

Edgar Filing: PAYCHEX INC - Form 8-K

PAYCHEX INC  
Form 8-K  
June 25, 2001

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 8-K

CURRENT REPORT  
PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

Date of Report: June 25, 2001  
(Date of earliest event reported)

PAYCHEX, INC.  
(Exact name of registrant as specified in its charter)

DELAWARE (State of incorporation)	0-11330 (Commission File Number)	16-1124166 (IRS Employer Identification Number)
911 PANORAMA TRAIL SOUTH, ROCHESTER, NEW YORK (Address of principal executive offices)		14625-0397 (Zip Code)

(716) 385-6666  
(Registrant's telephone number, including area code)

ITEM 9. REGULATION FD DISCLOSURE

The registrant's press release dated June 25, 2001, which reports its financial results for the fiscal year ended May 31, 2001, is attached. In addition, this report includes Management's Discussion and Analysis of Financial Condition and Results of Operations, which reviews the Company's results of operations for the three years ended May 31, 2001, 2000 and 1999, and its financial condition at May 31, 2001.

The attached Management's Discussion and Analysis is not a complete and comprehensive Management's Discussion and Analysis as required by the Securities and Exchange Commission for Annual Reports filed on Form 10-K or Quarterly Reports on Form 10-Q. The Company expects to file its 2001 Form 10-K with the Securities and Exchange Commission and mail the 2001 Annual Report to Shareholders in August 2001. The 2001 Annual Report to Shareholders and Form 10-K will contain a complete set of audited Consolidated Financial Statements and Notes to Consolidated Financial Statements and a complete Management's Discussion and Analysis of Financial Condition and Results of Operations for the Years ended May 31, 2001, 2000 and 1999, and Financial Condition at May 31, 2001.

All information included in this Form 8-K is qualified by the cautionary statement in Exhibit 99.

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.

## Edgar Filing: PAYCHEX INC - Form 8-K

Date: June 25, 2001

/s/ B. Thomas Golisano  
-----  
B. Thomas Golisano  
Chairman, President and  
Chief Executive Officer

Date: June 25, 2001

/s/ John M. Morphy  
-----  
John M. Morphy  
Vice President, Chief  
Financial Officer and  
Secretary

### FOR IMMEDIATE RELEASE

John M. Morphy, Chief Financial Officer or Jan Shuler 716-383-3406

Access the Webcast of the Paychex, Inc. Year End and Fourth Quarter  
Earnings Release Conference Call scheduled for June 25, 2001 at 11:00  
a.m. Eastern Standard Time at  
<http://www.paychex.com/paychex/finance/finance.html>.

Paychex, Inc. news releases, current financial information, related SEC  
filings and Investor Relations presentation are accessible at the same  
Web site.

### PAYCHEX, INC. REPORTS RECORD YEAR-END AND FOURTH QUARTER RESULTS

ROCHESTER, NY, June 25, 2001 -- Paychex, Inc. (NASDAQ: PAYX) today announced record net income of \$254.9 million, or \$.68 diluted earnings per share, for the fiscal year ended May 31, 2001, a 34% increase over net income of \$190.0 million, or \$.51 diluted earnings per share, for the prior year. Total revenues were \$869.9 million, an increase of 19% over \$728.1 million for the prior year.

For the fourth quarter ended May 31, 2001, net income increased 31% to \$67.8 million, or \$.18 diluted earnings per share, as compared to \$51.6 million, or \$.14 diluted earnings per share, for the same period last year. Total revenues were \$228.6 million, an increase of 16% over \$197.2 million for the prior year fourth quarter.

### PAYROLL SEGMENT

For the year ended May 31, 2001, operating income for the Payroll segment increased 21% to \$366.5 million from \$303.4 million for the prior fiscal year. Total Payroll segment revenues were \$772.0 million, an increase of 18% over \$653.2 million for the prior year.

For the fourth quarter ended May 31, 2001, operating income for the Payroll segment increased 17% to \$94.4 million from \$80.9 million for the same period last year. Total Payroll segment revenues were \$201.8 million, an increase of 15% over \$175.6 million for the prior year fourth quarter.

The increases in total Payroll segment revenues and operating income reflect continued growth in the client base, increased utilization of ancillary services, and leveraging of operating expenses. In addition, the Payroll segment benefited from growth in the interest on funds held for clients due to higher daily client balances and net realized gains. The full year period also reflected higher comparable average rates of return.

## Edgar Filing: PAYCHEX INC - Form 8-K

As of May 31, 2001, 83% of Paychex clients utilized Taxpay (Registered Trademark), the Company's tax filing and payment feature. The Company's Employee Pay Services, which includes Direct Deposit, Readychex and Access Card products, was utilized by 53% of its clients. Major Market Services revenue increased 56% and 58% for the fourth quarter and the fiscal year to \$13.5 million and \$47.4 million, respectively.

### HUMAN RESOURCE AND BENEFITS SEGMENT

For the year ended May 31, 2001, operating income for the Human Resource and Benefits segment increased 62% from \$23.4 million to \$37.9 million. Human Resource and Benefits service revenue was \$97.9 million, an increase of 31% over \$74.9 million for the prior fiscal year. For the fourth quarter ended May 31, 2001, operating income for the Human Resource and Benefits segment increased 73% from \$6.3 million to \$10.9 million. Human Resource and Benefits service revenue was \$26.8 million, an increase of 24% over \$21.6 million for the fourth quarter last year.

The increases in service revenue and operating income are primarily related to increases in clients for 401(k) Recordkeeping, Workers' Compensation Insurance, Section 125, PAS and PEO services. 401(k) Recordkeeping revenue increased 26% and 36% for the fourth quarter and the full year period to \$11.5 million and \$43.0 million, respectively.

### CORPORATE EXPENSES

Corporate expenses are primarily related to the Information Technology, Organizational Development, Finance, Marketing and Senior Management functions of the Company. For the year ended May 31, 2001, corporate expenses decreased 0.3% from \$67.9 million to \$67.7 million. For the quarter ended May 31, 2001, corporate expenses increased 1.7% to \$17.8 million from \$17.5 million. The relatively flat year-over-year comparisons reflect additional employees and other expenditures to support the growth of the Company's service operations and sales force offset by lower spending on national marketing efforts and other areas in fiscal 2001.

### INVESTMENT INCOME

Investment income for fiscal year 2001 increased 66% to \$27.3 million from \$16.5 million in the prior year. Investment income for the quarter ended May 31, 2001 increased 74% to \$8.5 million from \$4.9 million for the fourth quarter of fiscal 2000. The increases are due to higher balances of investments and net realized gains on the sale of available-for-sale securities. The full year period also benefited from higher comparable average rates of return.

### INCOME TAXES

The income tax rates for the fourth quarter and the year ended May 31, 2001 were 29.5% and 30.0%, respectively, as compared to 31.0% for the same periods last year.

B. Thomas Golisano, Chairman, President and Chief Executive Officer of Paychex, said, "We are pleased with our financial results for the fourth quarter and fiscal year. We have completed our eleventh straight year of record revenues and net income and our tenth consecutive year of net income growth exceeding 30%. These results have been achieved by applying our growth strategy - increasing our client base, increasing client utilization of ancillary services, developing new services and leveraging our infrastructure. Looking ahead to fiscal 2002, we recognize interest rate reductions will impact year-over-year net income growth. However, we expect to continue to generate record revenues and net income with total revenue growth in the range of 16% to 18%."

# Edgar Filing: PAYCHEX INC - Form 8-K

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

	For the three months ended		For the twelve months ended	
	May 31, 2001	May 31, 2000	May 31, 2001	May 31, 2000
Revenues:				
Payroll	\$179,154	\$157,401	\$688,650	\$594,445
Human Resource and Benefits	26,801	21,580	97,871	74,874
Total service revenues	205,955	178,981	786,521	669,319
Interest on funds held for clients	22,665	18,205	83,336	58,800
Total revenues	228,620	197,186	869,857	728,119
Operating costs	52,954	46,795	200,352	173,481
Selling, general and administrative expenses	88,097	80,593	332,803	295,745
Operating income	87,569	69,798	336,702	258,893
Investment income	8,546	4,925	27,279	16,479
Income before income taxes	96,115	74,723	363,981	275,372
Income taxes	28,354	23,164	109,112	85,365
Net income	\$ 67,761	\$ 51,559	\$254,869	\$190,007
Basic earnings per share	\$ .18	\$ .14	\$ .68	\$ .51
Diluted earnings per share	\$ .18	\$ .14	\$ .68	\$ .51
Weighted-average common shares outstanding	373,455	371,576	372,777	370,603
Weighted-average shares assuming dilution	377,397	376,407	377,510	375,081
Cash dividends per common share	\$ .09	\$ .06	\$ .33	\$ .22

- (A) Certain amounts for the three- and twelve-month periods ended May 31, 2000 have been reclassified to conform to the current year presentation.
- (B) Further information on interest on funds held for clients and investment income can be found in the Company's SEC filings under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" and subheadings "Results of Operations" and "Market Risk Factors." These SEC filings are accessible at the Company's Web site.

## PAYCHEX, INC. CONSOLIDATED BALANCE SHEETS (In thousands)

May 31, May 31,

# Edgar Filing: PAYCHEX INC - Form 8-K

	2001	2000
	-----	-----
ASSETS		
Cash and cash equivalents	\$ 45,784	\$ 47,136
Corporate investments	568,217	412,357
Interest receivable	28,281	22,436
Accounts receivable	100,640	87,608
Deferred income taxes	-	9,539
Prepaid expenses and other current assets	7,306	6,531
	-----	-----
Current assets before funds held for clients	750,228	585,607
Funds held for clients	2,041,045	1,776,968
	-----	-----
Total current assets	2,791,273	2,362,575
	-----	-----
Property and equipment - net	96,078	75,375
Goodwill and intangible assets - net	9,612	5,584
Deferred income taxes	1,361	2,494
Other assets	8,872	9,549
	-----	-----
Total assets	\$2,907,196	\$2,455,577
	=====	=====
LIABILITIES		
Accounts payable	\$ 16,377	\$ 17,086
Accrued compensation and related items	57,418	52,631
Deferred revenue	4,421	4,719
Accrued income taxes	9,783	2,969
Deferred income taxes	4,996	--
Other current liabilities	19,282	24,400
	-----	-----
Current liabilities before client funds deposits	112,277	101,805
Client funds deposits	2,031,565	1,785,140
	-----	-----
Total current liabilities	2,143,842	1,886,945
Long-term liabilities	5,512	5,200
	-----	-----
Total liabilities	2,149,354	1,892,145
	-----	-----
STOCKHOLDERS' EQUITY		
Common stock, \$.01 par value, 600,000 authorized shares		
Issued: 373,647/May 31, 2001 and 371,769/May 31, 2000	3,736	3,718
Additional paid-in capital	139,897	98,904
Retained earnings	601,142	469,385
Accumulated other comprehensive income/(loss)	13,067	(8,575)
	-----	-----
Total stockholders' equity	757,842	563,432
	-----	-----
Total liabilities and stockholders' equity	\$2,907,196	\$2,455,577
	=====	=====

## PAYCHEX, INC. BUSINESS SEGMENT INFORMATION (In thousands)

The Company has two business segments: Payroll and Human Resource and Benefits. The Payroll segment is engaged in the preparation of payroll checks, internal accounting records, federal, state and local payroll tax returns, and collection and remittance of payroll obligations for small- to medium-sized businesses. The Human Resource and Benefits segment specializes in providing

## Edgar Filing: PAYCHEX INC - Form 8-K

small- to medium-sized businesses with cost-effective outsourcing solutions for their employee benefits. Human Resource and Benefits products include 401(k) Plan Recordkeeping, Workers' Compensation Insurance Administration, Section 125 Plan Administration, Group Benefits, State Unemployment Insurance, Employee Handbooks and Management Services, Paychex Administrative Services (PAS) and Professional Employer Organization (PEO) services. Corporate expenses are primarily related to the Information Technology, Organizational Development, Finance, Marketing and Senior Management functions of the Company.

	For the three months ended		For the twelve months ended	
	May 31, 2001	May 31, 2000	May 31, 2001	May 31, 2000
	-----	-----	-----	-----
Revenues:				
Payroll service revenue	\$179,154	\$157,401	\$688,650	\$594,445
Interest on funds held for clients	22,665	18,205	83,336	58,800
	-----	-----	-----	-----
Total Payroll segment revenues	201,819	175,606	771,986	653,245
Human Resource and Benefits service revenue	26,801	21,580	97,871	74,874
	-----	-----	-----	-----
Total revenues	\$228,620	\$197,186	\$869,857	\$728,119
	=====	=====	=====	=====
Operating income:				
Payroll	\$ 94,377	\$ 80,926	\$366,498	\$303,360
Human Resource and Benefits	10,948	6,331	37,890	23,395
	-----	-----	-----	-----
Segment operating income	105,325	87,257	404,388	326,755
Corporate expenses	17,756	17,459	67,686	67,862
	-----	-----	-----	-----
Total operating income	87,569	69,798	336,702	258,893
Investment income	8,546	4,925	27,279	16,479
	-----	-----	-----	-----
Income before income taxes	\$ 96,115	\$ 74,723	\$363,981	\$275,372
	=====	=====	=====	=====

(A) Certain amounts for the three- and twelve-month periods ended May 31, 2000 have been reclassified to conform to the current year presentation.

### 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 Company's operating results for each of the three fiscal years in the period ended May 31, 2001 (fiscal 2001, 2000, and 1999), and its financial condition at May 31, 2001. This review provides additional analysis and disclosure than that contained in the Company's June 25, 2001 press release, which precedes this discussion.

This review is not a complete and comprehensive discussion and analysis as required by the Securities and Exchange Commission for Annual Reports filed on Form 10-K or Quarterly Reports on Form 10-Q. The Company expects to file its 2001 Form 10-K with the Securities and Exchange Commission and mail the 2001 Annual Report to Shareholders in August 2001. The 2001 Annual Report to Shareholders will contain a complete set of audited Consolidated Financial Statements and Notes to Consolidated Financial Statements and a complete Management's Discussion and Analysis of Financial Condition and Results of Operations for the Years ended May 31, 2001, 2000 and 1999, and Financial Condition at May 31, 2001.

## Edgar Filing: PAYCHEX INC - Form 8-K

Forward-looking statements in this Management's Discussion and Analysis are qualified by the cautionary statement in Exhibit 99, contained in this Form 8-K.

### RESULTS OF OPERATIONS

In thousands, except per share amounts	2001	Change	2000	Change	1999
Total revenues	\$869,857	19.5%	\$728,119	21.9%	\$597,296
Combined operating & SG&A expenses	\$533,155	13.6%	\$469,226	14.5%	\$409,734
Operating income	\$336,702	30.1%	\$258,893	38.0%	\$187,562
Operating margin	38.7%		35.6%		31.4%
Income before income taxes	\$363,981	32.2%	\$275,372	37.6%	\$200,143
Net income	\$254,869	34.1%	\$190,007	36.6%	\$139,099
% of total revenues	29.3%		26.1%		23.3%
Basic earnings per share	\$ .68	33.3%	\$ .51	34.2%	\$ .38
Diluted earnings per share	\$ .68	33.3%	\$ .51	37.8%	\$ .37

The financial results for Paychex, Inc. in fiscal 2001 reflect the eleventh consecutive year of record service revenues and net income, and the tenth consecutive year of net income growth of 30% or more. The Company's ability to grow its client base, increase client utilization of ancillary services, develop new services, implement price increases and decrease operating expenses as a percent of total revenues has driven the increases in total revenues and net income in fiscal 2001 and fiscal 2000.

The increases in combined operating and selling, general and administrative (SG&A) expenses reflect increases in personnel, information technology and facility costs necessary to support the growth of the Company. At the end of fiscal 2001, the Company had 7,300 employees compared with 6,200 at the end of fiscal 2000. In fiscal 2002, combined operating and SG&A costs are expected to grow at a rate slightly below the growth rates experienced in fiscal 2001.

The increase in operating income and the improvement in operating margins reflect the Company's ability to add profitable ancillary services and leverage its infrastructure to grow profits faster than revenue growth.

In fiscal 2001, total revenues and net income benefited from higher comparable average rates of interest earned and net realized gains on available-for-sale securities related to the funds held for clients and corporate investments portfolios. The recent trend of interest rate reductions is evidenced by the Federal Funds rate moving from 6.50% at the beginning of January 2001 to 4.00% at the end of May 2001. Looking ahead to fiscal 2002, the interest rate reductions will impact year-over-year net income growth. The Company expects to continue to generate record revenues and net income with total revenue growth in the range of 16% to 18%.

In fiscal 2001, 2000 and 1999, the Company had two reportable business segments: Payroll and Human Resource and Benefits.

#### Payroll segment

In thousands	2001	Change	2000	Change	1999
Service revenue	\$688,650	15.8%	\$594,445	20.6%	\$492,914
Interest on funds held for clients	\$ 83,336	41.7%	\$ 58,800	12.4%	\$ 52,335

## Edgar Filing: PAYCHEX INC - Form 8-K

Total payroll segment revenues	\$771,986	18.2%	\$653,245	19.8%	\$545,249
Operating income	\$366,498	20.8%	\$303,360	27.9%	\$237,236
Operating margin	47.5%		46.4%		43.5%

Revenues: Total Payroll segment revenues include service fees and interest on funds held for clients. Service fee revenue is earned primarily from Payroll, Taxpay, Employee Pay Services and other ancillary services. The Employee Pay Services includes the Direct Deposit, Readyhex, and Access Card products. In addition to service fees paid by clients, the Company earns interest on Taxpay and Employee Pay Services funds that are collected before due dates and invested (funds held for clients) until remittance to the applicable tax authorities for Taxpay clients and employees of Employee Pay Services clients. Interest on funds held for clients is included in total revenues on the Consolidated Statements of Income as the collection, holding and remittance of these funds is a critical component of providing these particular product services. Interest on funds held for clients also includes net realized gains and losses from the sale of available-for-sale securities.

The increases in Payroll service revenue are primarily related to the addition of new clients, new services, price increases and increased utilization of ancillary services, by both new and existing clients. At May 31, 2001, 83% of Paychex clients utilized Taxpay, the Company's tax filing and payment feature, compared with 81% at the end of 2000 and 79% at the end of 1999. Client utilization of the Taxpay product is expected to mature within a range of 83% to 87%. The Company's Employee Pay Services was utilized by 53% of clients at May 31, 2001, versus 47% and 42% at May 31, 2000 and 1999, respectively. During fiscal 2001 and 2000, the Company continued expansion of its Major Market Services (MMS) payroll product offering. MMS is now available in approximately one-half the markets served by the Company. MMS revenues totaled \$47.4 million, \$30.0 million and \$19.3 million in fiscal 2001, 2000 and 1999, respectively. This represents year-over-year revenue growth of 58% for fiscal 2001 and 55% for fiscal 2000. Employee Pay Services and MMS are expected to provide continuing revenue growth opportunities for fiscal 2002 and beyond. In fiscal 2001, the Company introduced new payroll product enhancements including Employee Garnishments and "After-The-Fact" payroll. Fiscal 2002's percentage growth in Payroll service revenue is expected to be in the range of 16% to 18%.

In fiscal 2001 and 2000, interest on funds held for clients increased due to growth in the utilization of Taxpay and Employee Pay Services by new and existing clients and higher average daily balances. Average daily portfolio balances for funds held for clients were approximately \$1.7 billion, \$1.4 billion, and \$1.1 billion in fiscal 2001, 2000, and 1999, respectively. The significantly higher percentage growth in interest on funds held for clients in fiscal 2001 reflects the benefit of higher comparable average rates of return and net realized gains on the sale of available-for-sale securities. In fiscal 2001, interest on funds held for clients included net realized gains of \$5.7 million compared with net realized losses of \$2.9 million and net realized gains of \$2.4 million in fiscal 2000 and 1999, respectively. During the third and fourth quarters of fiscal 2001, market rates of interest declined significantly with the Federal Funds rate decreasing 2.50 percentage points during the period. Due to the decrease in interest rates, the Company expects that interest on funds held for clients in fiscal 2002 will be lower than in fiscal 2001. For further discussion of interest rates and related risks, refer to the "Market Risk Factors" section of this review.

Operating income: Operating income for 2001 and 2000 increased as a result of the increases in Payroll service revenue and interest on funds held for clients and continued leveraging of the segment's operating expense base as evidenced by the improvement in operating margins year-over-year.

Effective September 1, 1999, the Company increased its sales force compensation



## Edgar Filing: PAYCHEX INC - Form 8-K

package by approximately \$6.0 million on an annualized basis to increase the retention and quality of its payroll sales representatives. This compensation increase resulted in additional expense of approximately \$4.5 million in fiscal 2000 and \$1.5 million in the first quarter of fiscal 2001 when compared to the prior years.

### Human Resource and Benefits

In thousands	2001	Change	2000	Change	1999
Service revenue	\$97,871	30.7%	\$74,874	43.9%	\$52,047
Operating income	\$37,890	62.0%	\$23,395	111.3%	\$11,072
Operating margin	38.7%		31.2%		21.3%

Revenues: The significant increases in service revenue for 2001 and 2000 are primarily related to increasing 401(k) Recordkeeping, Workers' Compensation Insurance Administration and Section 125 clients, and PAS and PEO client employees serviced. At May 31, 2001, over 19,000 clients utilized the Company's 401(k) Recordkeeping service, and over \$1.7 billion of client employee funds were managed externally. The growth in 401(k) clients reflects the continuing interest of small- to medium-sized businesses in offering retirement savings benefits to their employees. 401(k) Recordkeeping revenues were \$43.0 million, \$31.5 million and \$19.7 million in fiscal 2001, 2000 and 1999, respectively. This represents year-over-year growth of 36% in fiscal 2001 and 60% in fiscal 2000. The Company continued to expand its Workers' Compensation Insurance Administration product, which provides insurance for qualified clients through leading insurance providers and a reporting method to stabilize their cash flows throughout the year.

In fiscal 2000, the Company began a nationwide expansion of its Paychex Administrative Services (PAS) product, a combined package of payroll, employer compliance, employee benefit administration, and risk management outsourcing services designed to make it easier for small businesses to manage their payroll and related benefit costs. Expansion efforts continued throughout fiscal 2001, and the PAS product is now available nationwide. The Company operates a Professional Employer Organization (PEO) which provides the same combined package of services as the PAS product, but as a co-employer of the client's employees. The Company's PEO service is primarily focused in the states of Florida and Georgia where PEO's are popular and operate under an attractive regulatory environment. At the end of fiscal 2001, the PAS and PEO products serviced over 60,000 client employees.

Operating income: For 2001 and 2000, the increases in operating income are primarily related to the service revenue gains and the leveraging of operating expenses.

Full-year fiscal 2002's Human Resource and Benefits service revenue is expected to grow at a rate slightly higher than in fiscal 2001. Fiscal 2002's quarter-over-quarter percentage comparisons in Human Resource and Benefits revenue and operating income may vary significantly throughout the year, and any one particular quarter's results may not be indicative of expected full-year results.

### Corporate expenses

In thousands	2001	Change	2000	Change	1999
Corporate expenses	\$67,686	-.3%	\$67,862	11.7%	\$60,746

Corporate expenses are primarily related to the Information Technology,

## Edgar Filing: PAYCHEX INC - Form 8-K

Organizational Development, Finance, Marketing, and Senior Management functions of the Company. Corporate expenses have increased primarily due to additional employees and other expenditures required to support the continued growth of the Company's service operations and sales force. In fiscal 2001, these increases were offset by lower spending on national marketing efforts and other areas, resulting in a relatively flat growth year-over-year. Looking forward, the Company expects the growth in corporate expenses to be in the range of 10% to 13% in fiscal 2002.

### Investment income

In thousands	2001	Change	2000	Change	1999
Investment income	\$27,279	65.5%	\$16,479	31.0%	\$12,581

Investment income primarily represents earnings from the Company's cash and cash equivalents and investments in available-for-sale securities. Investment income does not include interest on funds held for clients, which are recorded within the Payroll segment and total revenue. The increases in investment income in fiscal 2001 and 2000 are primarily due to the increase in average daily invested balances generated from increases in overall cash flows. Average daily balances invested were \$.6 billion, \$.4 billion and \$.3 billion for fiscal 2001, 2000 and 1999, respectively. Fiscal 2001 also benefited from higher comparable average rates of return and net realized gains on available-for-sale securities. In fiscal 2001, investment income included net realized gains on available-for-sale securities of \$1.7 million compared to net realized losses of \$0.8 million in fiscal 2000 and net realized gains of \$0.5 million in fiscal 1999. During the third and fourth quarters of fiscal 2001, market rates of interest declined significantly with the Federal Funds rate decreasing 2.50 percentage points during the period. As a result of the decrease in interest rates, investment income for fiscal 2002 is expected to grow at a rate significantly lower than in fiscal 2001. Refer to the "Market Risk Factors" section of this review for further discussion of interest rates and the related risks.

### Income taxes

In thousands	2001	Change	2000	Change	1999
Income taxes	\$109,112	27.8%	\$85,365	39.8%	\$61,044
Effective income tax rate	30.0%		31.0%		30.5%

The change in the effective income tax rate in 2001 is due to the growth in tax-exempt income exceeding the growth in taxable income and other tax reduction opportunities. Tax-exempt income is derived primarily from income earned on municipal debt securities. Fiscal 2002's effective income tax rate is expected to approximate 31.0%.

## LIQUIDITY AND CAPITAL RESOURCES

### Operating activities

In thousands	2001	Change	2000	Change	1999
Operating cash flows	\$304,938	22.5%	\$249,028	43.0%	\$174,120

The increases in operating cash flows resulted primarily from the achievement of higher net income. Projected operating cash flows are expected to

## Edgar Filing: PAYCHEX INC - Form 8-K

adequately support normal business operations, forecasted growth, purchases of property and equipment and dividend payments. At May 31, 2001, the Company had \$614 million in available cash and corporate investments. The Company also had \$140 million of available, uncommitted, unsecured lines of credit and \$350 million available under an uncommitted, secured line of credit.

Investing activities					
In thousands	2001	Change	2000	Change	1999
Net funds held for clients and corporate investment activities	\$ (144,270)	--	\$ (144,322)	74.5%	\$ (82,724)
Purchases of property and equipment	(45,250)	32.5%	(34,154)	54.4%	(22,116)
Proceeds from the sale of property and equipment	32	--	1,266	--	12
Purchases of other assets	(8,290)	19.0%	(6,964)	94.0%	(3,590)
Net cash used in investing activities	\$ (197,778)	7.4%	\$ (184,174)	69.9%	\$ (108,418)

Funds held for clients and corporate investments: Funds held for clients are primarily comprised of short-term funds and available-for-sale debt securities, and corporate investments are primarily comprised of available-for-sale debt securities.

The reported amount of funds held for clients will vary significantly based upon the timing of collecting client funds, and the related remittance of funds to the applicable tax authorities for Taxpay clients and employees of clients utilizing Employee Pay Services. Corporate investments have increased due to the investment of growing cash balances provided by operating activities offset by purchases of property and equipment and dividend payments. At May 31, 2001 the total available-for-sale portfolio included unrealized gains of \$20.5 million, compared to a portfolio at May 31, 2000 that included unrealized losses of \$13.4 million. Additional discussion of interest rates and related risks is included in the "Market Risk Factors" section of this review.

Purchases of property and equipment: To support the Company's client and ancillary product growth, investments are regularly made in data processing equipment and software, and for the expansion and upgrade of various branch facilities. In fiscal 2001, the Company made purchases of property and equipment of \$45.3 million compared with \$34.2 million of purchases in fiscal 2000. In May 2001, the Company purchased a 135,000 square foot office facility in Rochester for approximately \$5.0 million. This facility will house a centralized information technology data center and various other support functions. As a result of this purchase, the Company has delayed previously announced plans to construct a new 300,000 square foot building at an estimated cost of \$40 million. During fiscal 2000, the Company sold an office facility in California for \$1.2 million and purchased a branch office facility in Pennsylvania for \$6.1 million. Purchases of property and equipment in fiscal 2002 are expected to be in the range of \$35 million to \$40 million. Fiscal 2002 depreciation expense is projected to be approximately \$28 million.

Effective June 1, 1999, the Company adopted Statement of Position (SOP) 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The SOP requires the capitalization of internal use computer software costs if certain criteria are met, including all external direct costs for materials and services and certain payroll and related fringe benefit costs. Prior to fiscal 2000, the Company expensed as incurred certain payroll and related fringe benefit costs to develop and enhance its internal computer

## Edgar Filing: PAYCHEX INC - Form 8-K

programs and software. The effect of adopting the SOP increased net income by approximately \$3.2 million and \$2.4 million for the years ended May 31, 2001 and May 31, 2000, respectively.

Financing activities					
In thousands, except per share amounts	2001	Change	2000	Change	1999
Dividends paid	\$ (123,112)	50.9%	\$ (81,583)	50.9%	\$ (54,055)
Proceeds from exercise of stock options	14,600	29.9%	11,242	103.1%	5,535
Other	--	--	(69)	13.1%	(61)
Net cash used in financing activities	\$ (108,512)	54.1%	\$ (70,410)	44.9%	\$ (48,581)
Cash dividends per common share	\$ .33	50.0%	\$ .22	46.7%	\$ .15

Dividends paid: On October 10, 2000 and October 7, 1999, the Company increased its quarterly cash dividend rate per share by 50%. Future dividends are dependent on the Company's future earnings and cash flow. The Company has declared three-for-two stock splits effected in the form of 50% stock dividends on outstanding shares in May of 2000 and 1999.

Proceeds from exercise of stock options: The increase in proceeds from the exercise of stock options is primarily due to an increase in the number of shares exercised and higher comparable exercise prices per share. The Company has recognized a tax benefit from the exercise of stock options of \$26.4 million, \$19.4 million and \$16.3 million for fiscal 2001, fiscal 2000 and fiscal 1999, respectively. This tax benefit reduces the accrued income tax liability and increases additional paid-in capital, with no impact on the expense amount for income taxes.

### MARKET RISK FACTORS

Interest rate risk: Funds held for clients are primarily comprised of short-term funds and available-for-sale debt securities, and corporate investments are primarily comprised of available-for-sale debt securities. The Company's available-for-sale debt securities are exposed to interest rate risk as interest rate volatility will cause fluctuations in the market value of held investments and the earnings potential of future investments. Decreases in interest rates normally increase the market value of the available-for-sale securities, while increases in interest rates decrease the market value of the available-for-sale securities. The Company's available-for-sale securities and short-term funds are exposed to earnings risk from changes in interest rates, as rate volatility will cause fluctuations in the earnings potential of future investments. Decreases in interest rates quickly decrease earnings from short-term funds, and over time decrease earnings from the available-for-sale securities portfolio. Increases in interest rates have the opposite earnings effect on the available-for-sale securities and short-term funds. Earnings from the available-for-sale securities do not reflect changes in rates until the investments are sold or mature, and the proceeds are reinvested at current rates. The immediate impact of changing interest rates on earnings from short-term funds may be temporarily offset by realized gains or losses from transactions in the Company's available-for-sale portfolio. The Company estimates that the earnings effect of a 25 basis point change in interest rates (17 basis points for tax-exempt investments) at this point in time would equate to approximately \$3.0 million for fiscal 2002.

## Edgar Filing: PAYCHEX INC - Form 8-K

The Company directs investments towards high credit-quality, tax-exempt securities to mitigate the risk that earnings from the portfolio could be adversely impacted by changes in interest rates in the near term. The Company invests in short- to intermediate-term, fixed-rate municipal and government securities, which typically have lower interest rate volatility, and manages the securities portfolio to a benchmark duration of 2.5 to 3.0 years. The Company does not utilize derivative financial instruments to manage interest rate risk.

The recent trend in interest rates has been toward interest rate reductions versus interest rate increases during fiscal 2000. The following table summarizes the changes in the Federal Funds rate over the last three years:

	2001	2000	1999
Federal Funds rate - beginning of fiscal year	6.50%	4.75%	5.50%
Rate increase/(decrease):			
First quarter	-	.50	-
Second quarter	-	.25	(.75)
Third quarter	(1.00)	.25	-
Fourth quarter	(1.50)	.75	-
Federal Funds rate - end of fiscal year	4.00%	6.50%	4.75%
Three Year "AAA" Municipal Securities			
Yields at May 31:	3.44%	4.96%	3.85%

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 and intermediate-term investments, the proportionate mix of taxable and tax-exempt investments, and changes in tax-exempt municipal rates versus taxable investment rates - which are not synchronized or simultaneous. Subject to these factors, a 25 basis point change generally affects the Company's tax-exempt interest rates by approximately 17 basis points. Realized gains are more prevalent in a decreasing rate environment and realized losses are more prevalent in an increasing rate environment. During fiscal 2001, the Company's total investment portfolio averaged approximately \$2.3 billion compared with an average of \$1.8 billion for fiscal 2000. The total investment portfolio is expected to average \$2.6 billion in fiscal 2002. The Company's normal and anticipated allocation is approximately 50% invested in short-term securities with a duration of less than 30 days and 50% invested in intermediate-term municipal securities with an average duration of three years.

As of May 31, 2001, the available-for-sale securities included unrealized gains of \$20.5 million, compared with a portfolio at May 31, 2000 that included unrealized losses of \$13.4 million. In fiscal 2000, the available-for-sale portfolio had a market value less than its cost basis as a result of the upward trend in interest rates throughout the year. The decreasing interest rate environment in fiscal 2001 resulted in the improvement in the market value of the available-for-sale portfolio. As of May 31, 2001 and May 31, 2000, the Company had \$1.3 billion and \$1.0 billion invested in available-for-sale securities at fair value, with weighted average yields to maturity of 4.3% and 4.5%, respectively. Assuming a hypothetical decrease in interest rates of 25 basis points given the May 31, 2001 securities portfolios, the resulting potential increases in fair value would be in the range of \$7.5 million to \$8.5 million. Conversely, a corresponding increase in interest rates would result in a comparable decrease in fair value. This hypothetical decrease or increase 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'

## Edgar Filing: PAYCHEX INC - Form 8-K

equity, with no related or immediate impact to the results of operations.

**Credit risk:** The Company is exposed to credit risk in connection with these investments through the possible inability of the borrowers to meet the terms of the bonds. The Company attempts to limit credit risk by investing primarily in AAA and AA rated securities and A-1 rated short-term securities, and by limiting amounts that can be invested in any single instrument. At May 31, 2001, approximately 98% of the available-for-sale securities held an AA rating or better, and all short-term securities classified as cash equivalents held an A-1 or equivalent rating.

### OTHER

**Recently issued accounting standards:** In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 101, "Revenue Recognition in Financial Statements." This SAB formalizes the SEC's position on application of revenue recognition rules. The Company adopted SAB No. 101 in the fourth quarter of fiscal 2001 with no material impact on the Company's results of operations or financial position.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement was most recently amended in June 2000 by Statement of Financial Accounting Standard No. 138 "Accounting for Certain Derivative Instruments and Certain Hedging Activities - An Amendment to FASB Statement No. 133." These statements are collectively referred to as SFAS 133. This statement establishes accounting and reporting standards for derivative instruments and for hedging activities and is effective for fiscal years beginning after June 15, 2000. The Company will adopt the provisions of SFAS No. 133 in the first quarter of fiscal 2002. The Company currently does not utilize derivative instruments and does not expect that adoption of SFAS No. 133 will have a significant effect on its consolidated results of operations or financial position.

Exhibit 99: "Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995.

### "SAFE HARBOR" STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain written and oral statements made by Paychex, Inc., (the "Company") management may constitute "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are identified by such words and phrases as "we expect", "expected to", "estimates", "we look forward to", "would equate to", "are projected at", "we believe", "could be" and other similar phrases. Because they are forward-looking, they should be evaluated in light of important risk factors. These risk factors include, but are not limited to, general market and economic conditions, including demand for the Company's products and services, availability of internal and external resources, executing expansion plans, competition, and price levels; changes in the laws regulating collection and payment of payroll taxes, professional employer organizations, and employee benefits, including 401(k) plans, workers' compensation, state unemployment, and section 125 plans; delays in the development, timing of the introduction, and marketing of new products and services; changes in technology including the use of the Internet; the possibility of catastrophic events that could impact the Company's operating facilities, computer technology and communication systems; and changes in short- and long-term interest rates, changes in market value of available-for-sale securities and the credit rating of cash, cash equivalents, and securities held in the Company's investment portfolios, all of which could cause actual results to differ materially from anticipated results.

## Edgar Filing: PAYCHEX INC - Form 8-K

The information provided in this document is based upon the facts and circumstances known at this time. The Company assumes no obligation to update this document for new information subsequent to its issuance.