November 30, 2017, 0.6 million shares of the Company's common stock were issued in relation to an immaterial business acquisition completed in August 2017. Refer to Note C below for further details.

In July 2016, the Company announced that its Board of Directors approved a program to repurchase up to \$350.0 million of the Company's common stock, with authorization expiring in May 2019. The purpose of the program is to manage common stock dilution. No shares were repurchased during the three months ended November 30, 2017.

During the six months ended November 30, 2017, the Company repurchased 1.6 million shares for \$94.1 million. During the three and six months ended November 30, 2016, the Company repurchased 2.9 million shares for \$166.2 million, of which \$59.7 million were repurchased under a previously authorized common stock repurchase program. All shares repurchased were retired.

Note C: Business Combination

Effective August 18, 2017, the Company acquired HR Outsourcing Holdings, Inc. ("HROI") and all of its operating subsidiaries. HROI is a national PEO that provides HR solutions to small- and medium-sized businesses in more than 35 states. The acquisition expands the Company's presence in the PEO industry. The purchase price was \$75.4 million and was comprised of \$42.2 million of cash plus \$33.2 million issued in the form of Paychex common stock. Goodwill in the amount of \$41.0 million was recorded as a result of the acquisition, which is not tax-deductible. The goodwill recorded is provisional and subject to change, pending completion of the valuation of the assets acquired and liabilities assumed. However, further changes to goodwill as a result of the acquisition are not anticipated to be material to the Company's Consolidated Balance Sheets.

The financial results of HROI are included in the Company's consolidated financial statements from the date of acquisition. The Company concluded that the acquisition was not material to its results of operations and financial position. Therefore, pro-forma financial information has been excluded.

Note D: Investment Income, Net

Investment income, net, consisted of the following items:

In millions	For the three months ended		For the six months ended	
	November 30, 2017	2016	November 30, 2017	2016
Interest income on corporate funds	\$ 2.7	\$ 2.4	\$ 5.6	\$ 4.8
Interest expense	(1.3)	(0.6)	(2.1)	(1.3)
Net gain/(loss) from equity-method investments	0.3	(0.9)	0.3	(1.1)
Investment income, net	\$ 1.7	\$ 0.9	\$ 3.8	\$ 2.4

6

---

Table of Contents

## Note E: Funds Held for Clients and Corporate Investments

Funds held for clients and corporate investments are as follows:

In millions Type of issue:	November 30, 2017			Fair value
	Amortized cost	Gross unrealized gains	Gross unrealized losses	
Funds held for clients money market securities and other cash equivalents	\$ 1,282.8	\$ —	\$ —	\$ 1,282.8
Available-for-sale securities:				
Corporate bonds	291.8	1.3	(1.7)	291.4
General obligation municipal bonds	1,365.2	4.2	(7.6)	1,361.8
Pre-refunded municipal bonds(1)	72.9	0.6	(0.1)	73.4
Revenue municipal bonds	892.4	2.4	(5.7)	889.1
U.S. government agency securities	398.2	—	(7.6)	390.6
Variable rate demand notes	1,142.6	—	—	1,142.6
Total available-for-sale securities	4,163.1	8.5	(22.7)	4,148.9
Other	16.0	2.8	—	18.8
Total funds held for clients and corporate investments	\$ 5,461.9	\$ 11.3	\$ (22.7)	\$ 5,450.5

In millions Type of issue:	May 31, 2017			Fair value
	Amortized cost	Gross unrealized gains	Gross unrealized losses	
Funds held for clients money market securities and other cash equivalents	\$ 264.8	\$ —	\$ —	\$ 264.8
Available-for-sale securities:				
Corporate bonds	208.6	2.7	(0.5)	210.8
General obligation municipal bonds	1,422.0	21.2	(0.9)	1,442.3
Pre-refunded municipal bonds(1)	54.6	0.9	—	55.5
Revenue municipal bonds	929.2	12.5	(0.8)	940.9



Edgar Filing: PAYCHEX INC - Form 10-Q

U.S. government agency securities	328.9	0.5	(3.6)	325.8
Variable rate demand notes	1,637.9	—	—	1,637.9
Total available-for-sale securities	4,581.2	37.8	(5.8)	4,613.2
Other	14.8	1.9	—	16.7
Total funds held for clients and corporate investments	\$ 4,860.8	\$ 39.7	\$ (5.8)	\$ 4,894.7

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

Included in money market securities and other cash equivalents as of November 30, 2017 were bank demand deposit accounts, commercial paper, and money market funds. Included in money market securities and other cash equivalents as of May 31, 2017 were bank demand deposit accounts and money market funds.

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

In millions	November 30, 2017	May 31, 2017
Funds held for clients	\$ 4,888.2	\$ 4,301.9
Corporate investments	81.4	138.8
Long-term corporate investments	480.9	454.0
Total funds held for clients and corporate investments	\$ 5,450.5	\$ 4,894.7

Table of Contents

The Company's available-for-sale securities reflected a net unrealized loss of \$14.2 million as of November 30, 2017 compared with a net unrealized gain of \$32.0 million as of and May 31, 2017. Included in the net unrealized loss as of November 30, 2017 were 689 available-for-sale securities in an unrealized loss position. Included in the net unrealized gain as of May 31, 2017 were 216 available-for-sale securities in an unrealized loss position. The available-for-sale securities in an unrealized loss position were as follows:

In millions	November 30, 2017				Total	
	Securities in an unrealized loss position for less than twelve months		Securities in an unrealized loss position for more than twelve months			
Type of issue:	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
Corporate bonds	\$ (1.0)	\$ 117.1	\$ (0.7)	\$ 35.3	\$ (1.7)	\$ 152.4
General obligation municipal bonds	(5.5)	723.2	(2.1)	76.3	(7.6)	799.5
Pre-refunded municipal bonds	(0.1)	13.4	—	5.8	(0.1)	19.2
Revenue municipal bonds	(4.3)	478.0	(1.4)	52.4	(5.7)	530.4
U.S. government agency securities	(2.0)	190.8	(5.6)	178.5	(7.6)	369.3
Total	\$ (12.9)	\$ 1,522.5	\$ (9.8)	\$ 348.3	\$ (22.7)	\$ 1,870.8

  

In millions	May 31, 2017				Total	
	Securities in an unrealized loss position for less than twelve months		Securities in an unrealized loss position for more than twelve months			
Type of issue:	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
Corporate bonds	\$ (0.5)	\$ 43.6	\$ —	\$ —	\$ (0.5)	\$ 43.6
General obligation municipal bonds	(0.9)	188.8	—	—	(0.9)	188.8
Pre-refunded municipal bonds	—	9.2	—	—	—	9.2
Revenue municipal bonds	(0.8)	154.8	—	1.0	(0.8)	155.8
U.S. government agency securities	(3.6)	210.0	—	—	(3.6)	210.0
Total	\$ (5.8)	\$ 606.4	\$ —	\$ 1.0	\$ (5.8)	\$ 607.4

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 held as of November 30, 2017 that had gross unrealized losses of \$22.7 million were not other-than-temporarily impaired. The Company believes that it is probable that the principal and interest will be collected in accordance with contractual terms, and that the unrealized losses on these securities were due to changes in interest rates and were not due to increased credit risk or other valuation concerns. A majority of the securities in an unrealized loss position as of November 30, 2017 and May 31, 2017 held an AA rating or better. The Company does not intend to sell these investments until the recovery of their amortized cost basis or maturity, and further believes that it is not more-likely-than-not that it will 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 and Comprehensive 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 were insignificant for the three and six months ended November 30, 2017 and November 30, 2016. There were no realized losses for the three and six months ended November 30, 2017. Realized losses were insignificant for the three and six months ended November 30, 2016.

Table of Contents

The amortized cost and fair value of available-for-sale securities that had stated maturities as of November 30, 2017 are shown below by contractual maturity. Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

	November 30, 2017	
In millions	Amortized cost	Fair value
Maturity date:		
Due in one year or less	\$ 326.8	\$ 326.8
Due after one year through three years	838.8	837.7
Due after three years through five years	1,041.4	1,041.9
Due after five years	1,956.1	1,942.5
Total	\$ 4,163.1	\$ 4,148.9

Variable rate demand notes are primarily categorized as due after five years in the table above as the contractual maturities on these securities are typically 20 to 30 years. Although these securities are issued as long-term securities, they are priced and traded as short-term instruments because of the liquidity provided through the tender feature.

## Note F: Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price), in an orderly transaction between market participants at the measurement date. The accounting standards related to fair value measurements include a hierarchy for information and valuations used in measuring fair value that is broken down into three levels based on reliability, as follows:

- Level 1 valuations are based on quoted prices in active markets for identical instruments that the Company can access at the measurement date.
- Level 2 valuations are based on inputs other than quoted prices included in Level 1 that are observable for the instrument, either directly or indirectly, for substantially the full term of the asset or liability including the following:

- o quoted prices for similar, but not identical, instruments in active markets;
  - o quoted prices for identical or similar instruments in markets that are not active;
  - o inputs other than quoted prices that are observable for the instrument; or
  - o inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 valuations are based on information that is unobservable and significant to the overall fair value measurement.

The carrying values of cash and cash equivalents, accounts receivable, net of allowance for doubtful accounts, accounts payable and short-term borrowings, when used by the Company, approximate fair value due to the short maturities of these instruments. Marketable securities included in funds held for clients and corporate investments consist primarily of securities classified as available-for-sale and are recorded at fair value on a recurring basis.

Table of Contents

The Company's financial assets and liabilities measured at fair value on a recurring basis were as follows:

In millions	November 30, 2017			
	Carrying value (Fair value)	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Cash equivalents:				
Commercial paper	\$ 11.9	\$ —	\$ 11.9	\$ —
Money market securities	31.7	31.7	—	—
Total cash equivalents	\$ 43.6	\$ 31.7	\$ 11.9	\$ —
Available-for-sale securities:				
Corporate bonds	\$ 291.4	\$ —	\$ 291.4	\$ —
General obligation municipal bonds	1,361.8	—	1,361.8	—
Pre-refunded municipal bonds	73.4	—	73.4	—
Revenue municipal bonds	889.1	—	889.1	—
U.S. government agency securities	390.6	—	390.6	—
Variable rate demand notes	1,142.6	—	1,142.6	—
Total available-for-sale securities	\$ 4,148.9	\$ —	\$ 4,148.9	\$ —
Other	\$ 18.8	\$ 18.8	\$ —	\$ —
Liabilities:				
Other long-term liabilities	\$ 18.8	\$ 18.8	\$ —	\$ —

In millions	May 31, 2017			
	Carrying value (Fair value)	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets:				
Available-for-sale securities:				
Corporate bonds	\$ 210.8	\$ —	\$ 210.8	\$ —
General obligation municipal bonds	1,442.3	—	1,442.3	—
Pre-refunded municipal bonds	55.5	—	55.5	—

Edgar Filing: PAYCHEX INC - Form 10-Q

Revenue municipal bonds	940.9	—	940.9	—
U.S. government agency securities	325.8	—	325.8	—
Variable rate demand notes	1,637.9	—	1,637.9	—
Total available-for-sale securities	\$ 4,613.2	\$ —	\$ 4,613.2	\$ —
Other	\$ 16.7	\$ 16.7	\$ —	\$ —
Liabilities:				
Other long-term liabilities	\$ 16.7	\$ 16.7	\$ —	\$ —

In determining the fair value of its assets and liabilities, the Company predominately uses the market approach. Money market securities, which are cash equivalents, are valued based on quoted market prices in active markets. Commercial paper is included in Level 2 because it may not trade on a daily basis. Available-for-sale securities, including municipal bonds, corporate bonds, and U.S. government agency securities, are included in Level 2 and are valued utilizing inputs obtained from an independent pricing service. To determine the fair value of the Company's Level 2 available-for-sale securities, the independent pricing service uses a variety of inputs, including benchmark yields, reported trades, non-binding broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, new issue data, and monthly payment information. The Company has not adjusted the prices obtained from the independent pricing service because it believes that they are appropriately valued.

Assets included as other are mutual fund investments, consisting of participants' eligible deferral contributions under the Company's non-qualified and unfunded deferred compensation plans. The related liability is reported as other long-term liabilities. The mutual funds are valued based on quoted market prices in active markets.

Table of Contents

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

## Note G: Accounts Receivable, Net of Allowance for Doubtful Accounts

The components of accounts receivable, net of allowance for doubtful accounts, consisted of the following:

In millions	November 30, 2017	May 31, 2017
PEO receivables(1)	\$ 123.5	\$ 137.8
Purchased receivables(2)	306.3	257.3
Other trade receivables(3)	171.8	118.4
Total accounts receivable, gross	601.6	513.5
Less: Allowance for doubtful accounts	6.4	6.0
Accounts receivable, net of allowance for doubtful accounts	\$ 595.2	\$ 507.5

- (1) PEO receivables are primarily client wages and related tax withholdings since the last payroll processed. Balances will vary based on timing of the last payroll processed and the end of the reporting period.
- (2) Purchased receivables relate to payroll funding arrangements with clients in the temporary staffing industry.
- (3) Other trade receivables primarily relate to other ongoing services provided to our clients and can vary based on the timing of these services and the end of the reporting period.

No single client had a material impact on total accounts receivable, service revenue, or results of operations.

## Note H: Property and Equipment, Net of Accumulated Depreciation

The components of property and equipment, at cost, consisted of the following:



In millions	November 30, 2017	May 31, 2017
Land and improvements	\$ 9.7	\$ 8.3
Buildings and improvements	123.7	103.5
Data processing equipment	207.5	199.7
Software (1)	507.1	496.1
Furniture, fixtures, and equipment	113.4	115.2
Leasehold improvements	108.2	109.5
Construction in progress (1)	52.2	18.7
Total property and equipment, gross	1,121.8	1,051.0
Less: Accumulated depreciation	744.7	713.8
Property and equipment, net of accumulated depreciation	\$ 377.1	\$ 337.2

(1) Software includes both purchased software and costs capitalized related to internally developed software placed in service. Capitalized costs related to internally developed software that has not yet been placed in service is included in construction in progress.

Depreciation expense was \$28.4 million and \$56.5 million for the three and six months ended November 30, 2017, respectively, compared to \$25.5 million and \$50.8 million for the three and six months ended November 30, 2016, respectively.

In August 2017, the Company announced its plan for a new multi-building Paychex campus based in Rochester, NY. This involves the purchase of five buildings and the renovation of over 300,000 square feet of existing space in Rochester for a total estimated cost of approximately \$60 million. The new campus will result in the consolidation of currently leased space in the Rochester area. During the three months ended November 30, 2017, the Company completed the purchase of these buildings for a combined cost of approximately \$34.7 million and placed approximately \$16.0 million in escrow for building renovations, which have commenced. In addition, in September 2017, the Company entered into a transaction with the County of Monroe Industrial Development Agency (“COMIDA”) for purposes of obtaining public benefits and inducements, expiring on December 31, 2039. The public inducements include exemption from sales and use taxes for goods and services directly related to the renovations of the new multi-building campus.

Table of Contents

## Note I: Goodwill and Intangible Assets, Net of Accumulated Amortization

The Company had goodwill balances on its Consolidated Balance Sheets of \$698.1 million as of November 30, 2017 and \$657.1 million as of May 31, 2017. The increase of \$41.0 million in goodwill since May 31, 2017 was the result of the acquisition of HROI in August 2017. Refer to Note C for further information.

The Company has certain intangible assets with finite lives. The components of intangible assets, at cost, consisted of the following:

In millions	November 30, 2017	May 31, 2017
Client lists	\$ 277.9	\$ 293.5
Other intangible assets	5.4	5.4
Total intangible assets, gross	283.3	298.9
Less: Accumulated amortization	205.9	241.3
Intangible assets, net of accumulated amortization	\$ 77.4	\$ 57.6

Amortization expense relating to intangible assets was \$5.3 million and \$9.2 million for the three and six months ended November 30, 2017, respectively, compared to \$4.5 million and \$8.9 million for the three and six months ended November 30, 2016, respectively.

As of November 30, 2017, the estimated amortization expense relating to intangible asset balances for the full year fiscal 2018 and the following four fiscal years is as follows:

In millions Year ending May 31,	Estimated amortization expense
2018	\$ 20.1
2019	18.1
2020	14.6

2021	11.5
2022	8.7

## Note J: Accumulated Other Comprehensive (Loss)/Income

The change in unrealized gains and losses, net of applicable taxes, related to investments in available-for-sale securities is the primary component reported in accumulated other comprehensive (loss)/income on the Company's Consolidated Balance Sheets. The changes in accumulated other comprehensive (loss)/income are as follows:

In millions	For the three months ended November 30,		For the six months ended November 30,	
	2017	2016	2017	2016
Beginning balance	\$ 24.4	\$ 39.2	\$ 20.0	\$ 29.2
Other comprehensive loss:				
Unrealized losses on available-for-sale securities, net of tax	(33.6)	(56.0)	(29.2)	(46.0)
Total other comprehensive loss, net of tax	(33.6)	(56.0)	(29.2)	(46.0)
Ending balance	\$ (9.2)	\$ (16.8)	\$ (9.2)	\$ (16.8)
Total tax benefit included in other comprehensive loss	\$ (19.3)	\$ (32.0)	\$ (16.8)	\$ (26.3)

Reclassification adjustments out of accumulated other comprehensive loss for realized gains and losses on the sale of available-for-sale securities were insignificant for the three and six months ended November 30, 2017 and November 30, 2016. Those reclassification adjustments are reflected in interest on funds held for clients on the Consolidated Statements of Income and Comprehensive Income.

Table of Contents

## Note K: Short-term Financing

The Company maintains credit facilities, letters of credit, and lines of credit as part of its normal and recurring business operations.

Credit Facilities: The Company maintains three committed, unsecured credit facilities, as follows:

Bank	Borrower (1)	Date Entered	Expiration Date	Maximum Amount Available	Purpose
JP Morgan Chase Bank, N.A.(2)	Paychex of New York, LLC	August 5, 2015	August 5, 2020	\$1 Billion	To meet short-term funding requirements.
JP Morgan Chase Bank, N.A.(2)	Paychex of New York, LLC	August 17, 2017	August 17, 2022	\$500 Million	To meet short-term funding requirements.
PNC Bank, National Association ("PNC")	Paychex Advance, LLC	March 17, 2016	March 17, 2020	\$150 Million	To finance working capital needs and general corporate purposes.

(1) Borrower is a wholly owned subsidiary of the Company.

(2) JP Morgan Chase Bank, N.A. ("JPM") acts as the administrative agent for this syndicated credit facility.

For all credit facilities, obligations under any facility are guaranteed by the Company and certain of its subsidiaries and will bear interest at competitive rates based on options provided to the borrower. Upon the expiration date, any borrowings outstanding will mature and be payable on such date.

JPM \$1 Billion Credit Facility: There were no borrowings outstanding under this credit facility as of November 30, 2017 or May 31, 2017. Details of borrowings under this credit facility during the three and six months ended November 30, 2017 and November 30, 2016 are as follows:

For the three months ended November 30,	For the six months ended November 30,
---	---------------------------------------

Edgar Filing: PAYCHEX INC - Form 10-Q

\$ in millions	2017	2016	2017	2016
Number of days borrowed	6	15	19	19
Maximum amount borrowed	\$ 700.0	\$ 350.0	\$ 700.0	\$ 350.0
Weighted-average amount borrowed	\$ 445.8	\$ 223.3	\$ 331.6	\$ 226.3
Weighted-average interest rate	4.25 %	2.53 %	4.24 %	2.74 %

The Company typically borrows on an overnight basis. During the six months ended November 30, 2017, in addition to overnight borrowings, the Company borrowed \$100.0 million for a three-day period at a weighted-average interest rate of 4.25%. During the six months ended November 30, 2016, the Company borrowed \$150.0 million for seven days and \$50.0 million for eighteen days at weighted-average LIBOR-based interest rates of 1.39%. Subsequent to November 30, 2017, the Company borrowed two times, on an overnight basis, \$125.0 million on a weighted-average basis.

JPM \$500 Million Credit Facility: During the three months ended November 30, 2017, the Company borrowed against this credit facility for the first time. As of November 30, 2017, the Company had \$75.0 million outstanding under this credit facility, which was subsequently repaid in December 2017. Details of borrowings under this credit facility during the three and six months ended November 30, 2017 are as follows:

\$ in millions	For the three and six months ended November 30, 2017
Number of days borrowed	20
Maximum amount borrowed	\$ 400.0
Weighted-average amount borrowed	\$ 215.8
Weighted-average interest rate	2.84 %

Table of Contents

The Company typically borrows on an overnight basis. In addition to overnight borrowings, during the three months ended November 30, 2017, the Company borrowed \$300.0 million for seven days and \$75.0 million for eleven days at weighted-average LIBOR-based interest rates of 2.13% and 2.19%, respectively.

PNC \$150 Million Credit Facility: As of November 30, 2017, the Company had \$58.4 million outstanding under this credit facility, which remains outstanding as of the date of this report. There were no borrowings outstanding under this credit facility as of May 31, 2017. Details of borrowings under this credit facility during the three and six months ended November 30, 2017 and November 30, 2016, are as follows:

\$ in millions	For the three months ended November 30,		For the six months ended November 30,	
	2017	2016	2017	2016
Number of days borrowed	91	91	179	177
Maximum amount borrowed	\$ 58.6	\$ 53.1	\$ 58.6	\$ 53.1
Weighted-average amount borrowed	\$ 57.8	\$ 52.2	\$ 56.8	\$ 51.8
Weighted-average interest rate	1.78 %	1.08 %	1.73 %	1.05 %

All of the Company's credit facilities contain various financial and operational covenants that are usual and customary for such arrangements. The Company was in compliance with all of these covenants as of November 30, 2017.

Certain lenders under these credit facilities, and their respective affiliates, have performed, and may in the future perform for the Company, various commercial banking, investment banking, underwriting, and other financial advisory services, for which they have received, and will continue to receive in the future, customary fees and expenses.

Letters of credit: The Company had irrevocable standby letters of credit outstanding totaling \$52.8 million and \$47.3 million as of November 30, 2017 and May 31, 2017, respectively, required to secure commitments for certain insurance policies. The letters of credit expire at various dates between April 2018 and December 2018 and are collateralized by securities held in the Company's investment portfolios. No amounts were outstanding on these letters of credit as of or during the six months ended November 30, 2017 and November 30, 2016, or as of May 31, 2017. Subsequent to November 30, 2017, the Company opened an additional irrevocable standby letter of credit totaling \$4.1 million, required to secure commitments for certain insurance policies related to the acquisition of HROI, expiring in November 2018.

Lines of credit: Effective August 17, 2017, the Company terminated four uncommitted, secured, short-term lines of credit totaling \$900.0 million. The lines of credit were available to the Company at market rates of interest and were

primarily used to meet short-term funding requirements related to deposit account overdrafts and client fund obligations arising from electronic payment transactions on behalf of clients in the ordinary course of business. There were no amounts outstanding under these lines of credit as of or during the six months ended November 30, 2017 and November 30, 2016.

Note L: Commitments and Contingencies

Other commitments: The Company enters into various purchase commitments with vendors in the ordinary course of business. The Company had outstanding commitments to purchase approximately \$4.5 million and \$7.4 million of capital assets as of November 30, 2017 and May 31, 2017, respectively.

In the normal course of business, the Company makes representations and warranties that guarantee the performance of services under service arrangements with clients. Historically, there have been no material losses related to such guarantees. In addition, the Company has entered into indemnification agreements with its officers and directors, which require the Company to defend and, if necessary, indemnify these individuals for certain pending or future claims as they relate to their services provided to the Company.

Paychex currently self-insures the deductible portion of various insured exposures under certain employee benefit plans. The Company's estimated loss exposure under these insurance arrangements is recorded in other current liabilities on the Consolidated Balance Sheets. Historically, the amounts accrued have not been material and are not material as of November 30, 2017. The Company also maintains insurance coverage in addition to its purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, theft and embezzlement, cyber threats, and acts of terrorism; and capacity for deductibles and self-insured retentions through its captive insurance company.

Table of Contents

Contingencies: The Company is subject to various claims and legal matters that arise in the normal course of its business. These include disputes or potential disputes related to breach of contract, tort, breach of fiduciary duty, employment-related claims, tax claims, and other matters.

The Company's management currently believes that resolution of any outstanding legal matters will not have a material adverse effect on the Company's financial position or results of operations. However, legal matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse impact on the Company's financial position and results of operations in the period in which any such effect is recorded.

Note M: Income Taxes

The Company's effective income tax rate was 35.0% and 35.2% for the three months ended November 30, 2017 and November 30, 2016, respectively, and 34.7% and 34.1% the six months ended November 30, 2017 and November 30, 2016, respectively. The effective income tax rates in these periods were impacted by the recognition of a net discrete tax benefit related to employee stock-based compensation payments. The net discrete tax benefit impacted the three months ended November 30, 2017 by approximately \$0.01 per diluted share and was immaterial for the three months ended November 30, 2016. The net discrete tax benefit impacted the six months ended November 30, 2017 and November 30, 2016 by approximately \$0.02 per diluted share and \$0.04 per diluted share, respectively.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations reviews the operating results of Paychex, Inc. and its wholly owned subsidiaries ("Paychex," the "Company," "we," "our," or "us") for the three months ended November 30, 2017 (the "second quarter") and six months ended November 30, 2017 (the "six months") and November 30, 2016, and our financial condition as of November 30, 2017. The focus of this review is on the underlying business reasons for material changes and trends affecting our revenue, expenses, net income, and financial condition. This review should be read in conjunction with the November 30, 2017 consolidated financial statements and the related Notes to Consolidated Financial Statements (Unaudited) contained in this Quarterly Report on Form 10-Q ("Form 10-Q"). This review should also be read in conjunction with our Annual Report on Form 10-K ("Form 10-K") for the year ended May 31, 2017 ("fiscal 2017"). Forward-looking statements in this review are qualified by the cautionary statement included under the next sub-heading, "Cautionary Note Regarding Forward-Looking Statements Pursuant to the United States Private Securities Litigation Reform Act of 1995."



Cautionary Note Regarding Forward-Looking Statements Pursuant to the United States Private Securities Litigation Reform Act of 1995

Certain written and oral statements made by us may constitute “forward-looking statements” within the meaning of the safe harbor provisions of the United States (“U.S.”) Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by such words and phrases as “we expect,” “expected to,” “estimates,” “estimated,” “overview,” “current outlook,” “we look forward to,” “would equate to,” “projects,” “projections,” “projected to be,” “anticipates,” “anticipate,” “we believe,” “believes,” “could be,” and other similar words or phrases. Examples of forward-looking statements include, among others, statements we make regarding operating performance, events, or developments that we expect or anticipate will occur in the future, including statements relating to our outlook, revenue growth, earnings, earnings-per-share growth, or similar projections.

Forward-looking statements are neither historical facts nor assurances of future performance. Instead, they are based only on our current beliefs, expectations, and assumptions regarding the future of our business, future plans and strategies, projections, anticipated events and trends, the economy, and other future conditions. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks, and changes in circumstances that are difficult to predict, many of which are outside our control. Our actual results and financial conditions may differ materially from those indicated in the forward-looking statements. Therefore, you should not place undue reliance upon any of these forward-looking statements. Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, among others, the following:

- general market and economic conditions including, among others, changes in U.S. employment and wage levels, changes to new hiring trends, legislative changes to stimulate the economy, changes in short- and long-term interest rates, changes in the fair value and the credit rating of securities held by us, and accessibility of financing;
- changes in demand for our services and products, ability to develop and market new services and products effectively, pricing changes, and the impact of competition;
- changes in the availability of skilled workers, in particular those supporting our technology and product development;

Table of Contents

- changes in the laws regulating collection and payment of payroll taxes, professional employer organizations (“PEO”s), and employee benefits, including retirement plans, workers’ compensation insurance, health insurance (including health care reform legislation), state unemployment, and section 125 plans;
- changes in health insurance and workers’ compensation insurance rates and underlying claims trends;
- changes in technology that adversely affect our products and services and impact our ability to provide timely enhancements to services and products;
- the possibility of cyber-attacks, security breaches, or other security vulnerabilities that could disrupt operations or expose confidential client data, and could also result in reduced revenues, increased costs, liability claims, or harm to our competitive position;
- the possibility of the failure of our operating facilities, or the failure of our computer systems, and communication systems during a catastrophic event;
- the possibility of third-party service providers failing to perform their functions;
- the possibility of a failure of internal controls or our inability to implement business processing improvements;
- the possibility that we may be subject to liability for violations of employment or discrimination laws by our clients and acts or omissions of client employees who may be deemed to be our agents, even if we do not participate in any such acts or violations, including possible liability related to our co-employment relationship with our PEO;
- potential outcomes related to pending or future legal and legislative matters, including possible tax reform; and
- risks related to the integration of the businesses we acquire.

Any of these factors, as well as such other factors as discussed in our Form 10-K for fiscal 2017 or other periodic filings with the Securities and Exchange Commission (“SEC”), could cause our actual results to differ materially from our anticipated results. The information provided in this Form 10-Q is based upon the facts and circumstances known at this time, and any forward-looking statements made by us in this Form 10-Q speak only as of the date on which they are made. Except as required by law, we undertake no obligation to update these forward-looking statements after the date of filing this Form 10-Q with the SEC to reflect events or circumstances after such date, or to reflect the occurrence of unanticipated events.

## Business

We are a leading provider of integrated human capital management (“HCM”) solutions for payroll, human resource (“HR”), retirement, and insurance services for small- to medium-sized businesses. Our business strategy focuses on flexible, convenient service; industry-leading integrated technology; providing a comprehensive suite of value-added HCM services; solid sales execution; continued service penetration; and engaging in strategic acquisitions. Success in our mission to be a leading provider of HCM services by being an essential partner with America's businesses will lead to strong, long-term financial performance.

We offer a comprehensive portfolio of HCM services and products that allow our clients to meet their diverse payroll and HR needs. Our payroll services are the foundation of our portfolio of HCM services. We support the small-business market through our core payroll, utilizing our robust Paychex Flex® processing platform, or SurePayroll® products. Mid-market companies are serviced through our Paychex Flex Enterprise solution set, which offers an integrated suite of HCM solutions on the Paychex Flex platform, or through our legacy platform. Clients using Paychex Flex Enterprise are offered a software-as-a-service solution that integrates payroll processing with HR management, employee benefits administration, time and labor management, applicant tracking, and onboarding solutions. Paychex Flex Enterprise allows our mid-market clients to choose the services and software they need to meet the complexity of their business and have them integrated through one HCM solution.

Table of Contents

Our services and products are as follows:

Service	Description
Payroll Services:	
Payroll processing	Includes the calculation, preparation, and delivery of employee payroll checks; production of internal accounting records and management reports; preparation of federal, state, and local payroll tax returns; and collection and remittance of clients' payroll obligations.
Payroll tax administration services	Provides accurate preparation and timely filing of quarterly and year-end tax returns, as well as the electronic transfer of funds to the applicable federal, state, and local tax or regulatory agencies.
Employee payment services	Provides the employer the option of paying their employees by direct deposit, payroll debit card, a check drawn on a Paychex account (Readychex®), or a check drawn on the employer's account and electronically signed by us.
Regulatory compliance services	Includes new-hire reporting and garnishment processing, which allow employers to comply with legal requirements and reduce the risk of penalties.
Human Resource Services ("HRS"):	
Paychex HR Services	Available through an administrative services organization ("ASO") and a PEO, both options offer businesses a combined package that includes payroll, employer compliance, HR and employee benefits administration, risk management outsourcing, and on-site availability of a professionally trained HR representative, among other services. Our PEO differs from the ASO in that we serve as a co-employer of the clients' employees, offer health care coverage to PEO client employees, and assume the risks and rewards of workers' compensation insurance and certain health insurance offerings. Paychex HR Essentials is an ASO product that provides support to our clients over the phone or online to help manage employee-related topics.
Retirement services administration	Offers a variety of retirement plan options to clients, as well as recordkeeping services, which include plan implementation, ongoing compliance with government regulations, employee and employer reporting, participant and employer online access, electronic funds transfer, and other

administrative services.

Insurance services

Our licensed insurance agency, Paychex Insurance Agency, Inc., provides insurance through a variety of carriers. Insurance offerings include property and casualty coverage, such as workers' compensation; business-owner policies; commercial auto; and health and benefits coverage, including health, dental, vision, and life. We also offer comprehensive solutions to help clients navigate the Affordable Care Act ("ACA").

HR administration services

Offers cloud-based HR administration software products for employee benefits management and administration, time and attendance solutions, recruiting, and onboarding.

Other HR services and products

Includes section 125 plans, state unemployment insurance services, employee handbooks, management manuals, and personnel and required regulatory forms.

Our wholly owned subsidiary, Paychex Advance LLC, provides a portfolio of services to the temporary staffing industry. This includes payroll funding via the purchase of accounts receivable to clients in the temporary staffing industry.

Table of Contents

Overview

Our financial results for the second quarter reflected continued growth across our major HCM product lines. Total service revenue increased 7% for the second quarter. The acquisition of HR Outsourcing Holdings, Inc. (“HROI”), completed during August 2017, contributed approximately 3% to total service revenue growth for the second quarter. We are integrating HROI into our existing PEO business with favorable initial results. This integration further strengthens and expands our presence in the PEO market and positions us for stronger, long-term growth. Payroll service revenue and HRS revenue increased by 1% and 15%, respectively, for the second quarter. We are managing our personnel costs and expenses while continuing to invest in our business, achieving operating income margins of 40.2% for the second quarter.

Interest rates available on high-quality financial instruments remain low, but are gradually increasing. Our combined funds held for clients and corporate investment portfolios earned an average rate of return of 1.5% for the second quarter, compared to 1.2% for the same period last year. In December 2017, the U.S. Federal Reserve raised the Federal Funds rate by 25 basis points to a range of 1.25% to 1.50%.

We continue to focus on driving growth in the number of clients, revenue, and profits, while providing award-winning service and leading-edge technology solutions to our clients and their employees. Concentrated effort remains on the continued enhancement of Paychex Flex, our robust, cloud-based HCM platform, which allows direct client access to payroll, HR, and benefits information in a streamlined and integrated approach to workplace management.

We have continued our focus on leading-edge technology, where we are committed to delivering to our clients the best and most robust solutions available on the market. At the HR Technology Conference and Exposition in October 2017, we were excited to introduce our new product bundles, including our new do-it-yourself online employee handbook offering and our cutting-edge InVision™ Iris Time Clock. We are proud to continue to receive recognition for our innovation in technology, including our recent gold-medal award for the “Best Advance in HR or Workforce Management Technology for Small and Medium-sized Businesses” from Brandon Hall Group.

In August 2017, we announced our plans for a new multi-building Paychex campus based in Rochester, NY, the home of our corporate headquarters. This involves the purchase of five buildings and the renovation of over 300,000 square feet of existing space in Rochester for an estimated total cost of approximately \$60 million. The new campus will result in the consolidation of currently leased space in the Rochester area. During the second quarter, we completed the purchase of these buildings for a combined cost of approximately \$34.7 million and placed approximately \$16.0 million in escrow for the building renovations, which have commenced. Looking to the future, we believe that investing in our products, people, and service capabilities will position us to capitalize on opportunities for long-term growth.

Highlights of the financial results for the second quarter as compared to the same period last year are as follows:

- Total revenue increased 7% to \$826.5 million.
- Total service revenue increased 7% to \$812.5 million; 3% of this growth contributed by HROI.
  - o Payroll service revenue increased 1% to \$444.8 million.
  - o HRS revenue increased 15% to \$367.7 million.
- Interest on funds held for clients increased 23% to \$14.0 million.
- Operating income increased 7% to \$332.2 million.
- Net income and diluted earnings per share each increased 7% to \$217.0 million and \$0.60 per share, respectively.
- Adjusted net income(1) increased 7% to \$214.4 million and adjusted diluted earnings per share(1) increased 5% to \$0.59 per share.

(1) Adjusted net income and adjusted diluted earnings per share are not U.S. generally accepted accounting principles (“GAAP”) measures. Refer to the “Non-GAAP Financial Measures” section within the discussion of “Results of Operations” of this Item 2 for a discussion of these non-GAAP measures.

## Table of Contents

### Financial Position and Liquidity

Our financial position as of November 30, 2017 remained strong with cash and total corporate investments of \$819.5 million. Short-term borrowings totaled \$133.4 million as of November 30, 2017. Our investment strategy focuses on protecting principal and optimizing liquidity. Yields on high credit quality financial instruments remain low, although they are beginning to increase gradually, tempering growth in our income earned on funds held for clients and corporate investments. We invest predominately in municipal bonds – including general obligation bonds; pre-refunded bonds, which are secured by a U.S. government escrow; and essential services revenue bonds – along with U.S. government agency securities and corporate bonds. During the second quarter, our primary short-term investment vehicles were Variable Rate Demand Notes (“VRDNs”) and bank demand deposit accounts.

A substantial portion of our investment portfolio is invested in high credit quality securities with ratings of AA or higher, and A-1/P-1 ratings on short-term securities. We limit the amounts that can be invested in any single issuer and invest in short- to intermediate-term instruments whose fair values are less sensitive to interest rate changes. We believe that our investments as of November 30, 2017 that were in an unrealized loss position were not other-than-temporarily impaired, nor has any event occurred subsequent to that date that would indicate any other-than-temporary impairment.

Our primary source of cash is generated from our ongoing operations. Cash flow from operations was \$519.4 million for the six months, an increase of 26% over the same period last year. Historically, we have funded our operations, capital purchases, business acquisitions, share repurchases, and dividend payments from our operating activities. Our positive cash flows have allowed us to support our business and to pay substantial dividends, targeting approximately 80% of our net income, to our stockholders. It is anticipated that cash and total corporate investments as of November 30, 2017, along with projected operating cash flows and available short-term financing, will support our normal business operations, capital purchases, share repurchases, dividend payments, and business acquisitions, if any, for the foreseeable future.

For further analysis of our results of operations for the second quarter and our financial position as of November 30, 2017, refer to the analysis and discussion in the “Results of Operations” and “Liquidity and Capital Resources” sections of this Item 2.

### Outlook

Our outlook for the fiscal year ending May 31, 2018 (“fiscal 2018”) is based upon current market, economic, and interest rate conditions continuing with no significant changes. Our guidance for fiscal 2018 is unchanged from what



## Edgar Filing: PAYCHEX INC - Form 10-Q

we disclosed in our last Form 10-Q filing made on October 5, 2017, and is summarized as follows:

- Payroll service revenue is anticipated to increase in the range of 1% to 2%;
- HRS revenue is anticipated to increase in the range of 12% to 14%;
- Interest on funds held for clients is expected to reflect growth in the mid- to upper-teens;
- Total revenue is expected to grow approximately 6%;
- Operating income, as a percent of total revenue, is anticipated to be in the range of 39% to 40%;
- Investment income, net is expected to be in the range of \$9.0 million to \$11.0 million;
- The effective income tax rate is anticipated to be in the range of 35.0% to 35.5%;
- Net income is expected to increase approximately 5% and adjusted net income(1) is anticipated to increase approximately 7%; and
- Diluted earnings per share is expected to increase in the range of 5% to 6% and adjusted diluted earnings per share(1) is expected to increase in the range of 7% to 8%.

Our fiscal 2018 guidance presented above does not include any impact from tax reform legislation. We anticipate that the impact of tax reform legislation will be a benefit of 10% to 12% on our annualized effective income tax rate. This is based upon our current understanding of the legislation and may be subject to change upon further review of the final law and interpretive guidance that may be missed. We expect a portion of these benefits to be reinvested in the business to drive future growth.

Table of Contents

(1) Adjusted net income and adjusted diluted earnings per share are not U.S. GAAP measures. Refer to the “Non-GAAP Financial Measures” section within the discussion of “Results of Operations” of this Item 2 for a discussion of these non-GAAP measures. The difference between our guidance for the GAAP measures of net income and diluted earnings per share and the related non-GAAP measures of adjusted net income and adjusted diluted earnings per share is limited to the additional tax benefit or shortfall related to employee stock-based compensation payments recognized in income taxes. We have not incorporated any assumptions regarding such a discrete tax benefit in our fiscal 2018 projections for the second half of the year, as factors impacting the amount are subject to uncertainty. The uncertainty primarily relates to employee decisions regarding exercise of stock-based awards and the market price of our common stock at the time.

## RESULTS OF OPERATIONS

## Summary of Results of Operations:

In millions, except per share amounts	For the three months ended November 30,			For the six months ended November 30,		
	2017	2016	Change	2017	2016	Change
Revenue:						
Payroll service revenue	\$ 444.8	\$ 440.9	1 %	\$ 902.6	\$ 891.8	1 %
HRS revenue	367.7	319.1	15 %	713.0	641.7	11 %
Total service revenue	812.5	760.0	7 %	1,615.6	1,533.5	5 %
Interest on funds held for clients	14.0	11.4	23 %	27.7	23.4	19 %
Total revenue	826.5	771.4	7 %	1,643.3	1,556.9	6 %
Combined operating and SG&A						
expenses	494.3	460.3	7 %	966.1	922.8	5 %
Operating income	332.2	311.1	7 %	677.2	634.1	7 %
Investment income, net	1.7	0.9	94 %	3.8	2.4	59 %
Income before income taxes	333.9	312.0	7 %	681.0	636.5	7 %
Income taxes	116.9	109.9	6 %	236.2	217.0	9 %
Effective income tax rate	35.0 %	35.2 %		34.7 %	34.1 %	
Net income	\$ 217.0	\$ 202.1	7 %	\$ 444.8	\$ 419.5	6 %
Diluted earnings per share	\$ 0.60	\$ 0.56	7 %	\$ 1.23	\$ 1.16	6 %

Edgar Filing: PAYCHEX INC - Form 10-Q

We invest in highly liquid, investment-grade fixed income securities and do not utilize derivative instruments to manage interest rate risk. As of November 30, 2017, we had no exposure to high-risk or illiquid investments. Details regarding our combined funds held for clients and corporate investment portfolios are as follows:

\$ in millions	For the three months ended November 30,			For the six months ended November 30,				
	2017	2016	Change	2017	2016	Change		
Average investment balances:								
Funds held for clients	\$ 3,660.9	\$ 3,661.7	—%	\$ 3,723.8	\$ 3,726.3	— %		
Corporate investments	893.7	897.8	—%	911.7	932.7	(2) %		
Total	\$ 4,554.6	\$ 4,559.5	—%	\$ 4,635.5	\$ 4,659.0	(1) %		
Average interest rates earned (exclusive of net realized gains):								
Funds held for clients	1.5	%	1.2	%	1.5	%	1.3	%
Corporate investments	1.2	%	1.1	%	1.2	%	1.0	%
Combined funds held for clients and corporate investments	1.5	%	1.2	%	1.4	%	1.2	%
Total net realized gains	\$ —		\$ —		\$ —		\$ 0.1	

Table of Contents

As of:	November 30,	May 31,
\$ in millions	2017	2017
Net unrealized (losses)/gains on available-for-sale securities(1)	\$ (14.2)	\$ 32.0
Federal Funds rate(2)	1.25 %	1.0 %
Total fair value of available-for-sale securities	\$ 4,148.9	\$ 4,613.2
Weighted-average duration of available-for-sale securities in years(3)	3.3	3.2
Weighted-average yield-to-maturity of available-for-sale securities(3)	1.8 %	1.7 %

(1) The net unrealized loss on our investment portfolio was approximately \$8.0 million as of December 18, 2017.

(2) The Federal Funds rate was in the range of 1.0% to 1.25% as of November 30, 2017, compared to a range of 0.75% to 1.0% as of May 31, 2017. In December 2017, the Federal Funds rate was raised by 25 basis points to a range of 1.25% to 1.50%.

(3) These items exclude the impact of VRDNs as they are tied to short-term interest rates.

**Payroll service revenue:** Payroll service revenue was \$444.8 million for the second quarter and \$902.6 million for the six months, both reflecting increases of 1% as compared to the same periods last year. The payroll service revenue growth in both the second quarter and the six months was primarily driven by growth in revenue per check, which reflects price increases, net of discounts. Payroll service revenue growth was tempered by changes in client base mix.

**HRS revenue:** HRS revenue was \$367.7 million for the second quarter and \$713.0 million for the six months, reflecting increases of 15% and 11%, respectively, compared to the same periods last year, including the contributions from HROI. The HRS revenue growth was primarily driven by increases in client base across most major HCM services, including: comprehensive HR outsourcing services; retirement services; time and attendance; and insurance services. Our largest HRS revenue stream is Paychex HR Services, which includes our ASO and PEO. Retirement services revenue benefited from an increase in asset fee revenue earned on the asset value of participants' funds as well as an increase in the number of plans served. Insurance services revenue benefited from an increase in the number of health and benefit applicants, coupled with higher average premiums for our workers' compensation insurance services.

**Total service revenue:** Total service revenue was \$812.5 million for the second quarter and \$1.6 billion for the six months, reflecting increases of 7% and 5%, respectively, compared to the same periods last year. The increases were primarily attributable to the items previously discussed. HROI contributed approximately 3% to the total service revenue growth for the second quarter and approximately one and one-half percent for the six months.

Edgar Filing: PAYCHEX INC - Form 10-Q

Interest on funds held for clients: Interest on funds held for clients was \$14.0 million for the second quarter and \$27.7 million for the six months, reflecting increases of 23% and 19%, respectively, compared to the same periods last year. The increases resulted primarily from higher average interest rates earned. The funds held for clients average investment balances were largely flat for both the second quarter and the six months compared to the same periods last year, as the impact from wage inflation was offset by the impact from client base mix.

Combined operating and SG&A expenses: Total expenses were \$494.3 million for the second quarter and \$966.1 million for the six months, reflecting increases of 7% and 5%, respectively, compared to the same periods last year. The following table summarizes total combined operating and selling, general and administrative (“SG&A”) expenses:

In millions	For the three months ended			For the six months ended		
	November 30, 2017	2016	Change	November 30, 2017	2016	Change
Compensation-related expenses	\$ 296.8	\$ 286.6	4 %	\$ 587.3	\$ 577.4	2 %
Depreciation and amortization	33.7	30.0	12 %	65.7	59.7	10 %
PEO insurance costs	53.9	34.4	57 %	91.3	68.8	33 %
Other expenses	109.9	109.3	1 %	221.8	216.9	2 %
Total expenses	\$ 494.3	\$ 460.3	7 %	\$ 966.1	\$ 922.8	5 %

Compensation-related expenses increased 4% for the second quarter and 2% for the six months primarily due to higher wages. Headcount was approximately 14,000 for both November 30, 2017 and November 30, 2016, as the increase in headcount related to the acquisition of HROI was offset by headcount savings in other areas. The growth in compensation-related expenses was tempered by lower variable selling costs.

Table of Contents

Depreciation expense is primarily related to buildings, furniture and fixtures, data processing equipment, and software. Amortization of intangible assets is primarily related to client list acquisitions, which are amortized using either straight-line or accelerated methods. The higher growth rates for depreciation and amortization for both the second quarter and the six months were primarily driven by an increase in internally developed software that was placed in service over the past two years.

PEO insurance costs increased for both the second quarter and the six months primarily as a result of the acquisition of HROI as well as growth in our minimum premium insurance plan offering.

Growth in our PEO, including HROI, contributed to growth in total expenses for both the second quarter and the six months. Other expenses include items such as non-capital equipment, delivery, forms and supplies, communications, travel and entertainment, professional services, and other costs incurred to support our business. Other expenses were impacted primarily by investment in technology as well as acquisition-related costs.

Operating income: Operating income was \$332.2 million for the second quarter and \$677.2 million for the six months, reflecting increases of 7% as compared with the same periods last year. The changes in operating income were attributable to the factors previously discussed. Operating income as a percent of total revenue was 40.2% for the second quarter and 41.2% for the six months, compared to 40.3% and 40.7% for the respective periods last year.

Investment income, net: Investment income, net, primarily represents earnings from our cash and cash equivalents and investments in available-for-sale securities. Investment income does not include interest on funds held for clients, which is included in total revenue. Investment income, net, was \$1.7 million for the second quarter and \$3.8 million for the six months, reflecting increases of 94% and 59%, respectively, compared to the same periods last year. These increases were primarily due to higher average interest rates earned. Average corporate investment balances were largely flat for the second quarter, but declined 2% for the six months. The decrease in average investment balances for the six months was due to funds used for the acquisition of HROI, stock repurchases over the past twelve months, and higher dividend payments.

Income taxes: Our effective income tax rate was 35.0% for the second quarter and 34.7% for the six months, compared to 35.2% and 34.1% for the respective prior year periods. The effective income tax rates in these periods were impacted by a net discrete tax benefit related to employee stock-based compensation payments. The net discrete tax benefits impacted diluted earnings per share by approximately \$0.01 per share for the second quarter and was immaterial for prior year same period. The net discrete tax benefits impacted diluted earnings per share by approximately \$0.02 per share for the six months and \$0.04 per share for the same period last year.

Net income and diluted earnings per share: Net income was \$217.0 million for the second quarter and \$444.8 million for the six months, reflecting increases of 7% and 6%, respectively, compared to the same periods last year. Diluted earnings per share was \$0.60 for the second quarter and \$1.23 for the six months, reflecting increases of 7% and 6%, respectively, compared to the same periods last year. These fluctuations were attributable to the factors previously discussed. Adjusted net income was \$214.4 million for the second quarter and \$437.2 million for the six months, reflecting increases of 7% and 8%, respectively, as compared to the same periods last year. Adjusted diluted earnings per share was \$0.59 per share for the second quarter and \$1.21 per share for the six months, reflecting increases of 5% and 8%, respectively, as compared to the same periods last year. Refer to the “Non-GAAP Financial Measures” section that follows for a discussion of these non-GAAP measures.

Table of Contents

Non-GAAP Financial Measures: Adjusted net income and adjusted diluted earnings per share are summarized as follows:

\$ in millions	For the three months ended			For the six months ended		
	November 30, 2017	2016	Change	November 30, 2017	2016	Change
Net income	\$ 217.0	\$ 202.1	7 %	\$ 444.8	\$ 419.5	6 %
Non-GAAP adjustments:						
Excess tax benefit related to employee stock-based compensation						
payments	(2.6)	(0.9)		(7.6)	(14.1)	
Total non-GAAP adjustments	(2.6)	(0.9)		(7.6)	(14.1)	
Adjusted net income	\$ 214.4	\$ 201.2	7 %	\$ 437.2	\$ 405.4	8 %
Diluted earnings per share	\$ 0.60	\$ 0.56	7 %	\$ 1.23	\$ 1.16	6 %
Non-GAAP adjustments:						
Excess tax benefit related to employee stock-based compensation						
payments	(0.01)	—		(0.02)	(0.04)	
Total non-GAAP adjustments	\$ (0.01)	\$ —		(0.02)	(0.04)	
Adjusted diluted earnings per share	\$ 0.59	\$ 0.56	5 %	\$ 1.21	\$ 1.12	8 %

In addition to reporting net income and diluted earnings per share, U.S. GAAP measures, we present adjusted net income and adjusted diluted earnings per share, which are non-GAAP measures. We believe adjusted net income and adjusted diluted earnings per share are appropriate additional measures, as they are indicators of our core business operations performance period over period. Adjusted net income and adjusted diluted earnings per share both exclude the additional tax benefit or shortfall related to employee stock-based compensation payments recognized in income taxes. This item is subject to volatility and will vary based on employee decisions on exercising employee stock options and fluctuations in our stock price, neither of which is within the control of management. We believe presenting net income and diluted earnings per share excluding this particular discrete tax item allows a better understanding of our core business performance. Adjusted net income and adjusted diluted earnings per share are not calculated through the application of GAAP and are not a required form of disclosure by the SEC. As such, they should not be considered as a substitute for the GAAP measures of net income and diluted earnings per share, and therefore should not be used in isolation, but in conjunction with, the GAAP measure. The use of any non-GAAP measure may produce results that vary from the GAAP measure and may not be comparable to a similarly defined non-GAAP measure used by other companies.



## LIQUIDITY AND CAPITAL RESOURCES

Our financial position as of November 30, 2017 remained strong with cash and total corporate investments of \$819.5 million. Short-term borrowings totaled \$133.4 million as of November 30, 2017. We believe that our investments in an unrealized loss position as of November 30, 2017 were not other-than-temporarily impaired, nor has any event occurred subsequent to that date to indicate any other-than-temporary impairment. It is anticipated that cash and total corporate investments as of November 30, 2017, along with projected operating cash flows and available short-term financing, will support our normal business operations, capital purchases, share repurchases, dividend payments, and business acquisitions, if any, for the foreseeable future.

### Short-term Financing

We maintain credit facilities, letters of credit, and lines of credit as part of our normal and recurring business operations.

Table of Contents

Credit Facilities: We maintain three committed, unsecured credit facilities as follows:

Bank	Borrower (1)	Date Entered	Expiration Date	Maximum Amount Available	Purpose
JP Morgan Chase Bank, N.A.(2)	Paychex of New York, LLC	August 5, 2015	August 5, 2020	\$1 Billion	To meet short-term funding requirements.
JP Morgan Chase Bank, N.A.(2)	Paychex of New York, LLC	August 17, 2017	August 17, 2022	\$500 Million	To meet short-term funding requirements.
PNC Bank, National Association (“PNC”)	Paychex Advance, LLC	March 17, 2016	March 17, 2020	\$150 Million	To finance working capital needs and general corporate purposes.

(1) Borrower is a wholly owned subsidiary of our Company.

(2) JP Morgan Chase Bank, N.A. (“JPM”) acts as the administrative agent for this syndicated credit facility.

For all of the credit facilities, obligations under any facility are guaranteed by us and certain of our subsidiaries and will bear interest at competitive rates based on options provided to the borrower. Upon the expiration date, any borrowings outstanding will mature and be payable on such date.

JPM \$1 Billion Credit Facility: There were no borrowings outstanding under this credit facility as of November 30, 2017 or May 31, 2017. Details of borrowings under this credit facility during the second quarter and the six months, as well as the respective prior year periods, are as follows:

\$ in millions	For the three months ended November 30,		For the six months ended November 30,	
	2017	2016	2017	2016
Number of days borrowed	6	15	19	19
Maximum amount borrowed	\$ 700.0	\$ 350.0	\$ 700.0	\$ 350.0
Weighted-average amount borrowed	\$ 445.8	\$ 223.3	\$ 331.6	\$ 226.3
Weighted-average interest rate	4.25 %	2.53 %	4.24 %	2.74 %

We typically borrow on an overnight basis. In addition to overnight borrowings, during the six months we borrowed \$100.0 million for three days at a weighted-average interest rate of 4.25%. During the respective prior year period, we borrowed \$150.0 million for seven days and \$50.0 million for eighteen days at weighted-average LIBOR-based interest rates of 1.39%. Subsequent to November 30, 2017, we borrowed two times, on an overnight basis, \$125.0 million on a weighted-average basis.

**JPM \$500 Million Credit Facility:** During the second quarter, we borrowed against this credit facility for the first time. As of November 30, 2017, we have \$75.0 million outstanding under this credit facility, which was subsequently repaid in December 2017. Details of borrowings under this credit facility during the second quarter and the six months are as follows:

\$ in millions	For the three and six months ended November 30, 2017
Number of days borrowed	20
Maximum amount borrowed	\$ 400.0
Weighted-average amount borrowed	\$ 215.8
Weighted-average interest rate	2.84 %

We typically borrow on an overnight basis. In addition to overnight borrowings, during the six months, we borrowed \$300.0 million for seven days and \$75.0 million for eleven days at weighted-average LIBOR-based interest rates of 2.13% and 2.19%, respectively.

Table of Contents

PNC \$150 Million Credit Facility: As of November 30, 2017, we have \$58.4 million outstanding under this credit facility, which remains outstanding as of the date of this report. There were no borrowings outstanding under this credit facility as of May 31, 2017. Details of borrowings under this credit facility during the second quarter and the six months, as well as the respective prior year periods, are as follows:

\$ in millions	For the three months ended		For the six months ended	
	November 30,		November 30,	
	2017	2016	2017	2016
Number of days borrowed	91	91	179	177
Maximum amount borrowed	\$ 58.6	\$ 53.1	\$ 58.6	\$ 53.1
Weighted-average amount borrowed	\$ 57.8	\$ 52.2	\$ 56.8	\$ 51.8
Weighted-average interest rate	1.78 %	1.08 %	1.73 %	1.05 %

All of our credit facilities contain various financial and operational covenants that are usual and customary for such arrangements. We were in compliance with all of these covenants as of November 30, 2017.

Certain lenders under these credit facilities, and their respective affiliates, have performed, and may in the future perform for us and our subsidiaries, various commercial banking, investment banking, underwriting, and other financial advisory services, for which they have received, and will continue to receive in the future, customary fees and expenses.

Letters of credit: We had irrevocable standby letters of credit available totaling \$52.8 million as of November 30, 2017, required to secure commitments for certain insurance policies. The letters of credit expire at various dates between April 2018 and December 2018, and are collateralized by securities held in our investment portfolios. No amounts were outstanding on these letters of credit as of or during the six months. Subsequent to November 30, 2017, we opened an additional irrevocable standby letter of credit totaling \$4.1 million, required to secure commitments for certain insurance policies related to the acquisition of HROI, expiring in November 2018.

Lines of credit: Effective August 17, 2017, we terminated four uncommitted, secured, short-term lines of credit totaling \$900.0 million. The lines of credits were available to us at market rates of interest and were primarily used to

meet short-term funding requirements related to deposit account overdrafts and client fund obligations arising from electronic payment transactions made on behalf of our clients in the ordinary course of business. There were no amounts outstanding under these lines of credit during the six months or during the respective prior year period.

Other commitments: We enter into various purchase commitments with vendors in the ordinary course of business. We had outstanding commitments to purchase approximately \$4.5 million of capital assets as of November 30, 2017.

In the normal course of business, we make representations and warranties that guarantee the performance of services under service arrangements with clients. Historically, there have been no material losses related to such guarantees. In addition, we have entered into indemnification agreements with our officers and directors, which require us to defend and, if necessary, indemnify these individuals for certain pending or future legal claims as they relate to their services provided to us.

We currently self-insure the deductible portion of various insured exposures under certain employee benefit plans. Our estimated loss exposure under these insurance arrangements is recorded in other current liabilities on our Consolidated Balance Sheets. Historically, the amounts accrued have not been material and are not material as of November 30, 2017. We also maintain insurance coverage in addition to our purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, theft and embezzlement, cyber threats, and acts of terrorism; and capacity for deductibles and self-insured retentions through our captive insurance company.

In August 2017, we announced our plan for a new multi-building Paychex campus based in Rochester, NY. This involves the purchase of five buildings and the renovation of over 300,000 square feet of existing space for an estimated total cost of approximately \$60.0 million. We completed the purchase of these buildings during the second quarter for a combined cost of approximately \$34.7 million and placed approximately \$16.0 million in escrow for the building renovations. Renovations on the buildings purchased have commenced. In addition, in September 2017, we entered into a transaction with the County of Monroe Industrial Development Agency (“COMIDA”) for purposes of obtaining public benefits and inducements, expiring on December 31, 2039. The public inducements include exemption from sales and use taxes for goods and services directly related to the renovations of the new multi-building campus.

Table of Contents

## Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions with unconsolidated entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other limited purposes. We do maintain investments as a limited partner in both low-income housing projects and a venture capital fund focused on the financial technology sector. These are not considered part of our ongoing operations. These investments are accounted for under the equity method of accounting and are less than 1% of our total assets as of November 30, 2017.

## Operating Cash Flow Activities

In millions	For the six months ended	
	2017	2016
Net income	\$ 444.8	\$ 419.5
Non-cash adjustments to net income	188.8	140.9
Cash used in changes in operating assets and liabilities	(114.2)	(147.0)
Net cash provided by operating activities	\$ 519.4	\$ 413.4

The increase in our operating cash flows for the six months, compared to the same period last year, was primarily a result of higher net income adjusted for non-cash items, offset slightly by fluctuations in our operating assets and liabilities. The increase in non-cash adjustments was primarily due to a higher provision for deferred income taxes, which was impacted by the utilization of alternative minimum tax (“AMT”) credits carried forward from prior years. This was offset in our operating assets and liabilities as accrued income taxes were lowered as the AMT credit was applied. The remaining fluctuations in our operating assets and liabilities were primarily related to the timing of income taxes and PEO payroll accruals and related unbilled receivables, which can fluctuate based on timing of period end compared to payroll check dates.

## Investing Cash Flow Activities

Edgar Filing: PAYCHEX INC - Form 10-Q

In millions	For the six months ended	
	November 30, 2017	2016
Net change in funds held for clients and corporate investment activities	\$ (633.6)	\$ 749.3
Purchases of property and equipment	(95.5)	(46.8)
Acquisition of businesses, net of cash acquired	(17.9)	—
Purchases of other assets	(4.1)	(4.6)
Net cash (used in)/provided by investing activities	\$ (751.1)	\$ 697.9

Funds held for clients and corporate investments: Funds held for clients consist of short-term funds and available-for-sale securities. Corporate investments are primarily comprised of available-for-sale securities. The portfolio of funds held for clients and corporate investments is detailed in Note E of the Notes to Consolidated Financial Statements (Unaudited) contained in Item 1 of this Form 10-Q.

In general, fluctuations in the net change in funds held for clients and corporate investment activities primarily relate to timing of purchases, sales, or maturities of investments. The amount of funds held for clients will also vary based upon the timing of collecting client funds, and the related remittance of funds to applicable tax or regulatory agencies for payroll tax administration services and to employees of clients utilizing employee payment services. Additional discussion of interest rates and related risks is included in the “Market Risk Factors” section of this Form 10-Q.

The six months reflected a net cash outflow resulting from the net change in funds held for clients and corporate investment activities, whereas there was a net cash inflow for the respective prior year period. These fluctuations were attributable to timing of collections and remittances within the client funds portfolio, and related investment or liquidation of funds held for client fund obligations, as discussed further in the “Financing Cash Flows Activities” section which follows.

Purchases of long-lived assets: To support our continued client and ancillary product growth, we made purchases of data processing equipment and software, and we upgraded various operating facilities.

The net cash outflow for purchases of property and equipment during the six months includes the purchase of five buildings and ongoing renovations of over 300,000 square feet of existing space in Rochester, NY. This new

multi-building Paychex campus, announced in August 2017, will result in the consolidation of current leased space in the Rochester area.

26

---



Table of Contents

Acquisitions of businesses, net of cash acquired, reflects our acquisition of HROI in August 2017. The acquisition consideration was a combination of cash and stock. The amount reflected as cash outflow for the six months was the cash portion offset by cash balances acquired.

Purchases of other assets relates primarily to client list acquisitions.

## Financing Cash Flow Activities

In millions, except per share amounts	For the six months ended	
	November 30,	
	2017	2016
Net change in client fund obligations	\$ 625.3	\$ (693.6)
Net proceeds from short-term borrowings	133.4	103.1
Dividends paid	(358.9)	(331.5)
Repurchases of common shares	(94.1)	(166.2)
Activity related to equity-based plans	(1.4)	10.4
Net cash provided by/(used in) financing activities	\$ 304.3	\$ (1,077.8)
Cash dividends per common share	\$ 1.00	\$ 0.92

Net change in client fund obligations: The client fund obligations liability will vary based on the timing of collecting client funds and the related required remittance of funds to applicable tax or regulatory agencies for payroll tax administration services and to employees of clients utilizing employee payment services. Collections from clients are typically remitted from one to 30 days after receipt, with some items extending to 90 days.

The six months reflected a net cash inflow resulting from the net change in client fund obligations, whereas there was a net cash outflow for the same period last year. For both the six months and the respective prior year period, payroll tax remittances exceeded collections, driven by timing of semi-weekly tax payments. Semi-weekly tax payments at the end of May were delayed due to the Memorial Day holiday and were not remitted until June. This pattern was the same in both years. However, in the six months of fiscal 2018 this impact was more than offset by much larger collections for net payroll. Since November 30, 2017 was a Thursday, which is a large collection day for payroll funds, there were significantly more net payroll funds on hand at that date compared to May 31, 2017 or November 30, 2016, which were both Wednesdays and much less significant collection days.

Net proceeds from short-term borrowings: During the six months, we borrowed funds under our credit facilities. Certain borrowings remained outstanding under the JPM \$500 million and PNC credit facilities as of November 30, 2017. Borrowings are to finance working capital needs and general corporate purposes and increased from the prior year period.

Dividends paid: In July 2017, we announced a 9% increase in the quarterly dividend paid to shareholders to \$0.50 per share from \$0.46 per share. The increase in dividend payments for the six months compared to the corresponding period last year is primarily due to this increase in rate, offset slightly by the impact of repurchases of our common stock. The payment of future dividends is dependent on our future earnings and cash flow and is subject to the discretion of our Board of Directors (the “Board”).

Repurchases of common stock: In July 2016, our Board approved a program to repurchase up to \$350.0 million of our common stock, with authorization expiring in May 31, 2019. The purpose of the program is to manage common stock dilution. During the six months, we repurchased 1.6 million shares of our common stock for \$94.1 million. During the six months ended November 30, 2016, we repurchased 2.9 million shares of our common stock for \$166.2 million, of which \$59.7 million was repurchased under a previously authorized common stock repurchase program. All shares of common stock repurchased were retired. As of November 30, 2017, approximately \$149.4 million remains available under the approved common stock repurchase program.

Activity related to equity-based plans: For the six months, there was a net cash outflow from activity related to equity-based plans compared to a net cash inflow for the respective prior year period. This fluctuation is largely a result of lower proceeds from stock option exercises, as 0.4 million options were exercised during the six months compared 0.9 million options exercised during the respective prior year period. The net cash outflow for the six months was a result of proceeds from stock options not exceeding the impact of shares withheld to cover taxes on lapses of stock awards.

Table of Contents

MARKET RISK FACTORS

Changes in interest rates and interest rate risk: Funds held for clients are comprised of short-term funds and available-for-sale securities. Corporate investments are primarily comprised of available-for-sale securities. As a result of our investing activities, we are exposed to changes in interest rates that may materially affect our results of operations and financial position. Changes in interest rates will impact the earnings potential of future investments and will cause fluctuations in the fair value of our longer-term available-for-sale securities. We follow an investment strategy of protecting principal and optimizing liquidity. A substantial portion of our portfolios is invested in high credit quality securities with ratings of AA or higher, and A-1/P-1 ratings on short-term securities. We invest predominantly in municipal bonds - including general obligation bonds; pre-refunded bonds, which are secured by a U.S. government escrow; and essential services revenue bonds - along with U.S. government agency securities and corporate bonds. We limit the amounts that can be invested in any single issuer and invest primarily in short- to intermediate-term instruments whose fair value is less sensitive to interest rate changes. We manage the available-for-sale securities to a benchmark duration of two and one-half to three and three-quarters years.

During the six months, our primary short-term investment vehicles were VRDNs and bank demand deposit accounts. We have no exposure to high-risk or illiquid investments. We have insignificant exposure to foreign investments. We have not and do not utilize derivative financial instruments to manage our interest rate risk.

During the six months, the average interest rate earned on our combined funds held for clients and corporate investment portfolios was 1.4% compared with 1.2% for the respective prior year period. When interest rates are rising, the full impact of higher interest rates will not immediately be reflected in net income due to the interaction of short- and long-term interest rate changes. During a rising interest rate environment, earnings increase from our short-term investments, and over time earnings increase from our longer-term available-for-sale securities. Earnings from the available-for-sale-securities, excluding VRDNs, which as of November 30, 2017 had an average duration of 3.3 years, would not reflect increases in interest rates until the investments are sold or mature and the proceeds are reinvested at higher rates.

The amortized cost and fair value of available-for-sale securities that had stated maturities as of November 30, 2017 are shown below by contractual maturity. Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

November 30, 2017

Edgar Filing: PAYCHEX INC - Form 10-Q

In millions	Amortized cost	Fair value
Maturity date:		
Due in one year or less	\$ 326.8	\$ 326.8
Due after one year through three years	838.8	837.7
Due after three years through five years	1,041.4	1,041.9
Due after five years	1,956.1	1,942.5
Total	\$ 4,163.1	\$ 4,148.9

VRDNs are primarily categorized as due after five years in the table above as the contractual maturities on these securities are typically 20 to 30 years. Although these securities are issued as long-term securities, they are priced and traded as short-term instruments because of the liquidity provided through the tender feature.

In December 2017, the Federal Funds rate was raised by 25 basis points to a range of 1.25% to 1.50%. The Federal Reserve has raised this rate by 25 basis points five times since December 2015.

Calculating the future effects of changing interest rates involves many factors. These factors include, but are not limited to:

- daily interest rate changes;
- seasonal variations in investment balances;
- actual duration of short-term and available-for-sale securities;
- the proportion of taxable and tax-exempt investments;
- changes in tax-exempt municipal rates versus taxable investment rates, which are not synchronized or simultaneous; and
- financial market volatility and the resulting effect on benchmark and other indexing interest rates.

Table of Contents

Subject to these factors and under normal financial market conditions, a 25-basis-point change in taxable interest rates generally affects our tax-exempt interest rates by approximately 17 basis points. Under normal financial market conditions, the impact to earnings from a 25-basis-point change in short-term interest rates would be in the range of \$3.0 million to \$4.0 million, after taxes, for a twelve-month period. Such a basis point change may or may not be tied to changes in the Federal Funds rate.

Our total investment portfolio (funds held for clients and corporate investments) is expected to average approximately \$5.0 billion for fiscal 2018. Our anticipated allocation is approximately 40% invested in short-term and VRDNs with an average duration of less than 30 days and 60% invested in available-for-sale securities, excluding VRDNs, with an average duration of two and one-half to three and three-quarters years.

The combined funds held for clients and corporate available-for-sale securities reflected a net unrealized loss of \$14.2 million as of November 30, 2017, compared with a net unrealized gain of \$32.0 million as of May 31, 2017. During the six months, the net unrealized (loss)/gain on our investment portfolios ranged from an unrealized loss of \$15.0 million to an unrealized gain of \$41.4 million. These fluctuations were driven by changes in market rates of interest. The net unrealized loss on our investment portfolios was approximately \$8.0 million as of December 18, 2017.

As of November 30, 2017 and May 31, 2017, we had \$4.1 billion and \$4.6 billion, respectively, invested in available-for-sale securities at fair value. The weighted-average yield-to-maturity was 1.8% as of November 30, 2017 and 1.7% as of May 31, 2017. The weighted-average yield-to-maturity excludes available-for-sale securities tied to short-term interest rates, such as VRDNs. Assuming a hypothetical increase in longer-term interest rates of 25 basis points, the resulting potential decrease in fair value for our portfolio of available-for-sale securities held as of November 30, 2017 would be approximately \$25.0 million. Conversely, a corresponding decrease in interest rates would result in a comparable increase in fair value. This hypothetical increase or decrease in the fair value of the portfolio would be recorded as an adjustment to the portfolio's recorded value, with an offsetting amount recorded in stockholders' equity. These fluctuations in fair value would have no related or immediate impact on the results of operations, unless any declines in fair value were considered to be other-than-temporary and an impairment loss recognized.

**Credit risk:** We are exposed to credit risk in connection with these investments through the possible inability of the borrowers to meet the terms of their bonds. We regularly review our investment portfolios to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns. We believe that the investments we held as of November 30, 2017 were not other-than-temporarily impaired. While \$1.9 billion of our available-for-sale securities had fair values that were below amortized cost, we believe that it is probable that the principal and interest will be collected in accordance with the contractual terms, and that the unrealized losses of \$22.7 million were due to changes in interest rates and were not due to increased credit risk or other valuation concerns. A majority of the securities in an unrealized loss position as of November 30, 2017 and May 31, 2017 held an AA rating or better. We do not intend to sell these investments until the recovery of their amortized cost basis or maturity, and further believe that it is not more-likely-than-not that we will be required to sell these investments prior

to that time. Our assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in our strategies or assumptions related to any particular investment.

We have some credit risk exposure in connection with our purchase of accounts receivable as a means of providing payroll funding to clients in the temporary staffing industry. This credit risk exposure is diversified amongst multiple client arrangements and all such arrangements are regularly reviewed for potential write-off. No single client is material in respect to total accounts receivable, service revenue, or results of operations.

## CRITICAL ACCOUNTING POLICIES

Our critical accounting policies are described in Item 7 of our Form 10-K for fiscal 2017, filed with the SEC on July 21, 2017. On an ongoing basis, we evaluate the critical accounting policies used to prepare our consolidated financial statements, including, but not limited to, those related to:

- revenue recognition;
- PEO insurance reserves;
- goodwill and other intangible assets;
- stock-based compensation costs; and
- income taxes.

There have been no material changes in these aforementioned critical accounting policies.

Table of Contents

NEW ACCOUNTING PRONOUNCEMENTS

Recently adopted accounting pronouncements: Refer to Note A of the Notes to Consolidated Financial Statements (Unaudited) contained in Item 1 of this Form 10-Q for a discussion of recently adopted accounting pronouncements.

Recently issued accounting pronouncements: Refer to Note A of the Notes to Consolidated Financial Statements (Unaudited) contained in Item 1 of this Form 10-Q for a discussion of recently issued accounting pronouncements.

Item 3. Quantitative and Qualitative Disclosure of Market Risk

The information called for by this item is provided under the caption “Market Risk Factors” under Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations and is incorporated herein by reference.

Item 4. Controls and Procedures

Disclosure Controls and Procedures: Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), such as this report, is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures: As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. Based on such evaluation, the Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer) have concluded that as of November 30, 2017, the end of the period covered by this report, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control over Financial Reporting: The Company carried out an evaluation of the internal control over financial reporting to determine whether any change occurred during the quarter ended November 30, 2017. Based on such evaluation, there has been no change in our internal control over financial reporting that occurred during the most recently completed fiscal quarter ended November 30, 2017, that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

#### Issuer Purchases of Equity Securities

In July 2016, the Company's Board of Directors approved a program to repurchase up to \$350.0 million of the Company's common stock, authorized through May 31, 2019. The purpose of the program is to manage common stock dilution and shares repurchased are retired. There were no repurchases of common stock under this program during the three months ended November 30, 2017. As of November 30, 2017, the dollar value of common shares that may yet be purchased under the program is approximately \$149.4 million.



Table of Contents

Item 6. Exhibits

INDEX TO EXHIBITS

Exhibit

number	Description
31.1	<u>Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
31.2	<u>Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>
32.1	<u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
32.2	<u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101.INS	XBRL instance document.
101.SCH	XBRL taxonomy extension schema document.
101.CAL	XBRL taxonomy extension calculation linkbase document.
101.LAB	XBRL taxonomy label linkbase document.
101.PRE	XBRL taxonomy extension presentation linkbase document.
101.DEF	XBRL taxonomy extension definition linkbase document.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PAYCHEX, INC.

Date: December 21, 2017 /s/ Martin Mucci  
Martin Mucci  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: December 21, 2017 /s/ Efrain Rivera  
Efrain Rivera  
Senior Vice President, Chief  
Financial Officer, and Treasurer  
(Principal Financial Officer)