

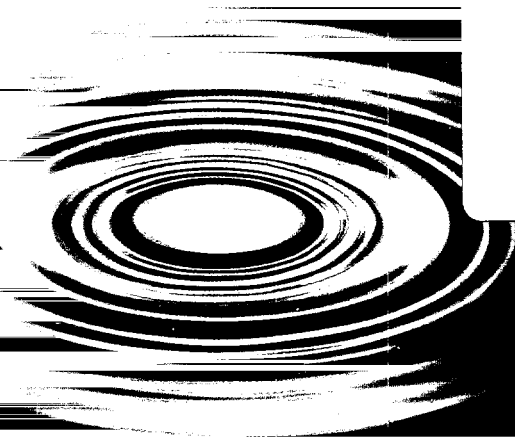
# PAYCHEX®



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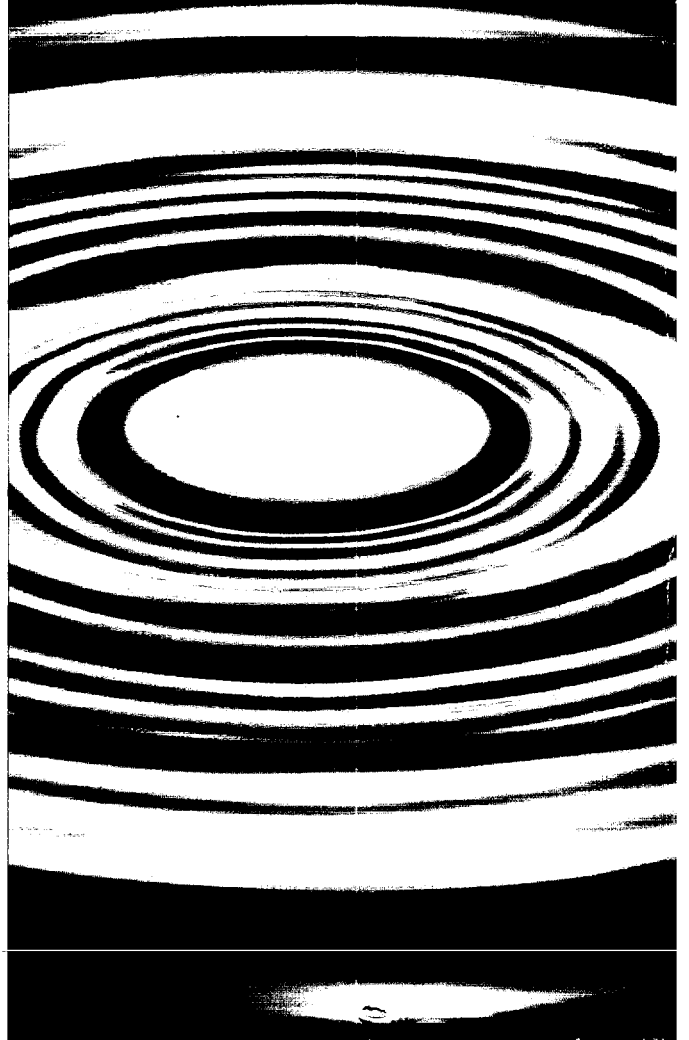
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EXPANDING OPPORTUNITIES

## CORPORATE PROFILE

Paychex, Inc. (NASDAQ:PAYX) is a leading provider of payroll, human resource, and benefits outsourcing solutions for small- to medium-sized businesses. The company offers comprehensive payroll services, including payroll processing, payroll tax administration, and employee pay services, including direct deposit, Readychex<sup>®</sup>, and check signing. Human resource services include 401(k) plan recordkeeping, workers' compensation administration, section 125 plans, a professional employer organization, time and attendance solutions, and other administrative services for businesses. Paychex was founded in 1971. With headquarters in Rochester, New York, the company has more than 100 offices and serves approximately 543,000 payroll clients nationwide. For more information about Paychex and our products, visit [www.paychex.com](http://www.paychex.com).



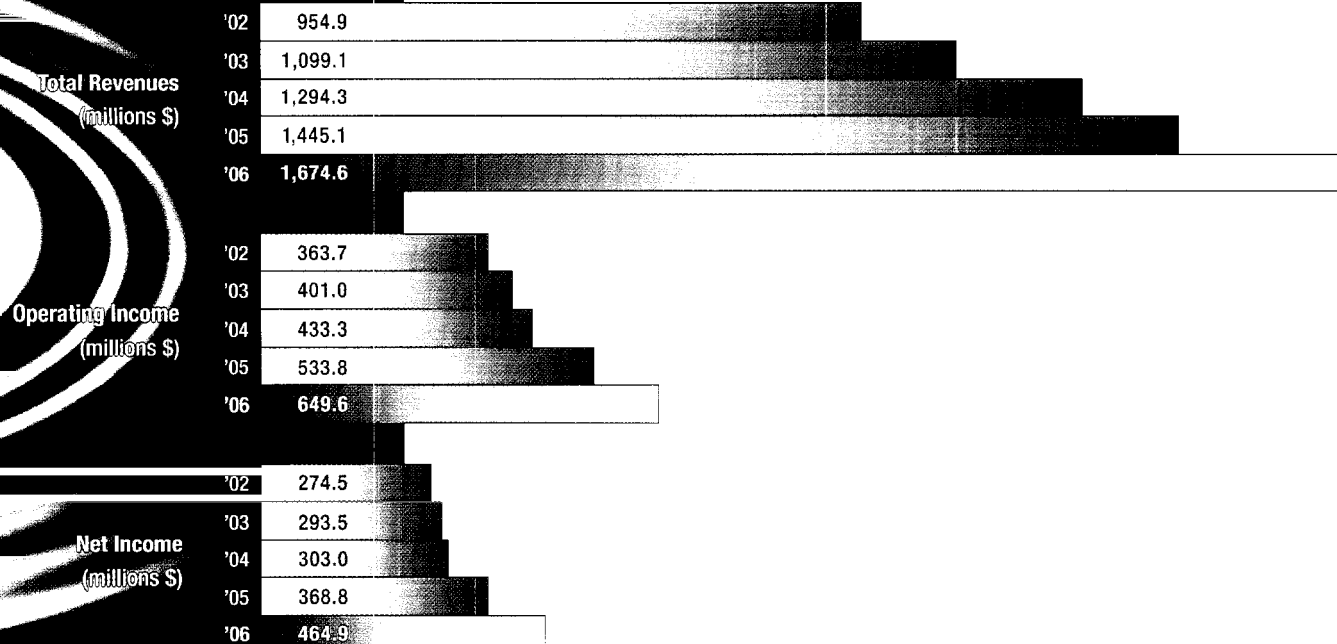
# FINANCIAL HIGHLIGHTS

In millions, except per share amount

	Year ended May 31,		
	2006	2005	Increase
<b>Results of Operations</b>			
Service revenues	\$ 1,573.8	\$ 1,384.7	14%
Interest on funds held for clients	100.8	60.4	67%
<b>Total revenues</b>	<b>\$ 1,674.6</b>	<b>\$ 1,445.1</b>	<b>16%</b>
Operating income	\$ 649.6	\$ 533.8	22%
As a percent of total revenues	39%	37%	
Net income	\$ 464.9	\$ 368.8	26%
As a percent of total revenues	28%	26%	
Diluted earnings per share	\$ 1.22	\$ 0.97	26%
Cash dividends per common share	\$ 0.61	\$ 0.51	20%
Operating income (excluding interest on funds held for clients)	\$ 548.8	\$ 473.4	16%
As a percent of service revenues	35%	34%	

## Financial Position

Purchases of property and equipment	\$ 81.1	\$ 70.7
Total assets	\$ 5,549.3	\$ 4,617.4
Total debt	\$ -	\$ -
Stockholders' equity	\$ 1,654.8	\$ 1,385.7
Return on stockholders' equity	30%	28%



Through our licensed insurance agency, we provide an ever-growing number of Paychex clients with workers' compensation insurance services. 52,000 clients use this great service that includes a budgeting tool to help manage their costs. The Paychex Insurance Agency ranks 16<sup>th</sup> in the nation among the biggest public and bank-owned insurance agencies, according to a leading industry publication.


We continue to expand our administrative service offerings, this year adding both COBRA services for health insurance and the Paychex Health Savings Account (HSA). We collaborated with Affiliated Computer Services (ACS) and Mellon Financial Corporation to offer the Paychex HSA.

Our business partners are integral to our success, and this year Paychex strengthened an important partnership with CPA2Biz, the marketing and technology subsidiary of

the American Institute of CPAs, by extending the Paychex Partner Program from AICPA Business Solutions for another five years. At the same time, the program was expanded to name Paychex the preferred provider of retirement plan services for CPAs' clients. We were named the preferred payroll provider for CPAs' clients when the Partner Program started in 2003. In 2006, we also launched Accountant Advisory Boards in three cities across the country – one more way for us to get valuable input on how we can best meet the needs of CPAs and their clients.

## COMMUNITY CONNECTION

All across this country, our employees partner with nonprofit organizations in the communities where we live, work, and derive our business. When the company reached



*The Paychex senior management team – (left to right) Jonathan Judge, President and Chief Executive Officer; John Morphy, Senior Vice President, Chief Financial Officer, and Secretary; Walter Turek, Senior Vice President, Sales and Marketing; Martin Mucci, Senior Vice President, Operations.*

## YEAR IN REVIEW

The results of the past year are a terrific example of that. Our financial performance was excellent. For the sixteenth straight year, Paychex delivered record revenues, net income, and diluted earnings per share. The key drivers to our success remain our people, our systems, and a highly focused commitment to execution.

Total revenues for the year ended May 31, 2006 grew by 16 percent to more than \$1.6 billion. Net income rose 26 percent to nearly \$465 million. Paychex has no debt, and our liquidity position remains strong with \$577.4 million in cash and short-term investments. We also have \$384.5 million in long-term corporate investments. Cash flow from operations was \$569.2 million. And dividend payments this year totaled 50 percent of net income, evidence of our pledge to provide shareholders with a great return on their investment.

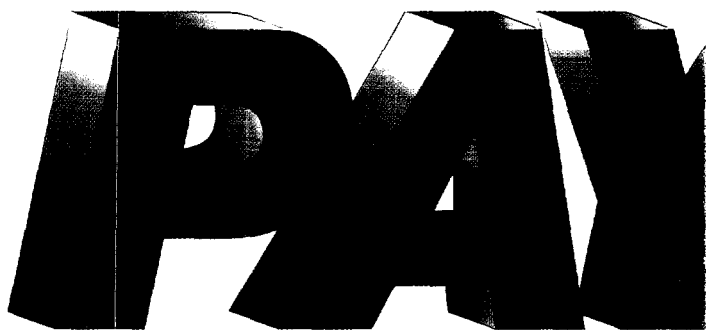
Paychex saw impressive improvement in key business metrics during fiscal 2006. Approximately 543,000 businesses across the United States now rely on our company to process their payroll – and we know the first-rate customer service they get with Paychex is an important part of why they stay. The loyalty of our clients is outstanding: survey results show we hit an all-time high in client retention this year and registered near-record levels in client satisfaction.

The performance of our sales and service teams continues to help drive our success. Client growth in 2006 was four percent, the highest since 2001, and the consistency and quality of customer service our clients receive after the sale is second to none. The array of world-class products and services we offer our clients keeps growing, just as our clients' needs continue to grow. The worry-free solution for today's business owner may start with payroll, but it includes much more in a competitive environment that mandates a full human resources solution. All of us at Paychex are absolutely committed to helping our customers navigate the journey from "hire to retire."

Our payroll services provide the foundation. The average Paychex client has 17 employees, although our offerings are the answer for the smallest business to larger ones with more complex needs. Among our core clients, we continue to see more and more usage of our suite of online products. More than 180,000 clients are enrolled in at least one of our online services. This year, we saw a 50 percent jump in the

number of customers using our Paychex Online Reports alone. Paychex Major Market Services (MMS) marks its tenth anniversary in 2006. Over 33,000 businesses with 50 or more employees, or with more complex payroll and HR needs, rely on MMS for an integrated solution that includes payroll, time and attendance products, and Paychex HR Online, our Internet-based human resources management system. MMS revenue climbed 27 percent this year to \$225.0 million.

We are also the market leader in offering a total HR outsourcing solution, serving over 295,000 worksite employees through our Paychex Premier Human Resources product and our professional employer organization, Paychex Business Solutions. Revenue from our Paychex Premier product grew by 57 percent during fiscal 2006 to \$52.6 million. PEO revenue was up 25 percent to \$67.1 million.



We opened a whole new distribution system for our Paychex 401(k) Recordkeeping service in fiscal 2006, allowing our clients and financial advisor partners access to more investment choices. This lets us go to current payroll clients who have 401(k) plans, but who don't use Paychex for their recordkeeping, and offer them a chance to use our 401(k) service while keeping their current investment choices. This new approach also means we can partner with stock brokers and insurance agents as the recordkeeper for their 401(k) customers. This is the kind of leadership that helped us once again rank as the top 401(k) recordkeeper in an industry survey, as measured by the number of plans sold. More than 38,000 businesses are now Paychex 401(k) clients. Our Retirement Services revenue was up 16 percent to \$106.1 million last year.



# o Our Shareholders

The basic principles and values that have been at the heart of Paychex since the beginning are very much alive and well as the company closes its first full fiscal year under the leadership of a new chief executive officer. The transition is now complete. The senior management team is intact, engaged, and performing extremely well. And the tremendous achievements of fiscal 2006 are reflected in financial results that again reached new heights – and did so with the uncompromising integrity you’ve come to expect from Paychex.

Our clients’ satisfaction is higher than nearly any time in our history. Every day, we deliver a “win-win” solution for our shareholders, clients, and business partners through great execution and the cost-effective delivery of leading-edge, highly valued products and services. Paychex’s business is clearly alive and well – and growing. And as we fuel the engine that is the heart of our business, we’re working hard to make the future even brighter through expanding opportunities. Ours is a high-performance culture that pairs a superb work ethic with extraordinary execution to produce exceptional results – now and in the future.



out to those communities this year, our employees showed an amazing spirit of caring.

Hurricane Katrina devastated parts of Louisiana and Mississippi. Both our clients and employees suffered unimaginable loss. But I witnessed one of the most amazing examples of compassion when thousands of our employees – unsolicited – stood up and said they wanted to help their fellow workers rebuild their lives. They raised \$175,000, and Paychex was proud to match that dollar for dollar. And our company stepped up when the Red Cross asked for help. In six weeks, we processed more than 270,000 disaster relief checks totaling nearly \$240 million, getting desperately needed funds to Katrina victims for basic needs.

Just months later, our employees did it again – raising nearly \$530,000 for United Way in Paychex's first-ever, company-wide campaign. Whether it's hundreds of corporate employees walking to raise money for the fight against juvenile diabetes, or dozens of our employees in Orange County collecting money to buy beds, books, and more for an African orphanage, Paychex employees are involved and invested. Thousands of our employees touched thousands of their neighbors by supporting deserving causes. This outpouring of generosity was waiting to be unleashed and inspirational to watch.

## **NATIONAL RECOGNITION**

The relationships we have with clients, business partners – and communities – are vital to one of my personal commitments: making Paychex the kind of place where employees can't wait to get to work. And it's rewarding when others recognize the great things going on here. For the fifth year in a row, *Training* magazine named our training organization to its list of the top 100 in the country. For the second straight year, Paychex was named one of the 100 best places to work in IT by *Computerworld* magazine. Paychex was ranked among America's largest corporations on the prestigious *Fortune* 1000 list. And in a survey done by *Institutional Investor* magazine, Paychex was rated one of the most shareholder-friendly companies.

## **STRATEGY FOR THE FUTURE**

We absolutely value our accomplishments, but we also know that being the best means expanding our opportunities – by looking ahead, planning for the strategic horizon, and ensuring that the appropriate investments are being made to seed a successful future for Paychex.

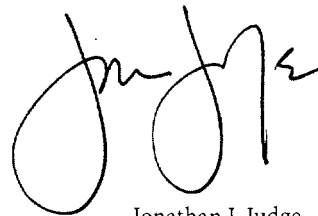
Our international expansion is part of that future. As the fiscal year ended, we had just opened our third and fourth offices in Germany, which gives us virtually a national footprint. In addition to offices in Berlin and Hamburg, we are now operating in Dusseldorf and Munich. We have over 500 payroll clients in Germany.

Time and attendance solutions are also part of our strategy for the future. The evolution of this exciting suite of products for us includes an online time and labor management system targeting our MMS clients. Another big growth area for Paychex is health and benefits. We now offer health insurance to businesses nationwide, simplifying the process for our clients and researching their options through relationships we have with national and regional insurers.

Paychex has been on an extraordinary journey to become the foremost provider in our industry. We started down the path to outsourcing leadership as a payroll company for small businesses. As their needs grew, so did our offerings – evolving to add products like Taxpay, direct deposit, and other pay options for employees. The addition of employee handbooks ultimately launched a whole new division – Paychex Human Resource Services. The pace of growth in our HR services keeps accelerating, moving from 401(k) recordkeeping and flexible spending accounts to our total outsourced HR solutions and health benefits.

Paychex is truly more than payroll. Payroll will always be our heritage and the foundation for what we develop and deliver to businesses of all types and sizes. The journey now is to prominence in the world of full HR outsourcing. We are clearly on our way.

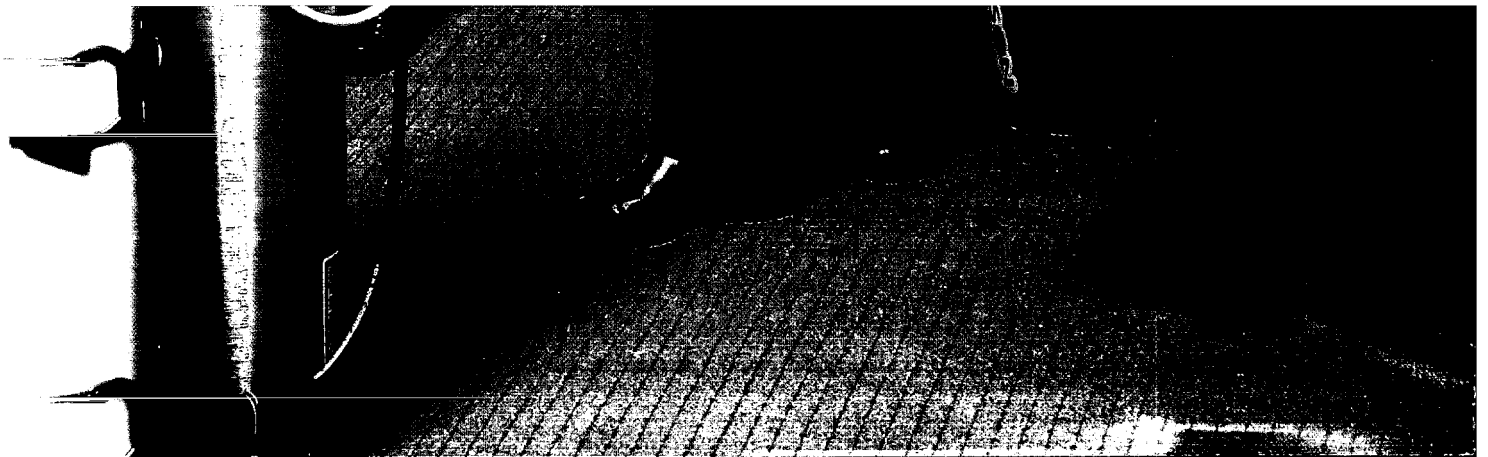
I thank our shareholders, Board of Directors, clients and employees for all you have done – and will do. We're honored to have you with us on our voyage to an incredibly bright future.



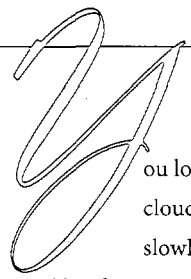
Jonathan J. Judge  
President and CEO



"We're sticking  
with Paychex"







ou look down through a crystalline sea as the cloud of bubbles coming from a diver below you slowly disperses, revealing the enormity of a naval battle cruiser sunk near Bikini Atoll in the Pacific. Or, in the ultramarine waters near Bali, you've achieved neutral buoyancy in a cloud of miniature sea horses, each no bigger than the tip of your little finger. For most, these wonders would be the highlights of a dream vacation or a signature event in a globetrotter's hobby. For Dianne Bloch and Joe Plano, co-owners of the Aquatic Center of Rochester, New York, these are frequent real-life adventures, because they have made a thriving business out of a sport they love.

"The core of our business is scuba and snorkel training. But if it's in the water, we do it," says Dianne. "Swim accessories have also become a significant business, where we get a lot of swim teams and members of senior swim groups in for goggles and suits. For many people it's the first step that leads to snorkeling and scuba. And then we offer a lot of accessories for surface water sports; wet suits for canoeing, kayaking, jet skiing. Also, part of our success comes from being a friendly place for anyone who comes in. A lot of dive shops look like the garage of some backyard mechanic. When we started out I told Joe that one condition for opening a shop was that it had to be a place that women wouldn't mind coming into."

Dianne and Joe got the business started in 1987 and, at that time, began using Paychex for their payroll. They did not initially use Taxpay, the Paychex payroll tax administration service. "We started by making our own payments at the bank," recalls Dianne. "Like everybody in a small business, the first thing you don't want to turn over is that cash. And you get busier and busier and you realize that it's not easy. Then the first time I almost missed the payment I said, okay, who'd want to be doing this themselves? It's silly."

The Aquatic Center represents a typical Paychex core client: not a large number of employees (four to six, depending on the business cycle), payroll, tax payments, a health insurance deduction, and all the miscellaneous payroll housekeeping chores like new-hire reporting. "I think the key is just knowing that whenever there's a change in a rule or a regulation, I don't have to deal with it," says Dianne. "For example, when New York came up with its regulation saying that when you hire a new employee you have to let the state know so they can make sure things like alimony get paid. When Paychex picked that up it was just one less thing to do. Every one of those things adds up.

If you let one slip you've got a problem or a fine comes at you. As a business person, you just want to say, do you realize which hat I'm wearing today? Give me a break! So, the more little things that Paychex can pick up and take care of makes it easier. Any small business person that tries to do it themselves is nuts. They are! What are you doing, people? You've got much better things to be doing with your time.

"I have payroll companies calling me all the time, trying to get us to switch," Dianne concludes. "And the best they can offer me is price. But you have to have a whole lot more than that. When the service is good, the product is good, and the support is good, you don't want to leave it. They've been doing everything right, so we're sticking with Paychex."

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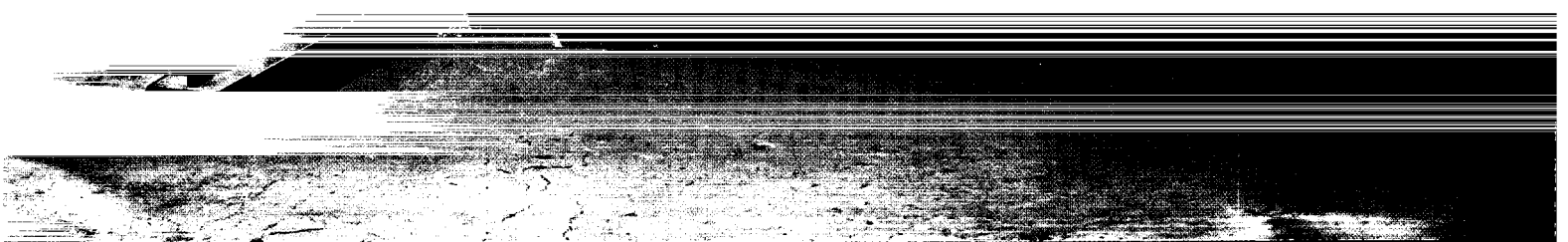
## PRIMARY PAYCHEX PAYROLL SERVICES

If there is such a thing as an "average" Paychex client, it is probably represented by the Aquatic Center, where they can report their time sheet information by phone, fax, or the Internet, and payroll checks and reports arrive by their chosen delivery method. Other payroll-related services used by our core clients include:

- Payroll tax computation, filing, and deposits.
- State unemployment insurance support.
- Electronic filing services for businesses required to deposit payroll or business taxes electronically.
- New-hire reporting.
- Employee pay options, including paper checks, direct deposit, and Visa® payroll debit card.
- Laser check signing and insertion of checks in security envelopes.
- Time and attendance solutions that improve productivity and accuracy.
- Online services that extend the convenience of the Internet to the handling of payroll, payroll reports, time sheets, and linking of payroll data to a general ledger.



“It was good having  
Paychex in our corner”



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hen a business decides on payroll outsourcing, cost, service, convenience, and many other features and benefits are considered. But, rarely is it key to a business continuity plan that the provider have a national presence. "I knew that Paychex was all over the country," says Robin Williams, comptroller of Crooks Printing Service, Inc., in Hollywood, Florida, "but I certainly never imagined the part that a Paychex office in Philadelphia would play when something bad happened." The "something bad" in October, 2005, was Hurricane Wilma.

A fourth-generation commercial printer using Paychex services for more than ten years, Crooks Printing Service has over sixty employees and produces full-color brochures, mailers, catalogs, and other high-quality publications. It's a business that runs on razor-sharp deadlines, tons of very large, sophisticated equipment, and lots of power.

"We were shut down for two and a half weeks," Robin recalls. "Nobody had power. Trying to drive around was a mess because you had debris all over the place. Getting bank deposits going was hard. Everybody had limited hours of operation.

"I got all my emergency contacts out, and Paychex was one of the first phone calls that I made. I got through to the folks in Philadelphia and told them what the situation was. I told them we usually report payrolls on the Internet and I didn't know if I was going to have power or a computer to access. They said, okay, don't worry. Whatever your situation is, we'll take care of it. If we have to do it manually, we'll do it manually. Your direct deposit will still work.

"My next question was how are you going to get the payroll here because your local office is out of action until we get electricity? They said, don't worry about that. We'll overnight the payroll and if we have to do a Saturday delivery or whatever we'll do it. Assuming that there's a delivery service running, we'll get the payroll to you. Just let us know what's convenient for you at what location. And that's what happened. The payroll was delivered to me at my house. From there I just went to the office and we disbursed checks. We did that for at least three payrolls.

"Of course, Paychex service has always been outstanding. We were stressing because in addition to the payroll we have a lot of other responsibilities here. Any time somebody can ease that burden it's certainly a big thing to us. We're a service business ourselves, and servicing the client and being a partner with the client is very important to us. We feel that's the type of service we get from Paychex. So we really appreciate that and identify with it."

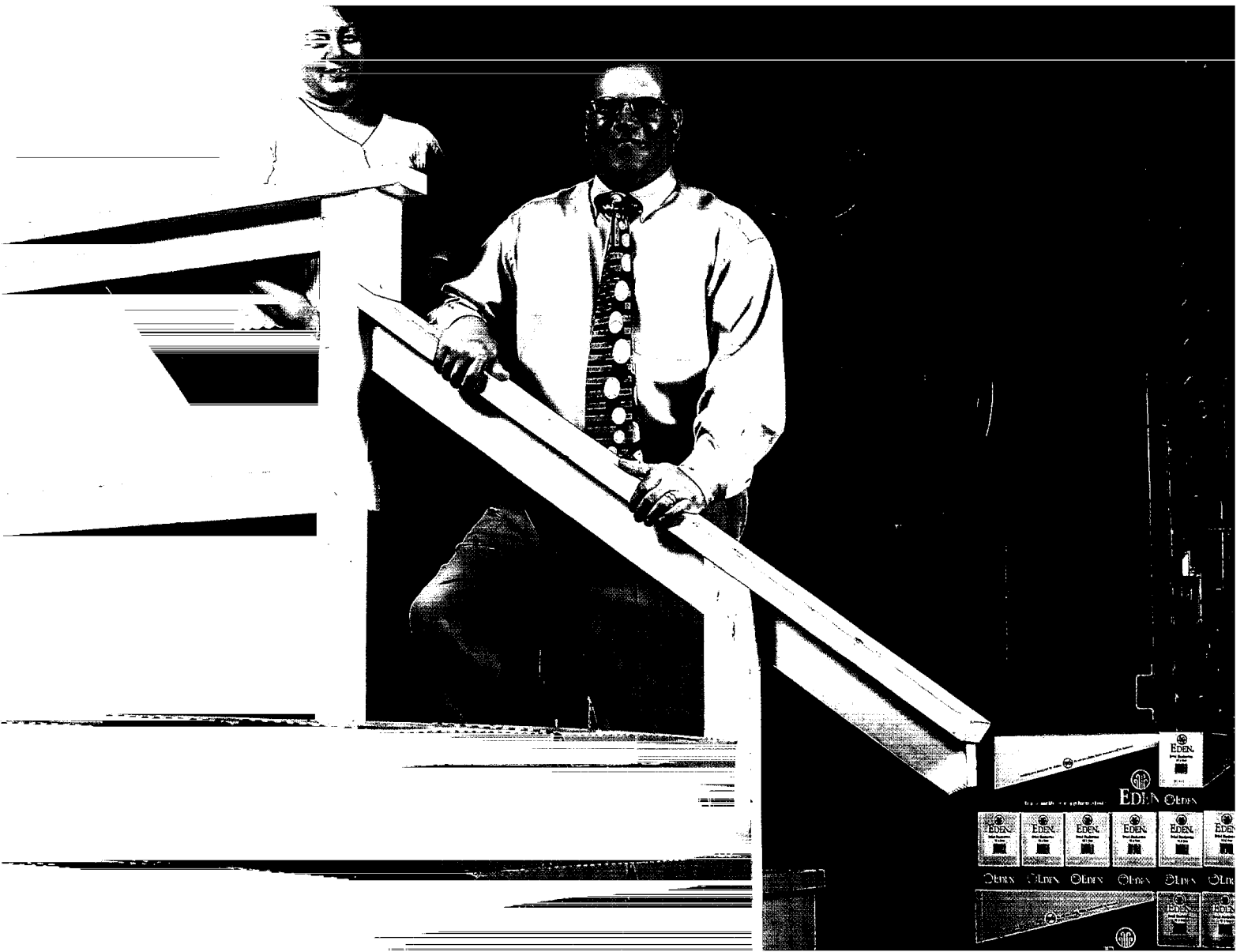
Robin is philosophical about the experience with Hurricane Wilma. "I've lived here all my life and been through many, many hurricanes, and that was the longest time I can ever remember power being out," she notes. "But you get through it and you learn, and hopefully you're better for it next time. It was just such a great relief not having to worry about the payroll part of it. It was good having Paychex in our corner."

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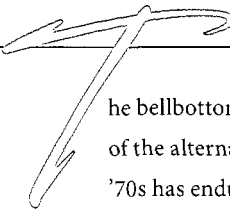
## PAYCHEX AND CLIENT BUSINESS CONTINUITY

The Crooks Printing Service story was repeated all along the Gulf Coast, where the devastation of Hurricanes Wilma and Katrina interrupted many essential business services. This put a new emphasis on a number of Paychex capabilities.

- With over 100 locations and redundant processing capabilities, service can be quickly shifted to unaffected areas when local or regional processing is interrupted.
- Direct deposit and the Paychex Access Visa® payroll card – usually considered conveniences but not necessities – provide the only means for employees to receive payment where delivery services are not operating.
- Integrated services guarantee that related activities continue without interruption: payroll tax remittances, retirement plan contributions, various plan premiums, and other transfers are all made in a timely fashion.



“Paychex performance  
has been flawless”



he bellbottoms, beads, and Beatles are gone, but part of the alternative lifestyle movement of the 1960s and '70s has endured. Organically produced food, once found primarily in communes and cooperatives, is now a staple from small markets to national food chains. *The Wall Street Journal* estimates that the natural foods industry represents a \$15.5 billion segment of the U.S. economy. A premier producer in this market is Eden Foods, Inc. They have relied on Paychex services since 1992.

"We began in 1969 as a small Ann Arbor co-op," explains the chief financial officer of Eden Foods, Jay Hughes. "Today, we have approximately 250 items, ranging from Eden Soy, which is our soy milk, to pasta, to beans, to tomatoes — even an organic trail mix snack that we've just introduced to great success. We process and distribute items harvested from a network of about 300 independent family farms that are certified free from the use of things like non-organic pesticides and fertilizers and genetically engineered seeds."

Having employees in Michigan, Colorado, Pennsylvania, Florida, Idaho, and California requires the kind of large company payroll capabilities supplied by Paychex Major Market Services (MMS). "With employees in so many places and so much potential liability associated with tax filings and employment tax returns," says Jay, "it just doesn't make sense to do payroll in-house. Because Paychex is in charge of filing all the necessary tax forms and keeping up to date with all the tax laws, we've really reduced our liability."

Joyce McLeskey, who manages payroll administration at Eden Foods, uses the MMS Preview® software program, which allows companies to retain employee and payroll data locally. She can "preview" various scenarios and transmit a payroll to Paychex for processing only after she has confirmed that it meets all of the company's needs for the pay period. "One small but important thing that Preview gives is the option of doing 'what if' scenarios for employees. What if I changed my tax status to this — how would it affect my check? What if I took a different amount out for my 401(k)? A capability like that is very beneficial to the employee," says Joyce. "We don't have to worry that we didn't notice a change in a law and gave the wrong information. Paychex is on top of what the states are requiring, and that's vital."

"I use Preview to prepare the payroll and then click a button and it's sent to Paychex online. We take particular advantage of Taxpay, reports for the general ledger, and direct deposit. With employees all over the country, we could not get along without direct deposit. And, the reports that I get from Paychex are so

well written and easy to understand that that it really cuts the amount of time I have to spend. If I didn't have well organized information it would take me twice as long to compile the reports I have to do for the three divisions of the company."

MMS and Preview have also cut the paperwork burden at Eden Foods. "Paychex has greatly reduced the amount of space taken up by paper and files," says Joyce. "It's streamlined the process," adds Jay. "Our employees get their checks, and there is information on them that we could never have provided prior to Paychex. It also used to take forever to get W-2s and 1099s out. It was a nightmare. Now, we get the forms on schedule, no problem. And, we save a lot of time not having to fill out tax forms. It's seamless. If we ever had to go back to internal payroll . . . well, I don't want to even think about it. But, with Paychex that's what I like about it. I don't have to think about it. Paychex keeps us up to date and accurate. It's totally reliable. In the fourteen years we've been with them, Paychex performance has been flawless."

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## **PAYCHEX MAJOR MARKET SERVICES**

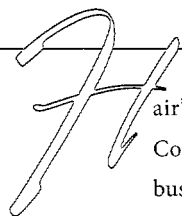
Paychex Major Market Services (MMS) focuses on the special needs of larger businesses like Eden Foods, Inc.

- Our "insourcing" solution lets businesses retain payroll and HR databases on an in-house personal computer or PC network, thus combining total in-house control of payroll and human resource (HR) information with the security and peace of mind of external processing.
- Reports, and even checks, can be created on demand, at the user's convenience.
- Preview's HR module has a seamlessly integrated database for payroll and human resource data, including COBRA, the Family Medical Leave Act, Equal Employment Opportunity legislation, and asset management.
- Paychex HR Online makes it easier to manage employee benefits, personal information, and workplace issues while meeting human resource compliance requirements. Employee self-service capabilities add administrative efficiency.



“We’re with Paychex.  
We’re under the umbrella”





Hair's Kay Beauty and Barber Salon in New Haven, Connecticut takes a comprehensive view of business and of payroll and human resource management. As owner Karaine Holness explains it, "We are here to attend to mind, body, and soul.

"We cater to a ninety-nine-percent African-American clientele. But, it's not that you are here for just your hair and then you leave. We try to nurture you. You know how they say that a bartender plays the role of a psychologist? Well, we see a lot of wives, mothers . . . all kinds of women, and often when they're in the chair they pour out their hearts to you. We try to help them leave here at least in some ways whole. So, it's not just coming in to get your hair done. We really care about our clients, their health, and their well-being."

This approach to business and commitment to customer service helped lead Hair's Kay Beauty and Barber Salon to Paychex Premier<sup>SM</sup> Human Resources. "We started using Paychex three or four years ago because we wanted to run the business as a business, not just as a hair salon," says Karaine. "I didn't want to owe the government. And I know that the tax laws can change. I didn't want that responsibility. It was hard being behind the chair and taking care of the paperwork at the end of the day. So, it was best for the business if we outsourced."

Karaine's business manager Sharmain Hatcher explains their philosophy further: "Our long-term goal is to become a day spa, so part of the reason we signed up with Paychex was it allows us to align ourselves for growth. It puts us a step ahead of our competitors by offering our staff more incentives to stay. We established a 401(k) retirement plan, which most of the salons around here don't have. It's been a wonderful selling tool when recruiting people we'd like to come into the business and for keeping the employees that are here now. It gives everyone something to work toward."

Both Karaine and Sharmain agree that the Premier employee assistance program is "awesome." "It kind of lets you have your own personal shepherd, for lack of a better word," says Karaine, "someone who can help you work through personal problems. The flexible spending account has also been popular for budgeting medical, dental, and child-care expenses. It helps recoup some of the co-pays and things like that."

With Paychex Premier Human Resources, an approach is used that is unique in the industry. The lead Paychex support representative provides a single primary contact for a business, delivering a great deal of help in person at the business site. This often involves consultation for employment and job exit

interviews, help with benefit enrollment meetings, and assistance with employment law and employee issues. Karaine mentions an example: "We recently got an employee handbook from Paychex. First, our representative came in, went over everything with us, gathered the information that we wanted to go in the book. She came back to consult on the job descriptions for the stylists. And now we have it on hand to let the staff know what our policies are. Each person signs off that they understand it. They see that this is a business for real. A lot of salons probably wouldn't do it because it's an expense. But, in the long run, for us, it's a saving. I have friends who own other salons and I try to help them understand. Probably they won't until they have a dispute or until they're fined. That's when they'll understand. But, we're okay right now. We're with Paychex. We're under the umbrella."

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## **PAYCHEX PREMIER<sup>SM</sup> AND OTHER HUMAN RESOURCE SERVICES**

By using Paychex Premier Human Resources, Hair's Kay Beauty and Barber Salon enjoys outsourcing of the entire gamut of Paychex capabilities. In addition to our payroll, payroll tax, and employee payment services, Paychex Premier and other HR services include:

- Premier on-site consulting and support for various HR functions.
- Premier on-site training and seminars, employee handbooks, and other management tools.
- Premier safety and loss control services.
- Administration of COBRA, state unemployment insurance, and an employee assistance program (EAP).
- Retirement plan services, including 401(k), profit sharing, safe harbor, and other options.
- Section 125 plans, with daily claim processing and disbursement.
- HR Online, an Internet-based human resources information system (HRIS).
- Workers' compensation services.
- Health insurance administration through partnerships with more than 100 carriers.

- Paychex was named to **The Wall Street Journal's** 2006 Shareholder Scoreboard. The publication annually ranks 1,000 companies in 76 industry groups based on compound annual total returns.
- Paychex was named to the prestigious **FORTUNE** 1000 list of America's largest corporations, based on 2005 revenues.
- **Forbes** included Paychex among the 2,000 biggest public companies. The company was number 1,203 on the 2006 Forbes Global 2000, a list of corporations ranked by a composite of sales, profits, assets, and market value.
- Paychex was named one of America's Most Shareholder-Friendly Companies by **Institutional Investor** magazine. Results of the first-ever survey reflected the views of more than 1,000 portfolio managers and analysts in the United States and abroad. All were asked to name the companies in their areas of expertise that are the most attentive to shareholders.
- Paychex ranked number 21 on **Training** magazine's 2006 Top 100 list of training organizations. *Training* also identified the Paychex payroll sales training program as one of 10 outstanding training initiatives. Paychex provides an average of 124 hours of training per Paychex employee per year.
- Paychex ranked number 43 on **Computerworld's** 2006 list of Best Places to Work in IT, up from number 52 in 2005. This is the second year Paychex has appeared on this list of the top 100 workplaces for information technology professionals.
- **PLANSPONSOR** and **CFO** magazines ranked Paychex among the nation's top 401(k) recordkeepers. Based on the number of new plans gained in 2005, *Plansponsor* rated Paychex first among all the recordkeepers surveyed. In *CFO* magazine's annual 401(k) Providers Guide, Paychex is the largest 401(k) recordkeeper, measured by the total number of plans.
- **AICPA Business Solutions** is an expanding suite of business services from the American Institute of Certified Public Accountants that is designed to serve the needs of CPAs in practice. Paychex has been the preferred payroll provider for the program since 2003. This year the program was extended for an additional five years and expanded to include Paychex retirement plan services.



*Paychex signed a lifetime sponsorship contract with six-time PGA winner Jeff Sluman, while recognizing the 20th anniversary of the partnership between Paychex and the pro golfer. The partnership is one of the longest-running corporate sponsorships on the PGA Tour today. On hand for the ceremony were Paychex President and CEO Jonathan Judge and golf legend Arnold Palmer.*

# 2006 Landmarks



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended May 31, 2006

Commission file number 0-11330

**Paychex, Inc.**

911 Panorama Trail South  
Rochester, New York 14625-2396  
(585) 385-6666

A Delaware Corporation

IRS Employer Identification Number: 16-1124166

Securities registered pursuant to Section 12(b) of the Act:	None
Securities registered pursuant to Section 12(g) of the Act:	Common Stock, \$.01 Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of November 30, 2005, the last business day of the most recently completed second fiscal quarter, shares held by non-affiliates of the registrant had an aggregate market value of \$14,387,643,144 based on the closing price reported for such date on the NASDAQ Stock Market.

As of June 30, 2006, 380,333,725 shares of the registrant's common stock, \$.01 par value, were outstanding.

**Documents Incorporated by Reference**

Portions of the registrant's definitive proxy statement to be issued in connection with its Annual Meeting of Stockholders to be held on October 5, 2006, to the extent not set forth herein, are incorporated herein by reference thereto into Part III, Items 10 through 14, inclusive.

**PAYCHEX, INC.**  
**INDEX TO FORM 10-K**

For the fiscal year ended May 31, 2006

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## PART I

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

Certain written and oral statements made by management of Paychex, Inc. and its wholly owned subsidiaries (“our,” “we,” “us”) may constitute “forward-looking statements” as defined in the Private Securities Litigation Reform Act of 1995 (the “Reform Act”). Forward-looking statements are identified by such words and phrases as “we expect,” “expected to,” “estimates,” “estimated,” “current outlook,” “we look forward to,” “would equate to,” “projects,” “projections,” “projected to be,” “anticipates,” “anticipated,” “we believe,” “could be,” and other similar phrases. All statements addressing operating performance, events, or developments that we expect or anticipate will occur in the future, including statements relating to revenue growth, earnings, earnings-per-share growth, or similar projections, are forward-looking statements within the meaning of the Reform Act. Because they are forward-looking, they should be evaluated in light of important risk factors. These risk factors include, but are not limited to, the following and those that are described in “Risk Factors” under Item 1A and elsewhere in this Annual Report on Form 10-K (“Form 10-K”):

- general market and economic conditions, including, among others, changes in United States employment and wage levels, changes in new hiring trends, changes in short- and long-term interest rates, and changes in the market value and the credit rating of securities held by us;
- changes in demand for our products and services, ability to develop and market new products and services effectively, pricing changes and the impact of competition, and the availability of skilled workers;
- changes in the laws regulating collection and payment of payroll taxes, professional employer organizations, and employee benefits, including retirement plans, workers’ compensation, state unemployment, and section 125 plans;
- changes in our Professional Employer Organization direct costs, including, but not limited to, workers’ compensation rates and underlying claims trends;
- the possibility of failure to keep pace with technological changes and provide timely enhancements to products and services;
- the possibility of failure of our operating facilities, computer systems, and communication systems during a catastrophic event;
- the possibility of third-party service providers failing to perform their functions;
- the possibility of penalties and losses resulting from errors and omissions in performing services;
- the possible inability of our clients to meet their payroll obligations;
- the possible failure of internal controls or our inability to implement business processing improvements; and
- potentially unfavorable outcomes related to pending legal matters.

Any of these factors could cause our actual results to differ materially from our anticipated results. The information provided in this document is based upon the facts and circumstances known at this time. We undertake no obligation to update these forward-looking statements after the date of filing of this Form 10-K with the Securities and Exchange Commission (“SEC” or “Commission”) to reflect events or circumstances after such date, or to reflect the occurrence of unanticipated events.

#### **Item 1. Business**

We are a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses in the United States (“U.S.”). At

May 31, 2006, we serviced approximately 543,000 clients and had approximately 10,900 employees. We maintain our corporate headquarters in Rochester, New York, and have more than 100 offices nationwide.

We also have approximately 500 clients in Germany as of May 31, 2006, which are serviced through offices in Hamburg and Berlin. It is anticipated that sales offices in Munich and Dusseldorf will be operational early in the fiscal year ending May 31, 2007 ("fiscal 2007").

Our company was formed as a Delaware corporation in 1979. We report our results of operations and financial condition as one business segment. Our fiscal year ends May 31.

### **Company Strategy**

We are focused on achieving strong long-term financial performance by:

- Providing high-quality, timely, accurate, and affordable comprehensive payroll and integrated human resource services.
- Delivering these services utilizing a well-trained and responsive work force through a network of local and corporate offices servicing more than 100 of the largest markets in the U.S. and in Germany.
- Growing our client base, primarily through the efforts of our direct sales force.
- Continually improving client service and maximizing client retention.
- Capitalizing on the growth opportunities within our current client base and from new clients, by increasing utilization of our payroll-related and human-resource-related ancillary products and services.
- Capitalizing on and leveraging our highly developed technological and operating infrastructure.
- Supplementing our growth through strategic acquisition or expansion of service offerings when opportunities arise.

### **Market Opportunities**

The outsourcing of business processes is a growing trend within the U.S. Outsourcing of the payroll and human resource functions allows small- to medium-sized businesses to minimize the administrative burden and compliance risks associated with increasingly complex and changing administrative requirements and federal, state, and local tax regulations. By utilizing the expertise of outsourcing service providers, businesses are better able to efficiently meet their compliance requirements and administrative burdens while, at the same time, providing competitive benefits for their employees. The technical capabilities, knowledge, and operational expertise that we have built, along with the broad portfolio of ancillary services we offer our clients, have enabled us to capitalize on the outsourcing trend.

We believe there are approximately 7.6 million employers in the geographic markets that we currently serve within the U.S. Of those employers, 99% have fewer than 100 employees and are our primary customers and target market. Based on publicly available industry data, we estimate that all payroll processors combined serve somewhere between 15% to 20% of the potential businesses in the target market, with much of the unpenetrated market being composed of businesses with ten or fewer employees. We remain focused on servicing small-to medium-sized businesses based upon the growth potential that we believe exists in this market segment.

Substantially all our revenue is generated within the U.S. We also generate revenue within Germany, which was less than 1% of our total revenue for the years ended May 31, 2006 and 2005.

### **Clients**

We serve a diverse base of small- to medium-sized clients operating in a broad range of industries located throughout the continental U.S. At May 31, 2006, we serviced approximately 543,000 clients. We utilize service agreements and arrangements with clients that are generally terminable by the client at any time or

upon relatively short notice. For the year ended May 31, 2006 (“fiscal 2006”), client retention was at a record level of slightly less than 80% of our beginning client base. The most significant factor contributing to client losses is companies going out of business. No single client has a material impact on total service revenue or results of operations.

The composition of the market and the client base we serve (in the U.S.) by employee size is as follows:

<u>Business size (Number of employees)</u>	<u>Estimated market distribution (7.6 million businesses in areas served)</u>	<u>Paychex, Inc. percentage of client base</u>
1-4	73%	39%
5-19	20%	42%
20-49	5%	13%
50-99	1%	4%
100+	1%	2%

### **Products and Services**

We offer a comprehensive portfolio of payroll, payroll-related, and human resource products and services to meet the diverse needs of our client base. These include:

- payroll processing;
- payroll tax administration services;
- employee payment services;
- regulatory compliance services (new-hire reporting and garnishment processing);
- comprehensive human resource administrative services;
- retirement services administration;
- workers’ compensation insurance administration;
- employee benefits administration;
- time and attendance solutions; and
- other human resource products and services.

By offering ancillary services that leverage the information gathered in the base payroll processing service, we are able to provide comprehensive outsourcing services that allow employers to expand their employee benefits offerings at an affordable cost. We earn our revenue primarily through recurring fees for services performed. Service revenue is primarily driven by the number of clients, utilization of ancillary services, and checks or transactions per client per pay period.

### **Payroll Processing**

Payroll processing is the foundation of our service portfolio. Our payroll service includes the calculation, preparation, and delivery of employee payroll checks; production of internal accounting records and management reports; and the preparation of federal, state, and local payroll tax returns. Payroll processing clients are charged a base fee each period that payroll is processed, plus a fee per employee check processed.

The Core Payroll service is generally targeted at clients with one to forty-nine employees, although many clients with fifty or more employees utilize this service. Our average Core Payroll client employs approximately thirteen people and processes approximately thirty payrolls each year. These figures are impacted year-over-year as larger clients, generally fifty or more employees, convert to our Major Market Services (“MMS”).

Core Payroll clients may communicate their payroll information, including hours worked by each employee and any personnel or compensation changes, by telephone, fax, use of the Paychex Paylink®

software, or the Internet. Each client is assigned a payroll specialist who is trained extensively and continuously in all facets of payroll preparation and applicable tax regulations. Clients receive payroll checks and reports from either a delivery service, the U.S. Postal Service, or by picking them up at the local Paychex branch.

We also offer Core Payroll services to our clients and their accountants through Paychex Online. This secure Internet site offers clients a suite of interactive, self-service products and services twenty-four hours a day, seven days a week. These include Paychex Online Payroll<sup>SM</sup>, Internet Time Sheet, Paychex Online Reports, and General Ledger Reporting Service. Clients can communicate payroll information through the Internet Time Sheet or use the Online Payroll service, and can access current and historical payroll information using Paychex Online Reports. The General Ledger Reporting Service transfers payroll information calculated by us to the clients' general ledger accounting software, eliminating manual entries and improving the accuracy of bookkeeping. Over 180,000 clients are currently utilizing some form of Paychex Online service.

MMS primarily targets companies that have more complex payroll and benefits needs or have outgrown our Core Payroll service, as well as new clients that have fifty or more employees. We currently offer this service in all of our significant markets. Approximately one-third of new MMS clients are conversions from our Core Payroll service.

Most MMS clients communicate their payroll information to us using our Preview<sup>®</sup> software. Preview provides clients with in-house control of payroll and human resource information because the software and the payroll and human resource database reside on the clients' personal computer or personal computer network. Clients can produce reports and checks at their convenience. We handle the software maintenance and provide the client ancillary products and services as requested.

#### **Ancillary Products and Services**

We provide our clients with a portfolio of ancillary products and services that have been developed and refined over many years. Ancillary products and services provide us with additional recurring revenue streams and increased service efficiencies as these products are integrated with payroll processing services. We offer the following ancillary products and services:

***Payroll Tax Administration Services:*** As of May 31, 2006, 92% of our clients utilized our payroll tax administration services (including Taxpay<sup>®</sup>), which provide accurate preparation and timely filing of quarterly and year-end tax returns, as well as the electronic transfer of funds to the applicable tax or regulatory agencies (federal, state, and local). More than 95% of new clients purchase our payroll tax administration services. We believe that the client utilization percentage of these services is near maturity. In connection with these services, we electronically collect payroll taxes from clients' bank accounts, typically on payday, prepare and file the applicable tax returns, and remit taxes to the applicable tax or regulatory agencies on the respective due dates. These taxes are typically paid between one and thirty days after receipt of collections from clients, with some items extending to ninety days. We handle all regulatory correspondence, amendments, and penalty and interest disputes, and we are subject to cash penalties imposed by tax or regulatory agencies for late filings and late or under payments of taxes. Clients utilizing the payroll tax administration services are charged a base fee and a fee per transaction for each period that payroll is processed. In addition to fees paid by clients, we earn interest on client funds that are collected before due dates and invested until remittance to the applicable tax or regulatory agencies.

***Employee Payment Services:*** As of May 31, 2006, 68% of our clients utilized our employee payment services, which provide the employer the option of paying their employees by direct deposit, Paychex Access Visa<sup>®</sup> Card, a check drawn on a Paychex account (Readychex<sup>®</sup>), or a check drawn on the employer's account and electronically signed by us. More than 75% of new clients purchase some form of employee payment services. For the first three methods, we electronically collect net payroll from the clients' bank account, typically one day before payday, and provide payment to the employee on payday. Our flexible payment options provide a cost-effective solution that offers the benefit of convenient, one-step payroll account reconciliation for employers. Clients utilizing employee payment services are charged a base fee for each

period that payroll is processed and a fee per transaction or per employee depending on the service provided. In addition to fees paid by clients, we earn interest on client funds that are collected before pay dates and invested until remittance to clients' employees.

The payroll tax administration services and employee payment services are integrated with our payroll processing service. Interest earned on funds held for clients is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services.

**Regulatory Compliance Services:** We offer new-hire reporting services, which enable clients to comply with federal and state requirements to report information on newly hired employees, to aid the government in enforcing child support orders, and to minimize fraudulent unemployment and workers' compensation insurance claims. Our garnishment processing service provides deductions from employees' pay, forwards payments to third-party agencies, including those that require electronic payments, and tracks the obligation to fulfillment. These services enable employers to comply with legal requirements and reduce the risk of penalties.

**Comprehensive Administrative Services:** The Paychex Premier<sup>SM</sup> Human Resource Services ("Paychex Premier") provide businesses a full-service approach to the outsourcing of employer and employee administrative needs. Paychex Premier offers businesses a combined package of services that includes payroll, employer compliance, human resource and employee benefits administration, risk management outsourcing, and the on-site availability of a professionally trained human resource representative. This comprehensive bundle of services is designed to make it easier for businesses to manage their payroll and benefit costs while providing a benefits package equal to that of larger companies. We also operate a Professional Employer Organization ("PEO"), which provides businesses with primarily the same services as Paychex Premier, except we serve as a co-employer of the clients' employees, assume the risks and rewards of workers' compensation insurance, and provide more sophisticated health care offerings to PEO clients. Our PEO service is available primarily for clients domiciled in Florida and Georgia, where the utilization of PEOs is more prevalent than other areas of the U.S. We offer our PEO service through our subsidiary, Paychex Business Solutions, Inc. For these two services, the client pays a fee per employee per processing period. As of May 31, 2006, Paychex Premier serviced over 236,000 client employees and our PEO product serviced approximately 59,000 client employees.

**Retirement Services Administration:** Our Retirement Services product line offers a variety of options to clients, including 401(k) plans, 401(k) SIMPLE, SIMPLE IRA, 401(k) plans with safe harbor provisions, profit sharing, and money purchase plans. These services provide plan implementation, ongoing compliance with government regulations, employee and employer reporting, participant and employer access online, electronic funds transfer, and other administrative services. Selling efforts for these services are focused primarily on our existing payroll client base, as the processed payroll information allows for data integration necessary to provide these services efficiently. Retirement Services were utilized by over 38,000 clients at May 31, 2006. This demonstrates the continuing interest of small- to medium-sized businesses in providing retirement savings benefits to their employees. We believe that we are now one of the largest 401(k) recordkeepers for small businesses in the U.S. Clients utilizing this service are charged a one-time set up fee, a monthly recurring fee, and a fee per employee. Client employee 401(k) funds externally managed totaled approximately \$6.3 billion at May 31, 2006. We earn a fee approximating forty basis points from the external managers based on the total of client employee 401(k) funds.

**Workers' Compensation Insurance Administration:** Most employers are required to carry workers' compensation insurance, which provides payments to employees who are unable to work because of job-related injuries. We provide workers' compensation insurance administration services by serving, through our licensed insurance agency, as a general agent providing qualified workers' compensation insurance through a variety of insurance carriers who are underwriters. Our Workers' Compensation Payment Service uses rate and job classification information to enable clients to pay workers' compensation premiums in regular monthly amounts rather than with large up-front payments, which stabilizes their cash flow and minimizes year-end adjustments. Our Workers' Compensation Report Service provides our clients with comprehensive informa-

tion to allow them to better manage workers' compensation insurance costs. As of May 31, 2006, over 52,000 clients utilized the workers' compensation insurance administration services.

**Employee Benefits Administration:** We offer the outsourcing of plan administration under section 125 of the Internal Revenue Code. The Premium Only Plan allows employees to pay for certain health insurance benefits with pretax dollars, which can result in a reduction in payroll taxes for employers and employees. The Flexible Spending Account Plan allows our clients' employees to pay, with pretax dollars, health and dependent care expenses not covered by insurance. All required implementation, administration, compliance, claims processing and reimbursement, and coverage tests are provided with these services. The Health Savings Account product serves as a tax savings tool for employers and employees, allowing individuals to save money tax-free to pay for qualified medical expenses now and in the future. It also provides the means to manage rising health insurance premiums.

**Time and Attendance Solutions:** We offer Time In A Box® and other time and attendance solutions, which help employers minimize the time spent compiling time sheet information. These computer-based systems allow the employer flexibility to handle multiple payroll scenarios and result in improved productivity, accuracy, and reliability in the payroll process. Certain clients are charged a monthly fee for use of hardware, software, and support. Clients also have the option to purchase the hardware and software with annual maintenance contracts. Time In A Box is marketed to our small- to medium-sized clients, while other time and attendance solutions are marketed to larger clients.

**Other Human Resource Products and Services:** Group health benefits are offered in select geographic areas, as are state unemployment insurance services, which provide clients with prompt processing for all claims, appeals, determinations, change statements, and requests for separation documents. Other Human Resource Services products include employee handbooks, management manuals, and personnel and required regulatory forms. These products are designed to simplify clients' office processes and enhance their employee benefits programs.

## **Sales and Marketing**

We market our services primarily through our direct sales force based in the metropolitan markets we serve. Our sales representatives specialize in Core Payroll, MMS payroll, or Human Resource Services product lines. For fiscal 2007, our sales force is expected to total approximately 2,035, with 1,190 for Core Payroll (including international), 225 for MMS payroll, and 620 for various Human Resource Services products. The Human Resource Services sales force includes 285 human resources and Retirement Services sales representatives, 190 Paychex Premier and PEO sales representatives, 110 licensed agents selling workers' compensation insurance and health and benefits services, and 35 time and attendance solution sales representatives. Growth in the direct sales force results from the offering of new products and services, particularly as it relates to licensed agents for health and benefits and the continued expansion within Germany. The direct sales force has grown with the addition of time and attendance solutions. The complexity of the time and attendance solutions requires specialized sales representatives.

In addition to our direct selling and marketing efforts, we utilize relationships with existing clients, certified public accountants ("CPAs"), and banks for new client referrals. Approximately two-thirds of our new clients (excluding acquisitions) come from these referral sources. To further enhance our strong relationship with CPAs, we have partnered with the American Institute of Certified Public Accountants ("AICPA") as the preferred payroll provider for its AICPA Business Solutions Partner Program. During the year ended May 31, 2005, the program was expanded to include our Retirement Services and MMS.

Our website at [www.paychex.com](http://www.paychex.com), which includes online payroll sales presentations and product and service information, is a cost-efficient tool that serves as a source of leads and new sales while complementing the efforts of our direct sales force. This online tool allows us to market to clients in more geographically remote areas. Our sales representatives are also supported by marketing, advertising, public relations, trade shows, and telemarketing programs. We have grown and expect to continue to grow our direct sales force. In recent years, we have increased our emphasis on the selling of ancillary services to both new clients and our existing client base.



In addition, Advantage Payroll Services, Inc. (“Advantage”) has license agreements with fifteen independently owned associate offices (“Associates”), which are responsible for selling and marketing Advantage payroll services and performing certain operational functions, while Paychex, Inc. and Advantage provide all centralized back-office payroll processing and payroll tax administration services. In addition, Advantage has a relationship with New England Business Service, Inc. (“NEBS”) whereby Advantage performs all client functions other than sales and marketing. The marketing and selling by both Associates and NEBS is conducted under their respective logos.

## **Competition**

The market for payroll processing and human resource services is highly competitive and fragmented. We believe our primary national competitor, ADP® (“Automatic Data Processing, Inc.”), is the largest U.S. third-party provider of payroll processing and human resource services in terms of revenue. We compete with other national, regional, local, and online service providers, all of which we believe have significantly smaller client bases than us.

In addition to traditional payroll processing and human resource service providers, we compete with in-house payroll and human resource systems and departments. Payroll and human resource systems and software are sold by many vendors. Our Human Resource Services products also compete with a variety of providers of human resource services, such as retirement services companies, insurance companies, and human resources and benefits consulting firms.

Competition in the payroll processing and human resource services industry is primarily based on service responsiveness, product quality and reputation, breadth of product and service offering, and price. We believe we are competitive in each of these areas.

## **Software Maintenance and Development**

The ever-changing mandates of federal, state, and local tax or regulatory agencies require us to regularly update the proprietary software we utilize to provide Payroll and Human Resource Services to our clients. We are continually engaged in developing enhancements to and maintenance of our various software platforms to meet the changing requirements of our clients and the marketplace.

## **Employees**

As of May 31, 2006, we employed approximately 10,900 people. None of our employees were covered by collective bargaining agreements.

## **Intellectual Property**

We own or license and use a number of trademarks, trade names, copyrights, service marks, trade secrets, computer programs and software, and other intellectual property rights. Taken as a whole, our intellectual property rights are material to the conduct of our business. Where it is determined to be appropriate, we take measures to protect our intellectual property rights, including, but not limited to, confidentiality/non-disclosure agreements or policies with employees, vendors, and others; license agreements with licensees and licensors of intellectual property; and registration of certain trademarks. We believe that the “Paychex” name, trademark, and logo are of material importance to us.

## **Seasonality**

There is no significant seasonality to our business. However, during our third fiscal quarter, which ends in February, the number of new Payroll clients, new Retirement Services clients, and new Paychex Premier and PEO worksite employees tends to be higher than during the rest of the fiscal year, primarily because a majority of new clients begin using our services in the beginning of a calendar year. In addition, calendar year-end transaction processing and client funds activity are traditionally higher during the third fiscal quarter due to clients paying year-end bonuses and requesting additional year-end services. Historically, as a result of these

factors, our total revenue has been slightly higher in the third fiscal quarter, with greater sales commission expenses also reported in this quarter.

## **Other**

Information about our products and services, stockholder information, press releases, and filings with the SEC can be found on our website at [www.paychex.com](http://www.paychex.com). Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and other SEC filings, and any amendments to such reports and filings, are made available, free of charge, on the Investor Relations section of our website as soon as reasonably practical after such material is filed with, or furnished to, the SEC. Also, copies of our Annual Report to Stockholders and Proxy Statement, to be issued in connection with our 2006 Annual Meeting of Stockholders, will be made available, free of charge, upon written request submitted to Paychex, Inc., c/o Corporate Secretary, 911 Panorama Trail South, Rochester, New York 14625-2396.

## **Item 1A. Risk Factors**

Our future results of operations are subject to a number of risks and uncertainties. These risks and uncertainties could cause actual results to differ materially from historical and current results and from our projections. Important factors known to us that could cause such differences include, but are not limited to, those discussed below and those contained in the "Safe Harbor" statement at the beginning of Part I of this Form 10-K.

***We may make errors and omissions in providing services, which could result in significant penalties and liabilities for us:*** Processing, tracking, collecting, and remitting client funds to the applicable tax or regulatory agencies, client employees, and other third parties are complex operations. These tasks could be subject to error and these errors could include, but are not limited to, late filing with applicable tax or regulatory agencies, underpayment of taxes, and failure to comply with applicable banking regulations and laws relating to employee benefits administration, which could result in significant penalties and liabilities that would adversely affect our results of operations. We could also transfer funds in error to an incorrect party or for the wrong amount, and may be unable to correct the error or recover the funds, resulting in a loss to us.

***Our business and reputation may be affected by our ability to keep clients' information confidential:*** Our business involves the use of significant amounts of private and confidential client information including employees identification numbers, bank accounts, and retirement account information. This information is critical to the accurate and timely provision of services to our clients, and certain information may be transmitted via the Internet. There is no guarantee that our systems and processes are adequate to protect against all security breaches. If our systems are disrupted or fail for any reason, or if our systems are infiltrated by unauthorized persons, our clients could experience data loss, financial loss, harm to reputation, or significant business interruption. Such events may expose us to unexpected liability, litigation, regulation investigation and penalties, loss of clients business, unfavorable impact to business reputation, and there could be a material adverse effect on our business and results of operations.

***We may be adversely impacted by changes in government regulations and policies:*** Many of our services, particularly payroll tax administration services and benefit plan administration services, are designed according to government regulations that continue to change. Changes in regulations could affect the extent and type of benefits employers are required, or may choose, to provide employees or the amount and type of taxes employers and employees are required to pay. Such changes could reduce or eliminate the need for some of our services and substantially decrease our revenue. Added requirements could also increase our cost of doing business. Failure by us to modify our services in a timely fashion in response to regulatory changes could have adverse effects on our business and results of operations.

***We may be adversely impacted by failure of third-party service providers to perform their functions:*** As part of providing services to clients, we rely on a number of third-party service providers. These providers include, but are not limited to, couriers used to deliver client payroll checks and banks used to electronically transfer funds from clients to their employees. Failure by these providers, for any reason, to deliver their

services in a timely manner could result in material interruptions to our operations, impact client relations, and result in significant penalties or liabilities to us.

***In the event of a catastrophe our business continuity plan may fail, which could result in the loss of client data and adversely interrupt operations:*** Our operations are dependent on our ability to protect our infrastructure against damage from catastrophe or natural disaster, unauthorized security breach, power loss, telecommunications failure, terrorist attack, or other events that could have a significant disruptive effect on our operations. We have a business continuity plan in place in the event of system failure due to any of these events. If the business continuity plan is unsuccessful in a disaster recovery scenario, we could potentially lose client data or experience material adverse interruptions to our operations or delivery of services to our clients.

***We may not be able to keep pace with changes in technology:*** To maintain our growth strategy, we must adapt and respond to technological advances and technological requirements of our clients. Our future success will depend on our ability to enhance capabilities and increase the performance of our internal use systems, particularly our systems that meet our clients' requirements. We continue to make significant investments related to the development of new technology. If our systems become outdated, we may be at a disadvantage when competing in our industry. There can be no assurance that our efforts to update and integrate systems will be successful. If we do not timely integrate and update our systems, or if our investments in technology fail to provide the expected results, there could be an adverse impact to our business and results of operations.

***We may not realize the anticipated benefits from acquisitions:*** The effective integration of acquired companies may be difficult to achieve. It is also possible that we may not realize any or all expected benefits from acquisitions or achieve benefits from acquisitions in a timely manner. In addition, we may incur significant costs and management's time and attention may be diverted in connection with the integration of acquisitions. Failure to effectively integrate future acquisitions could affect our results of operations. We currently have no definitive agreements or current plans with respect to any material prospective acquisitions.

***We may have an adverse outcome of legal matters, which could harm our business:*** We are subject to various claims and legal matters that arise in the normal course of business. These include disputes or potential disputes related to breach of contract, employment-related claims, tax claims, and other matters. As of May 31, 2006, we have a reserve of \$15.6 million for pending legal matters. See Item 3 of this Form 10-K for additional disclosure. In light of the legal reserve recorded, our management currently believes that resolution of these matters will not have a material adverse effect on our financial position or results of our operations. However, these matters are subject to inherent uncertainties and there exists the possibility that their ultimate resolution could have a material adverse impact on our financial position and results of operations in the period in which any such effect is recorded.

***We may experience a loss as the result of our clients having insufficient funds to cover payments we have made on their behalf to applicable tax or regulatory agencies and employees:*** As part of the payroll processing service, we are authorized by our clients to transfer money from their bank accounts to fund amounts owed to their employees and applicable tax or regulatory agencies. It is possible that we would be held liable for such amounts in the event the client has insufficient funds to cover them. We have in the past, and may in the future, make payments on our clients' behalf for which we are not reimbursed, resulting in a loss to us.

***Our interest earned on funds held for clients may be impacted by changes in government regulations mandating the amount of tax withheld or timing of remittance:*** We receive interest income from investing client funds collected but not yet remitted to applicable tax or regulatory agencies or to client employees. A change in regulations either decreasing the amount of taxes to be withheld or allowing less time to remit taxes to applicable tax or regulatory agencies would adversely impact this interest income.

***We may be exposed to additional risks related to a foreign operation as a result of our business in Germany:*** We currently have approximately 500 clients in Germany. As a result, our business is subject to political and economic instability unrelated to our operations in the U.S. Additionally, our business in Germany exposes us to currency fluctuations and we must operate under legal and tax regulations that differ from those of the U.S. We do not currently hedge our foreign currency transactions due to the relatively

insignificant amounts. Our entry into foreign operations requires a significant investment and management's attention. There can be no assurance that our investment in Germany will produce expected levels of revenue or that other factors noted previously will not harm our business.

**Quantitative and qualitative disclosures about market risk:** Refer to Item 7A of this Form 10-K for a discussion on Market Risk Factors.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

We owned and leased the following properties at May 31, 2006:

	<u>Square feet</u>
Owned facilities:	
Rochester, New York* .....	668,000
Other U.S. locations .....	<u>105,000</u>
Total owned facilities .....	<u>773,000</u>
Leased facilities:	
Rochester, New York .....	79,000
Other U.S. locations .....	2,040,000
Germany .....	<u>1,000</u>
Total leased facilities .....	<u>2,120,000</u>

\* Includes the 140,000-square-foot building complex of our corporate headquarters located at 911 Panorama Trail South, Rochester, New York 14625.

Our facilities in Rochester, New York house various distribution, processing, and technology functions, certain ancillary functions, a telemarketing unit, and other back-office functions. Facilities outside of Rochester, New York are at various locations throughout the U.S. and Germany and house our regional, branch, and sales offices and data processing centers. These locations are concentrated in metropolitan areas. We believe that adequate, suitable lease space will continue to be available for our needs.

**Item 3. Legal Proceedings**

We are subject to various claims and legal matters that arise in the normal course of our business. These include disputes or potential disputes related to breach of contract, employment-related claims, tax claims, and other matters.

We and our wholly owned subsidiary, Rapid Payroll, Inc. ("Rapid Payroll"), are currently defendants in three lawsuits pending in the United States Bankruptcy Court, Central District of California, thirteen lawsuits pending in the United States Court of Appeals for the Ninth Circuit, and one lawsuit pending in the California Court of Appeal, Second District, all brought in calendar years 2002 and 2003 by licensees of payroll processing software owned by Rapid Payroll.

In August 2001, Rapid Payroll informed seventy-six licensees that it intended to stop supporting the payroll processing software in August of 2002. Thereafter, lawsuits were commenced by licensees asserting various claims, including breach of contract and related tort and fraud causes of action. These lawsuits sought compensatory damages, punitive damages, and injunctive relief against Rapid Payroll, us, our former Chief Executive Officer, and our Senior Vice President of Sales and Marketing. In accordance with our indemnification agreements with our senior executives, we will defend and, if necessary, indemnify them in connection with these pending matters.

On July 5, 2002, the federal district court entered a preliminary injunction requiring that Rapid Payroll and us continue to support and maintain the subject software pursuant to the license agreements.

In 2005, judgment was entered in *Accuchex, Inc. v. Rapid Payroll, Inc., et al.* following a bench trial before a judge of the Los Angeles County Superior Court. The judgment provided that the limitation of liability clause in the parties' license agreement is valid and enforceable. The court awarded Accuchex damages of \$30.5 thousand plus a refund of approximately \$35.0 thousand in license fees. The court also ordered Rapid Payroll to support its software being used by Accuchex until such time as Rapid Payroll dissolves, which the court found Rapid Payroll was entitled to do without incurring any further liability to Accuchex. The court rejected all of the other causes of action asserted by the plaintiff. The case is pending on appeal with the California Court of Appeal, Second District.

On February 28 and March 1, 2005, the United States District Court, Central District of California entered judgment in thirteen of the cases pending before it. Those judgments provided that Rapid Payroll's liability is limited by the license fees paid to it by the plaintiff licensees, pursuant to express contractual provisions of the license agreements. Those judgments also extended the court's preliminary injunction, ordering that Rapid Payroll must support the licensed software through April 30, 2006, and, at that time, refund to each of the licensee plaintiffs the license fees paid by that plaintiff. The license fees received by Rapid Payroll under the agreements from these thirteen licensee plaintiffs total approximately \$2.5 million. The federal court also ordered the release of the source code pursuant to the escrow terms of the license agreements. The federal court judgments rejected the fraud and other tort claims brought by those plaintiffs against all of the defendants. Plaintiffs have appealed the federal court rulings and we have cross-appealed.

On May 4, 2006, following expiration of the federal district court's injunction, Rapid Payroll filed a petition under Chapter 11 of the U.S. Bankruptcy Code in order to develop a plan that allows Rapid Payroll to discontinue support for the software in a manner that deals fairly with its few remaining licensees. Rapid Payroll is continuing to operate as a debtor-in-possession, paying all of its post-petition debts as they become due.

Based on the application of Statement of Financial Accounting Standard ("SFAS") No. 5, "Accounting for Contingencies," we are required to record a reserve if we believe an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated. Our legal reserve for all litigation totaled \$15.6 million at May 31, 2006, and is included in current liabilities on the Consolidated Balance Sheets. The legal reserve has been reduced during fiscal 2006 as actual settlements and incurred professional fees have been charged against it.

In light of the legal reserve recorded, our management currently believes that resolution of these matters will not have a material adverse effect on our financial position or results of operations. However, these 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 our financial position and results of operations in the period in which any such effect is recorded.

#### **Item 4. *Submission of Matters to a Vote of Security Holders***

No matters were submitted to a vote of security holders, through the solicitation of proxies or otherwise, during the three months ended May 31, 2006.

## **PART II**

#### **Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock trades on The NASDAQ Stock Market® under the symbol "PAYX." Dividends have historically been paid in August, November, February, and May. The level and continuation of future dividends are dependent on our future earnings and cash flows, and are subject to the discretion of the Board of Directors.

On June 30, 2006, there were 18,240 holders of record of our common stock, which includes registered holders and participants in the Paychex, Inc. Dividend Reinvestment and Stock Purchase Plan. There were also 9,284 participants in the Paychex, Inc. Employee Stock Purchase Plan and 6,556 participants in the Paychex, Inc. Employee Stock Ownership Plan.

The high and low sale prices for our common stock as reported on The NASDAQ Stock Market and dividends for each of the years ended May 31, 2006 and 2005, are as follows:

	Fiscal 2006			Fiscal 2005		
	Sales prices		Cash dividends declared per share	Sales prices		Cash dividends declared per share
	High	Low		High	Low	
First quarter .....	\$35.37	\$28.60	\$0.13	\$38.88	\$28.83	\$0.12
Second quarter .....	\$43.37	\$32.37	\$0.16	\$34.45	\$29.25	\$0.13
Third quarter .....	\$43.20	\$35.52	\$0.16	\$34.57	\$29.69	\$0.13
Fourth quarter .....	\$42.37	\$36.11	\$0.16	\$34.69	\$28.88	\$0.13

The closing price of our common stock on May 31, 2006, as reported on The NASDAQ Stock Market, was \$36.71 per share.

#### Item 6. Selected Financial Data

In thousands, except per share amounts Year ended May 31,	2006	2005	2004	2003	2002
Service revenue .....	\$1,573,797	\$1,384,674	\$1,240,093	\$1,046,029	\$ 892,189
Interest on funds held for clients .....	100,799	60,469	54,254	53,050	62,721
Total revenue .....	\$1,674,596	\$1,445,143	\$1,294,347	\$1,099,079	\$ 954,910
Operating income .....	\$ 649,571	\$ 533,775	\$ 433,315	\$ 401,041	\$ 363,694
As a % of total revenue .....	39%	37%	33%	36%	38%
Net income .....	\$ 464,914	\$ 368,849	\$ 302,950	\$ 293,452	\$ 274,531
As a % of total revenue .....	28%	26%	23%	27%	29%
Diluted earnings per share .....	\$ 1.22	\$ 0.97	\$ 0.80	\$ 0.78	\$ 0.73
Cash dividends per common share .....	\$ 0.61	\$ 0.51	\$ 0.47	\$ 0.44	\$ 0.42
Purchases of property and equipment ..	\$ 81,143	\$ 70,686	\$ 50,562	\$ 60,212	\$ 54,378
Total assets .....	\$5,549,302	\$4,617,418	\$3,950,203	\$3,690,783	\$2,953,075
Total debt .....	\$ —	\$ —	\$ —	\$ —	\$ —
Stockholders' equity .....	\$1,654,843	\$1,385,676	\$1,199,973	\$1,077,371	\$ 923,981
Return on stockholders' equity .....	30%	28%	28%	29%	32%

#### Item 7. 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. ("we," "our," or "us") for each of the three fiscal years ended May 31, 2006 ("fiscal 2006"), May 31, 2005 ("fiscal 2005"), and May 31, 2004 ("fiscal 2004"), and our financial condition at May 31, 2006. This review should be read in conjunction with the accompanying Consolidated Financial Statements and the related Notes to Consolidated Financial Statements contained in Item 8 of this Annual Report on Form 10-K ("Form 10-K") and the "Risk Factors" discussed in Item 1A of this Form 10-K. Forward-looking statements in this review are qualified by the cautionary statement under the heading "Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995 contained at the beginning of Part I of this Form 10-K.

## Overview

We are a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses. Our Payroll and Human Resource Services product lines offer a portfolio of products and services that allow our clients to meet their diverse payroll and human resource needs.

Our Payroll services are provided through either our Core Payroll or Major Market Services (“MMS”) and include:

- payroll processing;
- payroll tax administration services;
- employee payment services; and
- other payroll-related services including regulatory compliance (new-hire reporting and garnishment processing).

MMS is utilized by clients that have more complex payroll and benefits needs. While MMS is focused on the more than fifty employees market segment, MMS has many clients with less than fifty employees that have more complex payroll requirements.

Our Human Resource Services primarily include:

- comprehensive human resource administrative services, which include Paychex Premier<sup>SM</sup> Human Resources (“Paychex Premier”) and our Professional Employer Organization (“PEO”);
- retirement services administration;
- workers’ compensation insurance administration;
- employee benefits administration;
- time and attendance solutions; and
- other human resource products and services.

We earn revenue primarily through recurring fees for services performed related to our products. Service revenue is primarily driven by the number of clients, utilization of ancillary services, and checks or transactions per client per pay period. We also earn interest on funds held for clients between the time of collection from our clients and remittance to the applicable tax or regulatory agencies or client employees. Our strategy is focused on achieving strong long-term financial performance while providing high-quality, timely, accurate, and affordable services, growing our client base, increasing utilization of our ancillary services, and leveraging our technological and operating infrastructure.

Fiscal 2006 was our sixteenth consecutive year of record total revenue, net income, and diluted earnings per share. Our financial results for fiscal 2006 included the following highlights:

- Net income increased 26% to \$464.9 million.
- We achieved \$1.22 diluted earnings per share in fiscal 2006, an increase of 26%.
- Total revenue increased 16% to \$1,674.6 million.
- Payroll service revenue increased 10% to \$1,248.9 million.
- Human Resource Services revenue increased 29% to \$324.9 million.
- Operating income increased 22% to \$649.6 million. Operating income excluding interest on funds held for clients increased 16% to \$548.8 million.
- Cash flow from operations increased 22% to \$569.2 million.
- Dividends of \$231.5 million were paid to stockholders, representing 50% of net income.

Our financial performance in fiscal 2006 was largely due to strong service revenue growth of 14%. This growth in service revenue was attributable to growth in client base, check volume, and utilization of ancillary services.

Our financial performance was also positively impacted by the effects of increases in interest rates earned on our funds held for clients and corporate investment portfolios. The Federal Reserve increased the Federal Funds rate by 200 basis points in fiscal 2005 and by another 200 basis points in fiscal 2006 to a rate of 5.00% at May 31, 2006. Our combined interest on funds held for clients and corporate investment income increased 73% for fiscal 2006. In fiscal 2006, our combined portfolios earned an average rate of return of 3.2%, increased from 2.2% in fiscal 2005 and 1.8% in fiscal 2004. The impact of changing interest rates and related risks is discussed in more detail in the "Market Risk Factors" section in Item 7A of this Form 10-K.

We continue to make investments in our business as part of our growth strategy. Some of these investments include the following:

**Growing the client base and increasing utilization of ancillary services:** Our client base increased to approximately 543,000 clients at May 31, 2006. This compares with approximately 522,000 clients at May 31, 2005, and approximately 505,000 clients at May 31, 2004. Client growth was approximately 4.0% for fiscal 2006, compared with approximately 3.5% for fiscal 2005.

We have continued to invest in our direct sales force, as we believe there is opportunity for growth within our target market of small- to medium-sized businesses. The approximate composition of our direct sales force is summarized in the following table:

<u>For fiscal year ended May 31,</u>	<u>Expected 2007</u>	<u>Change</u>	<u>2006</u>	<u>Change</u>	<u>2005</u>	<u>Change</u>	<u>2004</u>
Core Payroll (including international) .....	1,190	7%	1,115	6%	1,050	7%	985
MMS payroll .....	225	15%	195	15%	170	13%	150
Human Resources/Retirement Services .....	285	19%	240	9%	220	10%	200
Paychex Premier and PEO .....	190	19%	160	14%	140	33%	105
Licensed agents for workers' compensation and health and benefits .....	110	57%	70	40%	50	25%	40
Time and attendance solutions .....	35	40%	25	25%	20	100%	—
Total sales representatives .....	<u>2,035</u>	13%	<u>1,805</u>	9%	<u>1,650</u>	12%	<u>1,480</u>

We believe there are opportunities for growth within our current client base, as well as with new clients, through increased utilization of our payroll-related and human resource ancillary services. Ancillary services effectively leverage payroll processing data and, therefore, are beneficial to our operating margin. Penetration of our payroll tax administration services has continued to increase, and was 92% at May 31, 2006, compared with 90% at May 31, 2005, and 89% at May 31, 2004. Employee payment services penetration has increased to 68% at May 31, 2006, compared with 65% at May 31, 2005, and 63% at May 31, 2004. Our client bases in the Human Resource Services areas have continued to grow, as shown in the following table:

<u>As of May 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Retirement Services clients .....	38,000	33,000	29,000
Workers' compensation insurance clients .....	52,000	44,000	37,000
Paychex Premier worksite employees .....	236,000	171,000	106,000
PEO worksite employees .....	59,000	54,000	51,000

**Product and service initiatives:** During fiscal 2006, we made investments to broaden our portfolio of products and services and expand into new markets, and:

- Enhanced our 401(k) recordkeeping service, allowing our clients use of our recordkeeping with significantly expanded investment choices.



- Developed an online time and labor management tool to be added to our suite of time and attendance solutions to better serve our MMS clients.
- Continued our expansion within Germany.
- Expanded our health benefits nationwide, simplifying the process for our clients in obtaining coverage through our network of national and regional insurers.
- Released our Health Savings Account product, which serves as a tax savings tool for employers and employees, allowing individuals to save money tax-free to pay for qualified medical expenses now and in the future. This provides a means to manage rising insurance premiums.

**Business acquisitions:** We will supplement our growth through strategic acquisition when opportunities arise. In the fiscal year ended May 31, 2003, we expanded our client base through the acquisitions of Advantage Payroll Services, Inc. (“Advantage”) and InterPay, Inc. (“InterPay”). In fiscal 2004, the acquisition of substantially all the assets and certain liabilities of Stromberg LLC (“Stromberg”) along with the acquisition of Stromberg’s Time In A Box® product, allowed us to expand our product offering to include time and attendance solutions and thus offer value-added products and services to payroll and non-payroll clients. We currently have no definitive agreements or current plans with respect to any material prospective acquisition.

**Focus on customer service:** We have always focused on customer service and the maximization of client retention. Fiscal 2006 client retention is at record levels of slightly less than 80% of our beginning client base. The most significant factor contributing to client losses is companies going out of business. In fiscal 2006, we reduced the number of clients per payroll specialist due to our commitment to continuously improve client service.

**Financial position:** At May 31, 2006, we maintained a strong financial position with total cash and corporate investments of \$577.4 million. We also had \$384.5 million in long-term corporate investments at May 31, 2006. Our primary source of cash is our ongoing operations. Cash flow from operations was \$569.2 million in fiscal 2006 compared to \$466.6 million in fiscal 2005. Historically, we have funded our operations, capital purchases, and dividend payments from our operating activities. It is anticipated that current cash and corporate investment balances, along with projected operating cash flows, will support our normal business operations, capital purchases, and dividend payments for the foreseeable future.

For further analysis of our results of operations for fiscal years 2006, 2005, and 2004, and our financial position at May 31, 2006, refer to the tables and analysis in the “Results of Operations” and “Liquidity and Capital Resources” sections of this Item 7 and the discussion in the “Critical Accounting Policies” section of this Item 7.

## Outlook

Our current outlook for the full fiscal year ended May 31, 2007 (“fiscal 2007”) is based upon current economic conditions and interest rate levels as of May 31, 2006, and is summarized as follows:

- Payroll service revenue growth is projected to be in the range of 9% to 11%.
- Human Resource Services revenue growth is expected to be in the range of 20% to 23%.
- Total service revenue growth is projected to be in the range of 11% to 13%.
- Interest on funds held for clients is expected to increase approximately 28% to 30%.
- Total revenue growth is estimated to be in the range of 12% to 14%.
- Corporate investment income is anticipated to increase approximately 45% to 50%.
- Stock-based compensation costs will be primarily included in selling, general and administrative expenses and are expected to impact pre-tax and net income in the range of 4% to 5%.

- The effective income tax rate is expected to be approximately 31.0%.
- Net income growth is expected to be in the range of 12% to 14%.

Purchases of property and equipment in fiscal 2007 are expected to be in the range of \$85 million to \$90 million, in line with our growth rates. Fiscal 2007 depreciation expense is projected to be approximately \$55 million, and we project amortization of intangible assets for fiscal 2007 to be approximately \$14 million.

Our projections are based on current economic and interest rate conditions continuing with no significant changes. We estimate that the earnings effect of a 25-basis-point change in interest rates (17 basis points for tax-exempt investments) at the beginning of fiscal 2007 would be in the range of \$4.5 million to \$5.0 million for fiscal 2007. The total investment portfolio (funds held for clients and corporate investments) is expected to average approximately \$4.5 billion in fiscal 2007. Given current accounting interpretations, in order to preserve the accounting treatment on available-for-sale securities of recording market value fluctuations through comprehensive income instead of through the income statement, we do not expect to realize any losses in the investment portfolios in fiscal 2007.

## Results of Operations

### Summary of Results of Operations for the Fiscal Years Ended May 31:

<u>In millions, except per share amounts</u>	<u>2006</u>	<u>Change</u>	<u>2005</u>	<u>Change</u>	<u>2004</u>
<b>Revenue:</b>					
Payroll service revenue . . . . .	\$1,248.9	10%	\$1,133.5	9%	\$1,040.0
Human Resource Services revenue . . . . .	324.9	29%	251.2	26%	200.1
Total service revenue . . . . .	1,573.8	14%	1,384.7	12%	1,240.1
Interest on funds held for clients . . . . .	100.8	67%	60.4	11%	54.2
<b>Total revenue . . . . .</b>	<b>1,674.6</b>	<b>16%</b>	<b>1,445.1</b>	<b>12%</b>	<b>1,294.3</b>
Combined operating and SG&A expenses . . . . .	1,025.0	12%	911.3	6%	861.0
<b>Operating income . . . . .</b>	<b>649.6</b>	<b>22%</b>	<b>533.8</b>	<b>23%</b>	<b>433.3</b>
As a % of total revenue . . . . .	39%		37%		33%
Investment income, net . . . . .	25.2	103%	12.4	-25%	16.5
<b>Income before income taxes . . . . .</b>	<b>674.8</b>	<b>24%</b>	<b>546.2</b>	<b>21%</b>	<b>449.8</b>
As a % of total revenue . . . . .	40%		38%		35%
Income taxes . . . . .	209.9	18%	177.4	21%	146.8
<b>Net income . . . . .</b>	<b>\$ 464.9</b>	<b>26%</b>	<b>\$ 368.8</b>	<b>22%</b>	<b>\$ 303.0</b>
As a % of total revenue . . . . .	28%		26%		23%
<b>Diluted earnings per share . . . . .</b>	<b>\$ 1.22</b>	<b>26%</b>	<b>\$ 0.97</b>	<b>21%</b>	<b>\$ 0.80</b>

Details regarding our combined funds held for clients and corporate investment portfolios are as follows:

<u>\$ in millions</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Average investment balances:			
Funds held for clients .....	\$3,080.3	\$2,759.7	\$2,515.3
Corporate investments .....	<u>840.3</u>	<u>599.5</u>	<u>446.9</u>
Total .....	<u>\$3,920.6</u>	<u>\$3,359.2</u>	<u>\$2,962.2</u>
Average interest rates earned (exclusive of realized gains/losses):			
Funds held for clients .....	3.2%	2.2%	1.7%
Corporate investments .....	2.9%	2.1%	2.3%
Combined funds held for clients and corporate investments .....	3.2%	2.2%	1.8%
Net realized gains/ (losses):			
Funds held for clients .....	\$ 0.9	\$ 0.3	\$ 11.7
Corporate investments .....	<u>0.1</u>	<u>(0.1)</u>	<u>7.4</u>
Total .....	<u>\$ 1.0</u>	<u>\$ 0.2</u>	<u>\$ 19.1</u>
<u>As of May 31,</u>			
<u>\$ in millions</u>			
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Unrealized losses on available-for-sale securities .....	\$ (22.0)	\$ (9.9)	\$ (4.2)
Federal Funds rate .....	5.00%	3.00%	1.00%
Three-year "AAA" municipal securities yield .....	3.65%	2.85%	2.50%
Total market value of available-for-sale securities .....	\$3,852.4	\$3,567.2	\$3,269.9
Average duration of available-for-sale securities (in years) (A) ..	2.0	2.1	2.1
Weighted-average yield-to-maturity of available-for-sale securities (A) .....	3.0%	2.6%	2.3%

(A) These items exclude the impact of auction rate securities and variable rate demand notes ("VRDNs") as they are tied to short-term interest rates.

**Revenue:** The increases in Payroll service revenue in fiscal 2006 as compared to fiscal 2005, and in fiscal 2005 as compared to fiscal 2004, were primarily attributable to growth in clients, check volume, and utilization of our ancillary services.

As of May 31, 2006, 92% of all clients utilized our payroll tax administration services, compared with 90% at May 31, 2005, and 89% at May 31, 2004. We believe our client utilization percentage of these services is near maturity. Our employee payment services were utilized by 68% of our clients at May 31, 2006, compared with 65% at May 31, 2005, and 63% at May 31, 2004. More than 95% of new clients purchase our payroll tax administration services and more than 75% of new clients purchase our employee payment services.

MMS revenue increased 27% for both fiscal 2006 and fiscal 2005 to \$225.0 million and \$176.9 million, respectively. Approximately one-third of our new MMS clients are conversions from our Core Payroll service. We had over 33,000 MMS clients at May 31, 2006.

Human Resource Services revenue increased 29% in fiscal 2006 and 26% in fiscal 2005 as a result of higher revenue from the following services:

- We have continued to see growth in the number of clients utilizing our Retirement Services product. Retirement Services revenue increased 16% for fiscal 2006 and 17% for fiscal 2005 to \$106.1 million and \$91.4 million, respectively. We serviced over 38,000 and over 33,000 Retirement Services clients at May 31, 2006 and 2005, respectively.

- Sales of our Paychex Premier product, a comprehensive payroll and integrated human resource and employee benefits outsourcing solution for small- to medium-sized businesses, have been strong, as administrative fee revenue from this product increased 57% for fiscal 2006 and 66% for fiscal 2005 to \$52.6 million and \$33.6 million, respectively. The increases in administrative fee revenue were driven primarily by client growth. Administrative fee revenue in fiscal 2006 also benefited from the implementation of initial enrollment fees, effective May 1, 2005. As of May 31, 2006, our Paychex Premier product serviced over 236,000 client employees, as compared with over 171,000 client employees at May 31, 2005.
- Revenue from the PEO product increased 25% for fiscal 2006 and 14% for fiscal 2005 to \$67.1 million and \$53.7 million, respectively. This was the result of growth in clients and client employees served, price increases, and favorable fluctuations in workers' compensation claims experience. As of May 31, 2006, our PEO product serviced approximately 59,000 client employees, as compared with over 54,000 client employees at May 31, 2005.

Our PEO product provides essentially the same services as Paychex Premier, except we serve as a co-employer of the clients' employees, assume the risks and rewards of workers' compensation insurance, and provide more sophisticated health care offerings to PEO clients. The PEO product is available primarily for clients domiciled in Florida and Georgia, where the utilization of PEOs is more prevalent than other areas of the United States ("U.S."). Due to the characteristics of the PEO product, the revenue and profits from this product can fluctuate significantly between quarters. These fluctuations primarily relate to the assumption of the risks and rewards of workers' compensation insurance and, to a lesser extent, the other offerings unique to the PEO product. The risks and rewards of workers' compensation insurance are derived from actuarial changes in estimated losses under workers' compensation policies as the result of actual claims experience under our workers' compensation policies and changes in workers' compensation legislation by the state of Florida.

- Revenue from other Human Resource Services increased 36% for fiscal 2006 and 33% for fiscal 2005 to \$99.0 million and \$72.5 million, respectively. This was the result of increases in revenue from time and attendance solutions, state unemployment services, and employee handbooks. Other Human Resource Services revenue growth in fiscal 2005 compared to fiscal 2004 also reflected the benefit of revenue from the April 2004 acquisition of Stromberg time and attendance solutions.

The increase in interest on funds held for clients in fiscal 2006 compared to fiscal 2005 is the result of higher average interest rates earned in fiscal 2006 and higher average portfolio balances. The increase in interest on funds held for clients in fiscal 2005 compared to fiscal 2004 is the result of higher average interest rates earned in fiscal 2005 and higher average portfolio balances, offset by lower net realized gains on the sales of available-for-sale securities. The higher average portfolio balances in both fiscal 2006 and fiscal 2005 were driven by client base growth, wage inflation, check volume growth within our current client base, and increased utilization of our payroll tax administration services and employee payment services. See the "Market Risk Factors" section, contained in Item 7A of this Form 10-K, for more information on changing rates.

**Combined Operating and SG&A Expenses:** The following table summarizes total combined operating and selling, general and administrative (“SG&A”) expenses for the fiscal year ended May 31:

<u>In millions</u>	<u>2006</u>	<u>Change</u>	<u>2005</u>	<u>Change</u>	<u>2004</u>
Compensation-related expenses . . . . .	\$ 656.8	15%	\$571.4	12%	\$510.2
Facilities (excluding depreciation) expenses . . .	48.3	10%	44.1	-3%	45.3
Depreciation of property and equipment . . . . .	51.6	12%	46.2	18%	39.2
Amortization of intangible assets . . . . .	14.9	-6%	15.8	-5%	16.6
Other expenses . . . . .	<u>253.4</u>	8%	<u>233.8</u>	9%	<u>213.9</u>
	<u>1,025.0</u>	12%	<u>911.3</u>	10%	<u>825.2</u>
Expense charge to increase legal reserve . . . . .	<u>—</u>	0%	<u>—</u>	-100%	<u>35.8</u>
Total operating and SG&A expenses . . . . .	<u>\$1,025.0</u>	12%	<u>\$911.3</u>	6%	<u>\$861.0</u>
As a % of total service revenue . . . . .	<u>65.1%</u>		<u>65.8%</u>		<u>69.4%</u>

Combined operating and SG&A expenses increased 12% in fiscal 2006 and 10% in fiscal 2005, excluding the expense charge to increase the legal reserve in fiscal 2004. The increases in both fiscal 2006 and in fiscal 2005 were the result of our continued investment in information technology to create more efficient processes and systems as well as investment in personnel and other costs to support organic growth. During fiscal 2006, total expenses were affected by a strong sales year as our sales force exceeded its targets resulting in higher than normal levels of sales expense, continued investments in new products and services, geographic expansion within Germany, and other expenditures to continually improve client service. Fiscal 2005 growth was impacted by additional expenses as a result of our April 2004 acquisition of Stromberg. At May 31, 2006, we had approximately 10,900 employees compared with approximately 10,000 at May 31, 2005 and 9,400 at May 31, 2004.

Depreciation expense is primarily related to buildings, furniture and fixtures, data processing equipment, and software. Depreciation expense increased in fiscal 2006 compared to fiscal 2005 due to the purchase in May 2005 of a 127,000-square foot building in Rochester, New York and higher levels of capital expenditures. Amortization of intangible assets is primarily related to client lists obtained from previous acquisitions, which are amortized using accelerated methods. Other expenses include items such as delivery, forms and supplies, communications, travel and entertainment, professional services, and other costs incurred to support our business.

**Operating Income:** Operating income year-over-year growth was 22% for fiscal 2006 and 23% for fiscal 2005. The increases in operating income in fiscal 2006 and fiscal 2005 are attributable to the factors previously discussed.

**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. The increase in investment income in fiscal 2006 compared with fiscal 2005 is mainly due to higher average interest rates earned in fiscal 2006 and higher average portfolio balances resulting from investment of cash generated from ongoing operations. The decrease in investment income in fiscal 2005 compared with fiscal 2004 is mainly due to lower net realized gains on sales of available-for-sale securities and lower average interest rates earned on longer-term investments, offset by an increase in average daily balances.

**Income Taxes:** Our effective income tax rate was 31.1% in fiscal 2006, compared with 32.5% in fiscal 2005, and 32.6% in fiscal 2004. The decrease in our effective income tax rate in fiscal 2006 was primarily the result of higher levels of tax-exempt income, which is derived primarily from municipal debt securities in the funds held for clients and corporate investment portfolios and a lower effective state income tax rate. See Note H of the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for additional disclosures on income taxes.

**Net Income:** Net income growth was 26% for fiscal 2006 and 22% for fiscal 2005. The increases in net income for fiscal 2006 and fiscal 2005 are attributable to the factors previously discussed.

### Liquidity and Capital Resources

At May 31, 2006, our principal source of liquidity was \$577.4 million of cash and corporate investments. We also had \$384.5 million in long-term corporate investments at May 31, 2006. Current cash and corporate investments and projected operating cash flows are expected to support our normal business operations, capital purchases, and dividend payments for the foreseeable future.

### Commitments and Contractual Obligations

We have unused borrowing capacity available under four uncommitted, secured, short-term lines of credit with financial institutions at market rates of interest as follows:

<u>Financial institution</u>	<u>Amount available</u>	<u>Expiration date</u>
JP Morgan Chase Bank, N.A. ....	\$350 million	February 2007
Fleet National Bank, a Bank of America company .....	\$250 million	February 2007
PNC Bank, National Association .....	\$150 million	February 2007
Wells Fargo Bank, National Association .....	\$150 million	February 2007

Our credit facilities are evidenced by Promissory Notes and are secured by separate Pledge Security Agreements by and between Paychex, Inc. and each of the financial institutions (the "Lenders"), pursuant to which we have granted each of the Lenders a security interest in certain of our investment securities accounts. The collateral is maintained in a pooled custody account pursuant to the terms of a Control Agreement and is to be administered under an Intercreditor Agreement among the Lenders. Under certain circumstances, individual Lenders may require that collateral be transferred from the pooled account into segregated accounts for the benefit of such individual Lenders.

The primary uses of the lines of credit would be to meet short-term funding requirements related to deposit account overdrafts and client fund deposit obligations arising from electronic payment transactions on behalf of our clients in the ordinary course of business, if necessary. No amounts were outstanding against these lines of credit during fiscal 2006 or at May 31, 2006.

We had standby letters of credit outstanding totaling \$53.4 million at May 31, 2006, required to secure commitments for certain of our insurance policies. These letters of credit expire at various dates between July 2006 and December 2008 and are secured by securities held in our corporate investment portfolios, including a \$44.2 million letter of credit for which funds have been segregated into a separate account. Effective June 28, 2006, this \$44.2 million letter of credit was increased to \$50.9 million, bringing the total letters of credit outstanding to \$60.2 million. No amounts were outstanding on these letters of credit during fiscal 2006 or at May 31, 2006.

We have entered into various operating leases and purchase obligations that, under U.S. generally accepted accounting principles, are not reflected on the Consolidated Balance Sheets at May 31, 2006. The table below summarizes our estimated annual payment obligations under these commitments, as well as other contractual obligations shown as other liabilities on the Consolidated Balance Sheets at May 31, 2006:

<u>In millions</u>	<u>Payments due by period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>	<u>More than 5 years</u>
Operating leases <sup>(1)</sup> .....	\$134.2	\$37.6	\$60.1	\$31.6	\$4.9
Other purchase obligations <sup>(2)</sup> .....	77.0	40.4	18.0	14.5	4.1
Other liabilities <sup>(3)</sup> .....	1.5	0.3	0.6	0.4	0.2
Total .....	<u>\$212.7</u>	<u>\$78.3</u>	<u>\$78.7</u>	<u>\$46.5</u>	<u>\$9.2</u>

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- (1) Operating leases are primarily for office space and equipment used in our branch operations. These amounts do not include future payments under redundant leases related to the acquisitions of Advantage and InterPay, which are included in the table above with other liabilities.
  - (2) Purchase obligations include our estimate of the minimum outstanding commitments under purchase orders to buy goods and services and legally binding contractual arrangements with future payment obligations. Included in the total purchase obligations is \$8.2 million of commitments to purchase capital assets. Amounts actually paid under certain of these arrangements may be higher due to variable components of these agreements.
  - (3) The obligations shown as other liabilities represent business acquisition reserves and are reflected in the Consolidated Balance Sheets at May 31, 2006, with \$0.3 million in other current liabilities and \$1.2 million in other long-term liabilities. Certain deferred compensation plan obligations and other long-term liabilities amounting to \$39.4 million are excluded because the timing of actual payments cannot be specifically or reasonably determined due to the variability in assumptions required to project the timing of future payments.

Advantage has license agreements with fifteen independently owned associate offices (“Associates”), which are responsible for selling and marketing Advantage payroll services and performing certain operational functions, while Paychex, Inc. and Advantage provide all centralized back-office payroll processing and payroll tax administration services. In addition, Advantage has a relationship with New England Business Services, Inc. (“NEBS®”) whereby Advantage performs all client functions other than sales and marketing. Under these arrangements, Advantage pays the Associates and NEBS commissions based on processing activity for the related clients. Since the actual amounts of future payments are uncertain, obligations under these arrangements are not included in the table above. Commission expense for the Associates and NEBS in fiscal 2006 and fiscal 2005 was \$19.0 million and \$16.7 million, respectively.

We guarantee performance of service on annual maintenance contracts for clients who financed their service contracts through a third party. In the normal course of business, we make representations and warranties that guarantee the performance of services under service arrangements with clients. 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 to Paychex and our subsidiaries. Historically, there have been no material losses related to such guarantees and indemnifications.

We currently self-insure the deductible portion of various insured exposures under certain of our employee benefit plans. Our estimated loss exposure under these insurance arrangements is recorded in other current liabilities. Historically, the amounts accrued have not been material. We have insurance coverage in addition to our purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, and acts of terrorism, and capacity for deductibles and self-insured retentions through our captive insurance company.

#### **Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions with unconsolidated entities such as special purpose entities or structured finance 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 low-income housing projects that are not considered part of our ongoing operations. These investments are accounted for under the equity method of accounting.

## Operating Cash Flow Activities

<u>In millions</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net income .....	\$464.9	\$368.8	\$303.0
Non-cash adjustments to net income .....	99.5	106.7	105.6
Cash provided by/ (used in) changes in operating assets and liabilities .....	<u>4.8</u>	<u>(8.9)</u>	<u>(19.6)</u>
Net cash provided by operating activities .....	<u>\$569.2</u>	<u>\$466.6</u>	<u>\$389.0</u>

The increase in our operating cash flows in fiscal 2006 and fiscal 2005 was driven by higher net income, impacted by changes in operating assets and liabilities. The fluctuations in our operating assets and liabilities between periods were primarily related to the timing of accounts receivable billing and collection, and timing of payments for compensation, PEO payroll, income tax, and other liabilities.

## Investing Cash Flow Activities

<u>In millions</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net change in funds held for clients and corporate investment activities .....	\$(224.0)	\$(177.3)	\$(151.8)
Purchases of property and equipment, net of proceeds from the sale of property and equipment .....	(81.1)	(67.2)	(50.6)
Acquisitions of businesses, net of cash acquired .....	(0.7)	(0.4)	(13.2)
Purchases of other assets .....	<u>(4.2)</u>	<u>(2.7)</u>	<u>(2.4)</u>
Net cash used in investing activities .....	<u>\$(310.0)</u>	<u>\$(247.6)</u>	<u>\$(218.0)</u>

**Funds held for clients and corporate investments:** Funds held for clients are primarily comprised 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 D of the Notes to Consolidated Financial Statements, included in Item 8 of this Form 10-K.

The amount of funds held for clients will 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. Fluctuations in net funds held for clients and corporate investment activities primarily relate to timing of purchases, sales, or maturities of corporate investments. Additional discussion of interest rates and related risks is included in the "Market Risk Factors" section, contained in Item 7A of this Form 10-K.

**Acquisitions of businesses, net of cash acquired:** In fiscal 2004, we paid approximately \$12.6 million in cash for the acquisition of Stromberg and \$0.6 million of additional purchase price related to the InterPay acquisition.

**Purchases of property and equipment:** To support our continued client and ancillary product growth, purchases of property and equipment were made for data processing equipment and software, and for the expansion and upgrade of various operating facilities. In fiscal 2006, we made purchases of property and equipment of \$81.1 million, compared with \$70.7 million of purchases in fiscal 2005 and \$50.6 million of purchases in fiscal 2004. In May 2005, we purchased a 127,000-square-foot facility in Rochester, New York for \$10.5 million. Construction in progress totaled \$36.3 million and \$29.5 million at May 31, 2006 and 2005, respectively. Of these costs, \$29.4 million and \$18.9 million represent software being developed for internal use at May 31, 2006 and 2005, respectively. Capitalization of costs ceases when the software is ready for its intended use, at which time we will begin amortization of the costs.



During fiscal 2006, fiscal 2005, and fiscal 2004, we purchased approximately \$4.6 million, \$2.5 million, and \$1.2 million, respectively, of data processing equipment and software from EMC Corporation, whose Chairman, President, and Chief Executive Officer is a member of our Board of Directors.

### Financing Cash Flow Activities

<u>In millions, except per share amounts</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Dividends paid . . . . .	\$(231.5)	\$(193.0)	\$(177.4)
Proceeds from exercise of stock options . . . . .	32.1	9.0	18.3
Net cash used in financing activities . . . . .	<u>\$(199.4)</u>	<u>\$(184.0)</u>	<u>\$(159.1)</u>
Cash dividends per common share . . . . .	<u>\$ 0.61</u>	<u>\$ 0.51</u>	<u>\$ 0.47</u>

**Dividends paid:** In October 2005, our Board of Directors approved an increase in the quarterly dividend payment to \$0.16 per share from \$0.13 per share. In October 2004, our Board of Directors approved an increase in the quarterly dividend payment to \$0.13 per share from \$0.12 per share. The dividends paid as a percentage of net income totaled 50%, 52%, and 59% in fiscal 2006, fiscal 2005, and fiscal 2004, respectively. Future dividends are dependent on our future earnings and cash flow and are subject to the discretion of our Board of Directors.

**Proceeds from exercise of stock options:** The increase in proceeds from the exercise of stock options in fiscal 2006 compared with fiscal 2005 is primarily due to an increase in the number of stock options exercised and an increase in the average exercise price per share. The decrease in proceeds from the exercise of stock options in fiscal 2005 compared with fiscal 2004 is primarily due to a decrease in the number of stock options exercised. Common shares acquired through exercise of stock options in fiscal 2006 were 1.7 million shares compared with 0.7 million shares in fiscal 2005 and 1.3 million shares in fiscal 2004. We have recognized a tax benefit from the exercise of stock options of \$11.6 million, \$4.5 million, and \$10.2 million for fiscal 2006, fiscal 2005, and fiscal 2004, 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. See Note G to the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for additional disclosures on our stock option plans.

### Other

**New accounting pronouncements:** In December 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standard (“SFAS”) No. 123(R), “Share-Based Payment,” which replaces SFAS No. 123, “Accounting for Stock-Based Compensation” and supersedes Accounting Principles Board Opinion No. 25 (“APB 25”), “Accounting for Stock Issued to Employees.” This statement requires that all stock-based payments to employees, including grants of employee stock options, be recognized as compensation costs in the financial statements based on their fair values measured at the date of grant.

Prior to June 1, 2006, we had accounted for grants of employee stock options under the intrinsic value method allowed under APB 25 and related interpretations, and therefore had not recognized any compensation costs for stock-based awards. As permitted by SFAS No. 123, we presented pro forma financial results including the effects of share-based compensation costs in the footnotes to the financial statements. Refer to Note A to the Consolidated Financial Statements, included in Item 8 of this Form 10-K, under the heading “Stock-based compensation costs,” for the pro forma results for fiscal 2006, 2005, and 2004.

SFAS No. 123(R) is effective for fiscal years beginning after December 15, 2005 and permits adoption using one of the following two methods:

- Modified prospective method, in which compensation costs will be recognized in our Consolidated Financial Statements for all awards granted after the date of adoption as well as for the unvested portion of existing awards as of the date of adoption (the "Existing Awards"), and requires that prior periods not be restated.
- Modified retrospective method, which includes the requirements of the modified prospective method described above for new awards and Existing Awards, but also permits entities to restate prior periods based on amounts previously determined under SFAS No. 123 for pro forma disclosures.

We will adopt this standard beginning June 1, 2006, using the modified prospective method. Accordingly, the results of operations for future periods will not be comparable to our historical results of operations. We anticipate the adoption of SFAS No. 123(R) will negatively impact net income in the range of 4% to 5% in fiscal 2007, increasing our operating expenses and selling, general and administrative expenses.

Unrecognized stock-based compensation costs related to Existing Awards as of May 31, 2006 were approximately \$38.3 million and are expected to be recognized over a weighted-average period of 2.4 years. We cannot yet estimate what the compensation cost impact will be on our Consolidated Financial Statements for the awards that we issue after June 1, 2006, as it will depend on the terms of any future grants approved by the Board of Directors and the underlying assumptions used in calculating the fair value at the time of any such future grants. The calculation of fair value is very sensitive to changes in the underlying assumptions, especially volatility and expected option term life.

In addition, SFAS No. 123(R) will impact how income taxes are recorded to our Consolidated Financial Statements, as tax deductions for certain tax-qualified option grants ("incentive stock options") are allowed only at the time a taxable disposition occurs. This may result in an increase in our effective tax rate in the early periods after adoption and it could cause variability in our effective tax rate throughout a fiscal year as these events occur.

SFAS No. 123(R) also amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash inflow rather than a reduction of taxes paid in operating cash flows. We cannot estimate what the amount of excess tax deductions will be in future periods. However, the amounts of operating cash flows recognized in prior periods for excess tax deductions were \$11.6 million, \$4.5 million, and \$10.2 million for fiscal 2006, 2005, and 2004, respectively.

Our pro-forma disclosures under SFAS No. 123 utilized a Black-Scholes option pricing model for valuing employee stock options and allocated the expense using an accelerated method. Upon adoption of SFAS No. 123(R), we will continue to use a Black-Scholes option pricing model, but will begin to allocate the expense on a straight-line basis over the requisite service period as we believe this better aligns the cost with the employee services provided.

Upon adoption of SFAS No. 123(R), we will be required to estimate forfeitures and only record compensation costs for those awards that are expected to vest. In our pro forma disclosures under SFAS No. 123, we have accounted for forfeitures as they occurred. Our assumptions for forfeitures will be determined based on factors including type of award and historical experience, and will be reevaluated regularly as an award vests.

We currently offer an Employee Stock Purchase Plan to all employees, under which stock can be purchased through a payroll deduction with no discount to the market price and no look-back provision. We have determined that this plan is non-compensatory and is not subject to the provisions of SFAS No. 123(R). Therefore, no compensation costs will be recognized related to this plan.

The following FASB Staff Positions (“FSP”) issued during our fiscal year ended May 31, 2006 and related to SFAS No. 123(R) will be applied upon adoption of SFAS No. 123(R) for our fiscal year beginning June 1, 2006:

- FAS 123(R)-1, “Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R);”
- FAS 123(R)-2, “Practical Accommodation to the Application of Grant Date as Defined in FASB Statement 123(R);”
- FAS 123(R)-3, “Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards;” and
- FAS 123(R)-4, “Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event.”

In October 2005, the FASB issued FSP FAS 13-1, “Accounting for Rental Costs Incurred During a Construction Period.” This FSP provides that rental costs associated with operating leases that are incurred during a construction period should be recognized as rental expense and included in income from continuing operations. The guidance in this FSP was effective in the first reporting period beginning after December 15, 2005. We have historically expensed rental costs incurred during a construction period, and therefore, the adoption of this FSP did not have an impact on our results of operations or financial position.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” This FSP provides guidance on determining if an investment is considered to be impaired, if the impairment is other-than-temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities” and was effective for reporting periods beginning after December 15, 2005. We account for investments in accordance with this guidance, and therefore, the adoption of this FSP did not have an impact on our results of operations or financial position.

In February and March 2006, the FASB issued the following statements amending SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities” and SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a Replacement of FASB Statement No. 125:”

- SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments — an Amendment of FASB Statements No. 133 and 140;” and
- SFAS No. 156, “Accounting for Servicing of Financial Assets — an Amendment of FASB Statement No. 140.”

The guidance in these statements is effective in the first fiscal year beginning after September 15, 2006. We do not utilize derivative financial instruments and currently do not have any servicing assets or servicing liabilities that would fall under the guidance of either statement, and therefore, the adoption of these statements will not have a material impact on our results of operations or financial position.

### **Critical Accounting Policies**

Note A to the Consolidated Financial Statements, included in Item 8 of this Form 10-K, discusses the significant accounting policies of Paychex, Inc. Our discussion and analysis of our financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates, judgments, and assumptions that affect reported amounts of assets, liabilities, revenue, and expenses. On an ongoing basis, we evaluate the accounting policies and estimates used to prepare the Consolidated Financial Statements. We base our estimates on historical experience, future expectations,

and assumptions believed to be reasonable under current facts and circumstances. Actual amounts and results could differ from these estimates. Certain accounting policies that are deemed critical to our results of operations or financial position are discussed below.

**Revenue recognition:** Service revenue is recognized in the period services are rendered and earned under service arrangements with clients where service fees are fixed or determinable and collectibility is reasonably assured. Certain processing services are provided under annual service arrangements with revenue recognized ratably over the annual service period. Our service revenue is largely attributable to payroll-related processing services where the fee is based on a fixed amount per processing period or a fixed amount per processing period plus a fee per employee or transaction processed. The revenue earned on delivery service for the distribution of certain client payroll checks and reports is included in service revenue, and the costs for delivery are included in operating expenses on the Consolidated Statements of Income.

PEO revenue is included in service revenue and is reported net of direct costs billed and incurred, which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred for PEO worksite employees were \$2,414.5 million, \$2,230.8 million, and \$1,846.1 million for fiscal 2006, 2005, and 2004, respectively.

Revenue from certain time and attendance solutions is recognized using the residual method when all of the following are present: persuasive evidence of an arrangement exists, typically a non-cancelable sales order; delivery is complete for the software and hardware; the fee is fixed or determinable and free of contingencies; and collectibility is reasonably assured. Maintenance contracts are generally purchased by our clients in conjunction with their purchase of certain time and attendance solutions. Revenue from these maintenance contracts is recognized ratably over the term of the contract.

Interest on funds held for clients is earned primarily on funds that are collected from clients before due dates for payroll tax administration services and for employee payment services, and invested until remittance to the applicable tax or regulatory agencies or client employees. These collections from clients are typically remitted between one and thirty days after receipt, with some items extending to ninety days. The interest earned on these funds is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services. Interest on funds held for clients also includes net realized gains and losses from the sales of available-for-sale securities.

**PEO workers' compensation insurance:** Workers' compensation insurance reserves are established to provide for the estimated costs of paying claims underwritten by us. These reserves include estimates for reported losses, plus amounts for those claims incurred but not reported and estimates of certain expenses associated with processing and settling the claims. In establishing the workers' compensation insurance reserves, we utilize an independent actuarial estimate of undiscounted future cash payments that would be made to settle the claims.

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 social and 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 our present estimates, particularly when those payments may not occur until well into the future.

We regularly review the adequacy of our estimated workers' compensation insurance reserves. Adjustments to previously established reserves are reflected in the operating results of the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

In fiscal 2006 and fiscal 2005, workers' compensation insurance for PEO worksite employees was provided based on claims paid as incurred. Our maximum individual claims liability was \$750,000 under the fiscal 2006 policy and \$500,000 under the fiscal 2005 policy.

We had recorded the following amounts on our Consolidated Balance Sheets for workers' compensation claims as of May 31:

<u>In thousands</u>	<u>Prepaid expense</u>	<u>Current liability</u>	<u>Long-term liability</u>
2006 .....	\$3,150	\$7,061	\$18,374
2005 .....	\$3,702	\$7,164	\$13,963

**Valuation of investments:** Our investments in available-for-sale securities are reported at market value. Unrealized gains related to increases in the market value of investments and unrealized losses related to decreases in the market value are included in comprehensive income, net of tax, as reported on our Consolidated Statements of Stockholders' Equity. However, changes in the market value of investments impact our net income only when such investments are sold or impairment is recognized. Realized gains and losses on the sale of securities are determined by specific identification of the security's cost basis. On our Consolidated Statements of Income, realized gains and losses from funds held for clients are included in interest on funds held for clients, whereas realized gains and losses from corporate investments are included in investment income, net.

We are exposed to credit risk in connection with our available-for-sale securities from the possible inability of borrowers to meet the terms of their bonds. We attempt to mitigate this risk by investing primarily in high credit quality securities, AAA- and AA-rated securities, and A-1-rated short-term securities. We periodically review our investment portfolio to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns, which would require us to record an impairment charge in the period any such determination is made. In making this judgment, we evaluate, among other things, the duration and extent to which the market value of an investment is less than its cost, the credit rating and any changes in credit rating for the investment, and our ability and intent to hold the investment until the earlier of market price recovery or maturity. 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 assumption related to any particular investment.

**Goodwill and intangible assets:** For business combinations, we assign estimated fair values to all assets and liabilities acquired, including intangible assets, such as customer lists, certain license agreements, trade names, and non-compete agreements. The assignment of fair values to acquired assets and liabilities and the determination of useful lives for depreciable and amortizable assets requires significant estimates, judgments, and assumptions. For certain fixed assets, including software and intangible assets, we utilize the assistance of independent valuation consultants. The remaining purchase price of the acquired business not assigned to identifiable assets and liabilities is recorded as goodwill.

We have \$405.8 million of goodwill recorded on our Consolidated Balance Sheet at May 31, 2006, resulting from acquisitions in fiscal 2003 and fiscal 2004. SFAS No. 142, "Goodwill and Other Intangible Assets," requires that goodwill not be amortized, but instead tested for impairment on an annual basis and between annual tests if an event occurs or circumstances change in a way to indicate that there has been a potential decline in the fair value of the reporting unit. Impairment is determined by comparing the estimated fair value of the reporting unit to its carrying amount, including goodwill. We perform our annual review at the beginning of the fourth fiscal quarter. Our business is largely homogeneous and, as a result, substantially all of the goodwill is associated with one reporting unit. Based on the results of our goodwill impairment review, no impairment loss was recognized in the results of operations for fiscal 2006 or fiscal 2005. Subsequent to this review, there have been no events or circumstances that indicate any potential impairment of our goodwill balance.

We also test intangible assets for potential impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

**Accrual for client fund losses:** We maintain an accrual for estimated losses associated with our clients' inability to meet their payroll obligations. As part of providing payroll, payroll tax administration services, and employee payment services, we are authorized by the client to initiate money transfers from the client's

account for the amount of tax obligations and employees' direct deposits. Electronic money fund transfers from client bank accounts are subject to potential risk of loss resulting from clients' insufficient funds to cover such transfers. We evaluate certain uncollected amounts on a specific basis and analyze historical experience for amounts not specifically reviewed to determine the likelihood of recovery from the clients.

**Contingent liabilities:** We are subject to various claims and legal matters that arise in the normal course of business. At May 31, 2006, we had approximately \$15.6 million of reserves for pending legal matters. Based on the application of SFAS No. 5, "Accounting for Contingencies," which requires us to record a reserve if we believe an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated, we deem this amount adequate. The determination of whether any particular matter involves a probable loss or if the amount of a probable loss can be reasonably estimated requires considerable judgment. This reserve may change in the future due to new developments or changes in our strategies or assumptions related to any particular matter. In light of the legal reserve recorded, we currently believe that resolution of these matters will not have a material adverse effect on our financial position or results of operations. However, these 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 our financial position and our results of operations in the period in which any such effect is recorded. For additional information regarding pending legal matters, refer to Note L in the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K.

**Income taxes:** We account for deferred taxes by recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in our financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We account for the tax benefit from the exercise of non-qualified stock options by reducing our accrued income tax liability and increasing additional paid-in capital.

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

##### **Market Risk Factors**

**Changes in interest rates and interest rate risk:** Funds held for clients are primarily comprised of short-term funds and available-for-sale securities and corporate investments are primarily comprised of available-for-sale securities. As a result of our operating and 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 market value of our longer-term available-for-sale securities. In seeking to minimize the risks and/or costs associated with such activities, we generally direct investments towards high credit quality, fixed-rate municipal and government securities and manage the available-for-sale securities to a benchmark duration of two and one-half to three years. We do not utilize derivative financial instruments to manage our interest rate risk.

Our investment portfolios and the earnings from these portfolios have been impacted by the fluctuations in interest rates. The Federal Funds rate has increased to 5.00% as of May 31, 2006. During fiscal 2006, the average interest rate earned on our combined funds held for clients and corporate investment portfolios was 3.2% compared with 2.2% for fiscal 2005 and 1.8% for fiscal 2004. Short-term rates rose steadily throughout fiscal 2005 and fiscal 2006. In fiscal 2005, longer-term rates, on average, were basically unchanged from fiscal 2004, but have risen steadily in fiscal 2006. While short-term and long-term interest rates generally move in the same direction, there are certain economic and liquidity conditions that will affect this relationship. While interest rates are rising, the full benefit of higher interest rates will not immediately be reflected in net income due to the interaction of long- and short-term interest rate changes as discussed below. The Federal Funds rate decreased from 6.50% at May 31, 2000 to 1.00% at May 31, 2004. The decreasing interest rate environment experienced through fiscal 2004 negatively affected net income growth. During fiscal 2004, the decreasing rate environment generated significant unrealized gains for our longer-term available-for-sale securities and we were able to mitigate some of the impact of lower interest rates on earnings by realizing gains from sales of our investments.

Increases in interest rates increase earnings from our short-term investments, and over time will increase earnings from our longer-term available-for-sale securities. Earnings from the available-for-sale securities, which currently have an average duration of 2.0 years excluding the impact of auction rate securities and VRDNs that are tied to short-term interest rates, will not reflect increases in interest rates until the investments are sold or mature and the proceeds are reinvested at higher rates. An increasing interest rate environment will generally result in a decrease in the market value of our investment portfolio.

The cost and market value of available-for-sale securities that have stated maturities at May 31, 2006 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

<u>In thousands</u>	<u>May 31, 2006</u>	
	<u>Cost</u>	<u>Market value</u>
<b>Maturity date:</b>		
Due in one year or less . . . . .	\$ 545,046	\$ 542,178
Due after one year through three years . . . . .	688,411	678,728
Due after three years through five years . . . . .	282,107	276,241
Due after five years . . . . .	<u>2,356,196</u>	<u>2,352,513</u>
Total available-for-sale securities . . . . .	<u>\$3,871,760</u>	<u>\$3,849,660</u>

VRDNs and auction rate securities are primarily categorized as due after five years in the table above as the contractual maturities on these securities is typically twenty to thirty years. Although these securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature.

The following table summarizes the changes in the Federal Funds rate over the past three fiscal years:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Federal Funds rate — beginning of fiscal year . . . . .	3.00%	1.00%	1.25%
Rate increase/(decrease):			
First quarter . . . . .	0.50	0.50	(0.25)
Second quarter . . . . .	0.50	0.50	—
Third quarter . . . . .	0.50	0.50	—
Fourth quarter . . . . .	<u>0.50</u>	<u>0.50</u>	<u>—</u>
Federal Funds rate — end of fiscal year . . . . .	<u>5.00%</u>	<u>3.00%</u>	<u>1.00%</u>
Three-year “AAA” municipal securities yields — end of fiscal year . . . . .	<u>3.65%</u>	<u>2.85%</u>	<u>2.50%</u>

The Federal Funds rate was increased to 5.25% on June 29, 2006.

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 proportional 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 in taxable interest rates generally affects our tax-exempt interest rates by approximately 17 basis points.

Our total investment portfolio (funds held for clients and corporate investments) averaged approximately \$3.9 billion for the full year ended May 31, 2006. Our normal and anticipated allocation is approximately 60% invested in short-term securities and available-for-sale securities that are priced and traded as short-term securities (auction rate securities and VRDNs) with an average duration of thirty-five days, and 40% invested in other available-for-sale securities with an average duration of two and one-half to three years. Based on these current assumptions, we estimate that the earnings effect of a 25-basis-point change in interest rates

(17 basis points for tax-exempt investments) at the beginning of fiscal 2007 would be approximately \$4.5 million to \$5.0 million for fiscal 2007.

The combined funds held for clients and corporate available-for-sale securities reflected a net unrealized loss of \$22.0 million at May 31, 2006, compared with a net unrealized loss of \$9.9 million at May 31, 2005, and a net unrealized loss of \$4.2 million at May 31, 2004. During fiscal 2006, the net unrealized gain or loss position ranged from a net unrealized loss of \$25.2 million to \$6.1 million. During fiscal 2005, the net unrealized gain or loss position ranged from approximately \$14.4 million net unrealized loss to \$10.6 million net unrealized gain. The net unrealized loss position of our investment portfolios was approximately \$23.9 million at July 20, 2006.

As of May 31, 2006 and May 31, 2005, we had \$3.9 billion and \$3.6 billion, respectively, invested in available-for-sale securities at market value. Excluding auction rate securities and VRDNs classified as available-for-sale securities which are tied to short-term interest rates, the weighted average yields to maturity were 3.0% and 2.6%, as of May 31, 2006 and May 31, 2005, respectively. Assuming a hypothetical increase in both short-term and longer-term interest rates of 25 basis points, the resulting potential decrease in market value for our portfolio of securities at May 31, 2006, would be approximately \$8.5 million. Conversely, a corresponding decrease in interest rates would result in a comparable increase in market value. This hypothetical decrease or increase in the market value of the portfolio would be recorded as an adjustment to the portfolio's recorded value, with an offsetting amount recorded in stockholders' equity and with no related or immediate impact on the results of operations.

**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 the bonds. We attempt 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 issuer.



**Item 8. *Financial Statements and Supplementary Data***

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## REPORT ON MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Paychex, Inc. (the "Company") is responsible for establishing and maintaining an adequate system of internal control over financial reporting as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Consolidated Financial Statements. Our internal control over financial reporting is supported by a program of internal audits and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel, and a written Code of Business Conduct adopted by our Company's Board of Directors, applicable to all Company Directors and all officers and employees of our Company.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Audit Committee of our Company's Board of Directors meets with the independent public accountants, management, and internal auditors periodically to discuss internal control over financial reporting and auditing and financial reporting matters. The Audit Committee reviews with the independent public accountants the scope and results of the audit effort. The Audit Committee also meets periodically with the independent public accountants and the chief internal auditor without management present to ensure that the independent public accountants and the chief internal auditor have free access to the Audit Committee. The Audit Committee's Report can be found in the Definitive Proxy Statement to be issued in connection with the Company's 2006 Annual Meeting of Stockholders.

Management assessed the effectiveness of the Company's internal control over financial reporting as of May 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework*. Based on our assessment, management believes that the Company maintained effective internal control over financial reporting as of May 31, 2006.

The Company's independent public accountants, Ernst & Young LLP, a registered public accounting firm, are appointed by its Audit Committee. Ernst & Young LLP has audited and reported on the Consolidated Financial Statements of Paychex, Inc., management's assessment of the effectiveness of the Company's internal control over financial reporting and the effectiveness of the Company's internal control over financial reporting. The reports of the independent public accountants are contained in this Annual Report on Form 10-K.

/s/ Jonathan J. Judge  
\_\_\_\_\_  
Jonathan J. Judge  
President and Chief Executive Officer

/s/ John M. Morphy  
\_\_\_\_\_  
John M. Morphy  
Senior Vice President, Chief Financial Officer,  
and Secretary

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Audit Committee of the Board of Directors  
and the Stockholders of Paychex, Inc.

We have audited the accompanying consolidated balance sheets of Paychex, Inc. as of May 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006. Our audits also included the financial statement schedule listed in the index at Item 15(a). These financial statements and schedule are the responsibility of Paychex, Inc.'s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Paychex, Inc. at May 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended May 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Paychex, Inc.'s internal control over financial reporting as of May 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated July 13, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Cleveland, Ohio  
July 13, 2006

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING**

Audit Committee of the Board of Directors  
and the Stockholders of Paychex, Inc.

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control over Financial Reporting, that Paychex, Inc. (the Company) maintained effective internal control over financial reporting as of May 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Paychex Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Paychex, Inc. maintained effective internal control over financial reporting as of May 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Paychex, Inc. maintained, in all material respects, effective internal control over financial reporting as of May 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Paychex, Inc. as of May 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006, and our report dated July 13, 2006, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Cleveland, Ohio  
July 13, 2006

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

<u>Year ended May 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Revenue:</b>			
Service revenue .....	\$1,573,797	\$1,384,674	\$1,240,093
Interest on funds held for clients .....	<u>100,799</u>	<u>60,469</u>	<u>54,254</u>
<b>Total revenue .....</b>	<b><u>1,674,596</u></b>	<b><u>1,445,143</u></b>	<b><u>1,294,347</u></b>
<b>Expenses:</b>			
Operating expenses .....	560,255	499,025	463,465
Selling, general and administrative expenses .....	<u>464,770</u>	<u>412,343</u>	<u>397,567</u>
<b>Total expenses .....</b>	<b><u>1,025,025</u></b>	<b><u>911,368</u></b>	<b><u>861,032</u></b>
<b>Operating income .....</b>	<b><u>649,571</u></b>	<b><u>533,775</u></b>	<b><u>433,315</u></b>
Investment income, net .....	<u>25,195</u>	<u>12,391</u>	<u>16,469</u>
<b>Income before income taxes .....</b>	<b><u>674,766</u></b>	<b><u>546,166</u></b>	<b><u>449,784</u></b>
Income taxes .....	<u>209,852</u>	<u>177,317</u>	<u>146,834</u>
<b>Net income .....</b>	<b><u>\$ 464,914</u></b>	<b><u>\$ 368,849</u></b>	<b><u>\$ 302,950</u></b>
<b>Basic earnings per share .....</b>	<b><u>\$ 1.23</u></b>	<b><u>\$ 0.97</u></b>	<b><u>\$ 0.80</u></b>
<b>Diluted earnings per share .....</b>	<b><u>\$ 1.22</u></b>	<b><u>\$ 0.97</u></b>	<b><u>\$ 0.80</u></b>
<b>Weighted-average common shares outstanding .....</b>	<b><u>379,465</u></b>	<b><u>378,337</u></b>	<b><u>377,371</u></b>
<b>Weighted-average common shares outstanding, assuming dilution .....</b>	<b><u>381,351</u></b>	<b><u>379,763</u></b>	<b><u>379,524</u></b>
<b>Cash dividends per common share .....</b>	<b><u>\$ 0.61</u></b>	<b><u>\$ 0.51</u></b>	<b><u>\$ 0.47</u></b>

See Notes to Consolidated Financial Statements.

**PAYCHEX, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
In thousands, except per share amount

<u>At May 31,</u>	<u>2006</u>	<u>2005</u>
<b>Assets</b>		
Cash and cash equivalents .....	\$ 137,423	\$ 77,669
Corporate investments .....	440,007	225,719
Interest receivable .....	38,139	31,108
Accounts receivable, net of allowance for doubtful accounts .....	189,835	161,849
Deferred income taxes .....	18,314	19,946
Prepaid income taxes .....	7,574	5,781
Prepaid expenses and other current assets .....	21,398	20,587
<b>Current assets before funds held for clients .....</b>	<b>852,690</b>	<b>542,659</b>
Funds held for clients .....	3,591,611	2,979,348
<b>Total current assets .....</b>	<b>4,444,301</b>	<b>3,522,007</b>
Long-term corporate investments .....	384,481	404,152
Property and equipment, net of accumulated depreciation .....	234,664	205,319
Intangible assets, net of accumulated amortization .....	60,704	71,458
Goodwill .....	405,842	405,992
Deferred income taxes .....	12,783	1,213
Other long-term assets .....	6,527	7,277
<b>Total assets .....</b>	<b><u>\$5,549,302</u></b>	<b><u>\$4,617,418</u></b>
<b>Liabilities</b>		
Accounts payable .....	\$ 46,668	\$ 30,385
Accrued compensation and related items .....	130,069	106,635
Deferred revenue .....	5,809	4,271
Legal reserve .....	15,625	25,271
Other current liabilities .....	34,008	28,391
<b>Current liabilities before client fund deposits .....</b>	<b>232,179</b>	<b>194,953</b>
Client fund deposits .....	3,606,193	2,985,386
<b>Total current liabilities .....</b>	<b>3,838,372</b>	<b>3,180,339</b>
Deferred income taxes .....	15,481	17,545
Other long-term liabilities .....	40,606	33,858
<b>Total liabilities .....</b>	<b>3,894,459</b>	<b>3,231,742</b>
<b>Commitments and contingencies — Note L</b>		
<b>Stockholders' equity</b>		
Common stock, \$0.01 par value; Authorized: 600,000 shares; Issued and outstanding: 380,303 shares at May 31, 2006, and 378,629 shares at May 31, 2005, respectively .....	3,803	3,786
Additional paid-in capital .....	284,395	240,700
Retained earnings .....	1,380,971	1,147,611
Accumulated other comprehensive loss .....	(14,326)	(6,421)
<b>Total stockholders' equity .....</b>	<b>1,654,843</b>	<b>1,385,676</b>
<b>Total liabilities and stockholders' equity .....</b>	<b><u>\$5,549,302</u></b>	<b><u>\$4,617,418</u></b>

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

In thousands

	Common stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income/(loss)	Total
	Shares	Amount				
<b>Balance at May 31, 2003</b> . . . . .	<b>376,698</b>	<b>\$3,767</b>	<b>\$198,713</b>	<b>\$ 846,196</b>	<b>\$ 28,695</b>	<b>\$1,077,371</b>
Net income . . . . .				302,950		302,950
Unrealized losses on securities, net of tax . . . . .					(31,404)	(31,404)
Total comprehensive income . .						271,546
Cash dividends declared . . . . .				(177,408)		(177,408)
Exercise of stock options . . . . .	1,270	13	18,257			18,270
Tax benefit from exercise of stock options . . . . .			10,194			10,194
<b>Balance at May 31, 2004</b> . . . . .	<b>377,968</b>	<b>3,780</b>	<b>227,164</b>	<b>971,738</b>	<b>(2,709)</b>	<b>1,199,973</b>
Net income . . . . .				368,849		368,849
Unrealized losses on securities, net of tax . . . . .					(3,712)	(3,712)
Total comprehensive income . .						365,137
Cash dividends declared . . . . .				(192,976)		(192,976)
Exercise of stock options . . . . .	661	6	9,020			9,026
Tax benefit from exercise of stock options . . . . .			4,516			4,516
<b>Balance at May 31, 2005</b> . . . . .	<b>378,629</b>	<b>3,786</b>	<b>240,700</b>	<b>1,147,611</b>	<b>(6,421)</b>	<b>1,385,676</b>
Net income . . . . .				464,914		464,914
Unrealized losses on securities, net of tax . . . . .					(7,905)	(7,905)
Total comprehensive income . .						457,009
Cash dividends declared . . . . .				(231,554)		(231,554)
Exercise of stock options . . . . .	1,674	17	32,108			32,125
Tax benefit from exercise of stock options . . . . .			11,587			11,587
<b>Balance at May 31, 2006</b> . . . . .	<b>380,303</b>	<b>\$3,803</b>	<b>\$284,395</b>	<b>\$1,380,971</b>	<b>\$(14,326)</b>	<b>\$1,654,843</b>

See Notes to Consolidated Financial Statements.

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

<u>Year ended May 31,</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Operating activities</b>			
Net income .....	\$ 464,914	\$ 368,849	\$ 302,950
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization on property and equipment and intangible assets .....	66,517	62,004	55,837
Amortization of premiums and discounts on available-for-sale securities .....	27,897	28,618	26,079
(Benefit)/provision for deferred income taxes .....	(7,716)	9,590	(8,004)
Tax benefit related to exercise of stock options .....	11,587	4,516	10,194
Provision for allowance for doubtful accounts .....	2,173	2,179	2,941
Provision for legal reserves .....	—	—	35,800
Other non-cash adjustments .....	—	—	1,947
Net realized gains on sales of available-for-sale securities .....	(975)	(223)	(19,133)
Changes in operating assets and liabilities:			
Interest receivable .....	(7,031)	(8,544)	223
Accounts receivable .....	(30,057)	(28,264)	(19,622)
Prepaid expenses and other current assets .....	(2,604)	(3,620)	(5,288)
Accounts payable and other current liabilities .....	37,740	20,371	9,798
Net change in other assets and liabilities .....	6,788	11,148	(4,720)
<b>Net cash provided by operating activities .....</b>	<b>569,233</b>	<b>466,624</b>	<b>389,002</b>
<b>Investing activities</b>			
Purchases of available-for-sale securities .....	(90,551,938)	(84,226,693)	(80,325,156)
Proceeds from sales and maturities of available-for-sale securities .....	90,227,659	83,895,320	79,963,867
Net change in funds held for clients' money market securities and other cash equivalents .....	(520,504)	(37,494)	119,555
Net change in client fund deposits .....	620,807	191,647	89,874
Purchases of property and equipment .....	(81,143)	(70,686)	(50,562)
Proceeds from sale of property and equipment .....	42	3,506	7
Acquisition of businesses, net of cash acquired .....	(726)	(444)	(13,213)
Purchases of other assets .....	(4,247)	(2,742)	(2,395)
<b>Net cash used in investing activities .....</b>	<b>(310,050)</b>	<b>(247,586)</b>	<b>(218,023)</b>
<b>Financing activities</b>			
Dividends paid .....	(231,554)	(192,976)	(177,408)
Proceeds from exercise of stock options .....	32,125	9,026	18,270
<b>Net cash used in financing activities .....</b>	<b>(199,429)</b>	<b>(183,950)</b>	<b>(159,138)</b>
<b>Increase in cash and cash equivalents .....</b>	<b>59,754</b>	<b>35,088</b>	<b>11,841</b>
Cash and cash equivalents, beginning of fiscal year .....	77,669	42,581	30,740
<b>Cash and cash equivalents, end of fiscal year .....</b>	<b>\$ 137,423</b>	<b>\$ 77,669</b>	<b>\$ 42,581</b>

See Notes to Consolidated Financial Statements.



## PAYCHEX, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note A — Description of Business and Significant Accounting Policies

*Description of Business:* Paychex, Inc. and its wholly owned subsidiaries (the “Company” or “Paychex”) is a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses in the United States (“U.S.”). The Company also has approximately 500 clients in Germany. The Company, a Delaware corporation, reports one segment based upon the provision of Statement of Financial Accounting Standard (“SFAS”) No. 131, “Disclosures about Segments of an Enterprise and Related Information.”

Total revenue is comprised of service revenue and interest on funds held for clients. Service revenue is comprised of the Payroll and Human Resource Services product and service lines. Payroll service revenue is earned primarily from payroll processing, payroll tax administration services, employee payment services, and other ancillary services.

Payroll processing services include the calculation, preparation, and delivery of employee payroll checks; production of internal accounting records and management reports; the preparation of federal, state, and local payroll tax returns; and collection and remittance of payroll obligations for small- to medium-sized businesses.

In connection with the automated payroll tax administration services, the Company collects payroll taxes electronically from clients’ bank accounts, typically on payday, prepares and files the applicable tax returns, and remits taxes to the applicable tax or regulatory agencies on their due dates. These collections from clients are typically paid between one and thirty days after receipt, with some items extending to ninety days. The Company handles all regulatory correspondence, amendments, and penalty and interest disputes, and is subject to cash penalties imposed by tax or regulatory agencies for late filings and late or under payment of taxes. With employee payment services, employers are offered the option of paying their employees by direct deposit, Paychex Access Visa® Card, a check drawn on a Paychex account (Readychex®), or a check drawn on the employer’s account and electronically signed by Paychex. For the first three methods, net payroll is collected electronically from the clients’ bank account, typically one day before payday, and provides payment to the employee on payday. In connection with both the payroll tax administration and employee payment services, authorized electronic money transfers from client bank accounts are subject to potential risk of loss resulting from insufficient funds to cover such transfers.

In addition to service fees paid by clients, the Company earns interest on funds held for clients that are collected before due dates and invested until remittance to the applicable tax or regulatory agencies or client employees. The funds held for clients and related client deposit liability are included in the Consolidated Balance Sheets as current assets and current liabilities. The amount of funds held for clients and related client deposit liability varies significantly during the year.

The Human Resource Services product and service line provides small- to medium-sized businesses with retirement services administration, workers’ compensation insurance administration, employee benefits administration, group health benefits, and state unemployment insurance. The Company’s Paychex Premier<sup>SM</sup> Human Resource Services (“Paychex Premier”) product provides a combined package of services that include payroll, employer compliance, human resource and employee benefits administration, risk management outsourcing, and the on-site availability of a professionally trained human resource representative. This comprehensive bundle of services is designed to make it easier for businesses to manage their payroll and related benefits costs while providing a benefits package equal to that of larger companies. The Company also operates a Professional Employer Organization (“PEO”), which provides primarily the same package of services as the Paychex Premier product, except Paychex serves as a co-employer of the clients’ employees, assumes the risks and rewards of workers’ compensation insurance, and provides more sophisticated health care offerings to PEO clients. The Company makes available time and attendance solutions to larger companies, and offers solutions to small- to medium-sized businesses through Time In A Box®.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Principles of consolidation:** The Consolidated Financial Statements include the accounts of Paychex, Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

**Cash and cash equivalents:** Cash and cash equivalents consist of available cash, money market securities, and other investments with a maturity of three months or less at the Balance Sheet date. Amounts reported in the Consolidated Balance Sheets approximate fair value.

**Accounts receivable, net of allowance for doubtful accounts:** Accounts receivable balances are shown on the Consolidated Balance Sheets net of the allowance for doubtful accounts of \$2.5 million at both May 31, 2006 and 2005, respectively. Amounts reported in the Consolidated Balance Sheets approximate fair values. No single client has a material impact on total accounts receivable, service revenue, or results of operations.

**Funds held for clients and corporate investments:** Marketable securities included in funds held for clients and corporate investments consist primarily of securities classified as available-for-sale and are recorded at market value obtained from an independent pricing service. Funds held for clients also include cash, money market securities, and short-term investments. Unrealized gains and losses, net of applicable income taxes, are reported as comprehensive income in the Consolidated Statements of Stockholders' Equity. Realized gains and losses on the sales of securities are determined by specific identification of the cost basis of each security. On the Consolidated Statements of Income, realized gains and losses from funds held for clients are included in interest on funds held for clients and realized gains and losses from corporate investments are included in investment income, net.

**Concentrations:** Substantially all of the Company's deposited cash is maintained at two large credit-worthy financial institutions. These deposits may exceed the amount of any insurance provided. All of the Company's deliverable securities are held in custody with one of the two aforementioned financial institutions, for which that institution bears the risk of custodial loss. Non-deliverable securities, primarily time deposits and money market securities, are restricted to credit-worthy broker-dealers and financial institutions.

**Property and equipment, net of accumulated depreciation:** Property and equipment is stated at cost, less accumulated depreciation and amortization. Depreciation is based on the estimated useful lives of property and equipment using the straight-line method. The estimated useful lives of depreciable assets are generally ten to thirty-five years, or the remaining life, whichever is shorter, for buildings and improvements, two to seven years for data processing equipment, three to five years for software, seven years for furniture and fixtures, and ten years or the life of the lease, whichever is shorter, for leasehold improvements. Normal and recurring repair and maintenance costs are charged to expense as incurred. The Company reviews the carrying value of property and equipment, including capitalized software, for impairment when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable.

**Software development and enhancements:** Expenditures for software purchases and software developed for internal use are capitalized and depreciated on a straight-line basis over the estimated useful lives, which are generally three to five years, except for substantial changes in the functionality of processing applications, for which the estimated useful life may be longer. For software developed for internal use, costs are capitalized in accordance with Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Capitalized internal use software costs include external direct costs of materials and services associated with developing or obtaining the software, and payroll and payroll-related costs for employees who are directly associated with internal-use software projects. Capitalization of these costs ceases no later than the point at which the project is substantially complete and ready for its intended use. Costs associated with preliminary project stage activities, training, maintenance, and other post-implementation stage activities are expensed as incurred. The carrying value of software and development costs, along with other long-lived assets, is reviewed for impairment when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)

**Goodwill and other intangible assets, net of accumulated amortization:** The Company has recorded goodwill in connection with the acquisitions of businesses during the years ended May 31, 2003 ("fiscal 2003") and May 31, 2004 ("fiscal 2004"). See Note B of the Notes to Consolidated Financial Statements, included in Item 8 of this Form 10-K, for further discussion on the fiscal 2004 acquisition. Under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is tested for impairment on an annual basis and between annual tests if an event occurs or circumstances change in a way to indicate a potential decline in the fair value of the reporting unit. Impairment is determined by comparing the estimated fair value of the reporting unit to its carrying amount, including goodwill. The Company's business is largely homogeneous, and as a result, substantially all the goodwill is associated with one reporting unit. The Company performs its annual impairment testing in the fourth fiscal quarter. Based on the Company's review, no impairment loss was recognized in the results of operations for the year ended May 31, 2006 ("fiscal 2006") or the year ended May 31, 2005 ("fiscal 2005").

Intangible assets are primarily comprised of client list acquisitions and license agreements with independently owned associate offices and are reported net of accumulated amortization on the Consolidated Balance Sheets. Intangible assets are amortized over periods generally ranging from five to twelve years using either straight-line or accelerated methods. The Company tests intangible assets for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

**Other long-term assets:** Other long-term assets are primarily related to the Company's investment as a limited partner in various low-income housing partnerships. These partnerships were determined to be variable interest entities as defined by Financial Accounting Standards Board ("FASB") Interpretation No. 46, "Consolidation of Variable Interest Entities." The Company is not the primary beneficiary of these variable interest entities and, therefore, does not consolidate them in its results of operations and financial position. The investments in these partnerships are accounted for under the equity method, with the Company's share of partnership losses recorded in investment income, net on the Consolidated Statements of Income. The net investment in these entities recorded on the Consolidated Balance Sheets was \$4.5 million at May 31, 2006 and \$5.2 million at May 31, 2005.

**Revenue recognition:** Service revenue is recognized in the period services are rendered and earned under service arrangements with clients where service fees are fixed or determinable and collectibility is reasonably assured. Certain processing services are provided under annual service arrangements with revenue recognized ratably over the annual service period. The Company's service revenue is largely attributable to payroll-related processing services where the fee is based on a fixed amount per processing period or a fixed amount per processing period plus a fee per employee or transaction processed. The revenue earned from delivery service for the distribution of certain client payroll checks and reports is included in service revenue, and the costs for the delivery are included in operating expenses on the Consolidated Statements of Income.

PEO revenue is included in service revenue and is reported net of direct costs billed and incurred, which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred were \$2,414.5 million, \$2,230.8 million, and \$1,846.1 million for fiscal 2006, 2005, and 2004, respectively.

Revenue from certain time and attendance solutions is recognized using the residual method when all of the following are present: persuasive evidence of an arrangement exists, typically a non-cancelable sales order; delivery is complete for the software and hardware; the fee is fixed or determinable and free of contingencies; and collectibility is reasonably assured. Maintenance contracts are generally purchased by the Company's clients in conjunction with their purchase of the related time and attendance solutions. Revenue from these maintenance contracts is recognized ratably over the term of the contract.

Interest on funds held for clients is earned primarily on funds that are collected from clients before due dates for payroll tax administration services and employee payment services, and invested until remittance to

**PAYCHEX, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

the applicable tax or regulatory agencies or client employees. These collections from clients are typically remitted between one and thirty days after receipt, with some items extending to ninety days. The interest earned on these funds is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services. Interest on funds held for clients also includes net realized gains and losses from the sales of available-for-sale securities.

Advantage Payroll Services, Inc. (“Advantage”), a subsidiary of the Company, has license agreements with fifteen independently owned associate offices (“Associates”). The Associates are responsible for selling and marketing Advantage payroll services and performing certain operational functions. Paychex and Advantage provide all centralized back-office payroll processing and payroll tax administration services for the Associates, including the billing and collection of processing fees and the collection and remittance of payroll and payroll tax funds pursuant to Advantage’s service arrangement with Associate customers. The marketing and selling by the Associates is conducted under their respective logos. Commissions earned by the Associates are based on the processing activity for the related clients. Revenue generated from customers as a result of these relationships and commissions paid to Associates are included in the Consolidated Statements of Income as service revenue and selling, general and administrative expense, respectively.

**PEO workers’ compensation insurance:** Workers’ compensation insurance reserves are established to provide for the estimated costs of paying claims underwritten by the Company. These reserves include estimates for reported losses, plus amounts for those claims incurred but not reported and estimates of certain expenses associated with processing and settling the claims. In establishing the workers’ compensation insurance reserves, the Company utilizes an independent actuarial estimate of undiscounted future cash payments that would be made to settle the claims.

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and independent actuarial loss projections, and is subject to change due to multiple factors, including social and 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 when those payments may not occur until well into the future.

The Company regularly reviews the adequacy of its estimated workers’ compensation insurance reserves. Adjustments to previously established reserves are reflected in the operating results of the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

In fiscal 2006 and fiscal 2005, workers’ compensation insurance for PEO worksite employees was provided based on claims paid as incurred. The Company’s maximum individual claims liability was \$750,000 under its fiscal 2006 policy and \$500,000 under the fiscal 2005 policy.

The Company had recorded the following amounts on its Consolidated Balance Sheets for workers’ compensation claims as of May 31:

<u>In thousands</u>	<u>Prepaid expense</u>	<u>Current liability</u>	<u>Long-term liability</u>
2006 .....	\$3,150	\$7,061	\$18,374
2005 .....	\$3,702	\$7,164	\$13,963

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

**Other insurance:** The Company’s captive insurance company provides insurance coverage to Paychex in addition to primary insurance policies purchased by Paychex. The coverage provided includes gap coverage for

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (Continued)

employment practices liability, errors and omissions, warranty liability, acts of terrorism, capacity for deductibles, and self-insured retentions.

**Income taxes:** The Company accounts for deferred taxes by recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company accounts for the tax benefit from the exercise of non-qualified stock options by reducing its accrued income tax liability and increasing additional paid-in capital.

**Stock-based compensation costs:** SFAS No. 123, "Accounting for Stock-Based Compensation," establishes accounting and reporting standards for stock-based employee compensation plans. As permitted by SFAS No. 123, the Company accounts for such arrangements under Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense is recognized for stock option grants because the exercise price of the stock options equals the market price of the underlying stock on the date of the grant.

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

In thousands, except per share amounts	Year ended May 31,		
	2006	2005	2004
Net income, as reported	\$464,914	\$368,849	\$302,950
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	18,821	15,525	9,703
Pro forma net income	<u>\$446,093</u>	<u>\$353,324</u>	<u>\$293,247</u>
Earnings per share:			
Basic — as reported	\$ 1.23	\$ 0.97	\$ 0.80
Basic — pro forma	\$ 1.18	\$ 0.93	\$ 0.78
Diluted — as reported	\$ 1.22	\$ 0.97	\$ 0.80
Diluted — pro forma	\$ 1.17	\$ 0.93	\$ 0.77

For purposes of pro forma disclosures, the estimated fair value of the stock option is amortized to expense over the option's vesting period. The weighted-average fair value of stock options granted for fiscal 2006, 2005, and 2004 was \$11.10, \$9.02, and \$9.61 per share, respectively. The fair value of these stock options was estimated at the date of the grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

	Year ended May 31,		
	2006	2005	2004
Risk-free interest rate	4.0%	3.6%	2.8%
Dividend yield	1.6%	1.6%	1.4%
Volatility factor	.31	.31	.33
Expected option term life in years	6.4	5.0	4.7

Additional information related to the Company's stock option plans is detailed in Note G of the Notes to Consolidated Financial Statements.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

*Use of estimates:* The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, judgments, and assumptions that affect reported amounts of assets, liabilities, revenue, and expenses during the reporting period. Actual amounts and results could differ from these estimates.

*New accounting pronouncements:* In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes APB 25, "Accounting for Stock Issued to Employees." This statement requires that all stock-based payments to employees, including grants of employee stock options, be recognized as compensation costs in the financial statements based on their fair values measured at the date of grant.

Prior to June 1, 2006, the Company had accounted for grants of employee stock options under the intrinsic value method allowed under APB 25 and related interpretations, and therefore had not recognized any compensation costs for stock-based awards. As permitted by SFAS No. 123, the Company presented pro forma financial results including the effects of share-based compensation costs in this Note A to the Consolidated Financial Statements.

SFAS No. 123(R) is effective for fiscal years beginning after December 15, 2005 and permits adoption using one of the following two methods:

- *Modified prospective method*, in which compensation costs will be recognized in the Company's Consolidated Financial Statements for all awards granted after the date of adoption as well as for the unvested portion of existing awards as of the date of adoption (the "Existing Awards"), and requires that prior periods not be restated.
- *Modified retrospective method*, which includes the requirements of the modified prospective method described above for new awards and Existing Awards, but also permits entities to restate prior periods based on amounts previously determined under SFAS No. 123 for pro forma disclosures.

The Company will adopt this standard beginning June 1, 2006, using the modified prospective method. Accordingly, the results of operations for future periods will not be comparable to the Company's historical results of operations. Paychex anticipates the adoption of SFAS No. 123(R) will negatively impact net income in the range of 4% to 5% for the fiscal year ending May 31, 2007, increasing the Company's operating expenses and selling, general and administrative expenses.

Unrecognized stock-based compensation costs related to Existing Awards as of May 31, 2006 were approximately \$38.3 million and are expected to be recognized over a weighted-average period of 2.4 years. The Company cannot yet estimate what the compensation cost impact will be on the financial statements for the awards that the Company issues after June 1, 2006, as it will depend on the terms of any future grants approved by the Board of Directors and the underlying assumptions used in calculating the fair value at the time of any such future grants. The calculation of fair value is very sensitive to changes in the underlying assumptions, especially volatility and expected option term life.

In addition, SFAS No. 123(R) will impact how income taxes are recorded to the Company's Consolidated Financial Statements, as tax deductions for certain tax-qualified option grants ("incentive stock options") are allowed only at the time a taxable disposition occurs. This may result in an increase in the Company's effective tax rate in the early periods after adoption and it could cause variability in the Company's effective tax rate throughout a fiscal year as these events occur.

SFAS No. 123(R) also amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash inflow rather than a reduction of taxes paid in operating cash flows. The Company cannot estimate what the amount of excess tax deductions will be in future periods. However, the amounts of operating cash flows recognized in prior periods for excess tax deductions were \$11.6 million, \$4.5 million, and \$10.2 million for fiscal 2006, 2005, and 2004, respectively.

## PAYCHEX, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company's pro-forma disclosures under SFAS No. 123 utilized a Black-Scholes option pricing model for valuing employee stock options and allocated the expense using an accelerated method. Upon adoption of SFAS No. 123(R), Paychex will continue to use a Black-Scholes option pricing model, but will begin to allocate the expense on a straight-line basis over the requisite service period to better reflect the cost of employee services provided.

Upon adoption of SFAS No. 123(R), Paychex will be required to estimate forfeitures and only record compensation costs for those awards that are expected to vest. In the Company's pro forma disclosures under SFAS No. 123, it has accounted for forfeitures as they occurred. Assumptions for forfeitures will be determined based on factors including type of award and historical experience, and will be reevaluated regularly as an award vests.

Paychex currently offers an Employee Stock Purchase Plan to all employees, under which stock can be purchased through a payroll deduction with no discount to the market price and no look-back provision. The Company has determined that this plan is non-compensatory and is not subject to the provisions of SFAS No. 123(R). Therefore, no compensation cost will be recognized related to this plan.

The following FASB Staff Positions ("FSP") issued during the Company's fiscal year ended May 31, 2006 and related to SFAS No. 123(R) will be applied upon adoption of SFAS No. 123(R) for the Company's fiscal year beginning June 1, 2006:

- FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R);"
- FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement 123(R);"
- FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards;" and
- FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event."

In October 2005, the FASB issued FSP FAS 13-1, "Accounting for Rental Costs Incurred During a Construction Period." This FSP provides that rental costs associated with operating leases that are incurred during a construction period should be recognized as rental expense and included in income from continuing operations. The guidance in this FSP was effective in the first reporting period beginning after December 15, 2005. The Company has historically expensed rental costs incurred during a construction period, and therefore, the adoption of this FSP did not have an impact on the Company's results of operations or financial position.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP provides guidance on determining if an investment is considered to be impaired, if the impairment is other-than-temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and was effective for reporting periods beginning after December 15, 2005. The Company accounts for investments in accordance with this guidance, and therefore, the adoption of this FSP did not have an impact on the Company's results of operations or financial position.

In February and March 2006, the FASB issued the following statements amending SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS No. 140, "Accounting for

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a Replacement of FASB Statement No. 125:”

- SFAS No. 155, “Accounting for Certain Hybrid Financial Instruments — an Amendment of FASB Statements No. 133 and 140;” and
- SFAS No. 156, “Accounting for Servicing of Financial Assets — an Amendment of FASB Statement No. 140.”

The guidance in these statements is effective in the first fiscal year beginning after September 15, 2006. The Company does not utilize derivative financial instruments and currently does not have any servicing assets or servicing liabilities that would fall under the guidance of either statement, and therefore, the adoption of these statements will not have a material impact on the Company’s results of operations or financial position.

**Reclassifications:** Certain prior periods presented reflect the change in classification of variable rate demand notes (“VRDNs”) and auction rate securities from cash equivalents to available-for-sale securities. This reclassification had no impact on reported consolidated earnings.

VRDNs are variable rate securities where the interest rate is periodically reset, as established at the time of the notes issuance, and is often tied to short-term interest rates. However, the contractual maturity on these notes is typically twenty to thirty years. The Company invests in these securities to provide near-term liquidity as it can tender the notes at par to a remarketing agent either daily or within five business days. Auction rate securities are also variable rate and tied to short-term interest rates with maturities in excess of ninety days. Interest rates on these securities reset through a Dutch auction, at predetermined short-term intervals, usually every seven, twenty-eight, thirty-five, or forty-nine days. Interest paid during a given period is based upon the interest rate determined during the prior auction. Although VRDNs and auction rate securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature. The Company has historically classified these securities as cash equivalents if the period between interest rate resets was ninety days or less.

Based on the Company’s review of the maturity dates associated with the underlying securities and as liquidity is provided by a party other than the original issuer, the Company has reclassified VRDNs and auction rate securities to available-for-sale securities, within corporate investments and funds held for clients, for each of the periods presented in the accompanying Consolidated Balance Sheets. This reclassification was \$1.7 billion and \$1.6 billion from cash equivalents to available-for-sale securities within funds held for clients as of May 31, 2006 and May 31, 2005, respectively, and \$263.5 million and \$203.3 million from cash and cash equivalents to corporate investments as of May 31, 2006 and May 31, 2005, respectively. In addition, “Purchases of available-for-sale securities,” “Proceeds from sales and maturities of available-for-sale securities,” “Net change in funds held for clients’ money market securities and other cash equivalents,” and “Net realized gains on sales of available-for-sale securities” included in the accompanying Consolidated Statements of Cash Flows, have been revised to reflect the purchase and sale of VRDNs and auction rate securities during the periods presented.

Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications had no effect on reported consolidated earnings. Expenses have been reclassified between operating expenses and selling, general and administrative expenses to more appropriately reflect the Company’s current way of conducting business. The role of the branch and its relationship to corporate support and information technology functions has evolved to the point where the classification of branch-related expenses needed to be revised. The new classification provides better year-over-year comparisons for operating expenses and selling, general and administrative expenses.



PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Note B — Business Combinations**

As a result of acquisitions in fiscal 2003, the Company recorded reserves for severance and redundant lease costs in the allocation of purchase price under Emerging Issues Task Force 95-3, "Recognition of Liabilities in Connection With a Purchase Combination." The purchase price allocation for the acquisitions included reserves of \$10.0 million for severance and \$5.9 million for redundant lease costs. Activity for fiscal 2006 for these reserves is summarized as follows:

<u>In thousands</u>	<u>Balance at May 31, 2005</u>	<u>Utilization of reserve</u>	<u>Other reserve adjustments</u>	<u>Balance at May 31, 2006</u>
Severance costs .....	\$ 618	\$427	\$—	\$ 191
Redundant lease costs .....	\$2,490	\$996	\$45	\$1,539

The remaining severance payments will be complete by the end of the fiscal year ending May 31, 2008. The majority of redundant lease payments are expected to be complete in the fiscal year ending May 31, 2007, with the remaining payments extending until 2015. Payments of \$1.4 million extend beyond one year and are included in other long-term liabilities on the Consolidated Balance Sheets at May 31, 2006.

**Fiscal 2004 acquisition:** During fiscal 2004, the Company expanded its product offerings to include time and attendance solutions. Effective April 12, 2004, Paychex acquired substantially all the assets and certain liabilities of Stromberg LLC ("Stromberg"), a provider of time and attendance solutions for medium- to large-sized businesses, for approximately \$13.5 million. Paychex had purchased Stromberg's Time In A Box product, a time and attendance solution for small- to medium-sized businesses, in October 2003. The purchase price was allocated to the assets and liabilities of Stromberg based on their fair values as follows:

<u>In thousands</u>	<u>Stromberg</u>
Current assets and other long-term assets .....	\$ 723
Property and equipment .....	2,097
Intangible assets .....	950
Goodwill .....	11,757
Accounts payable and accrued expenses .....	<u>(2,053)</u>
Total purchase price .....	<u>\$13,474</u>

The amount assigned to property and equipment primarily represents the fair value of software and is based upon an independent appraisal. The goodwill balance is deductible for tax purposes.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note C — Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In thousands, except per share amounts	Year ended May 31,		
	2006	2005	2004
<b>Basic earnings per share:</b>			
Net income .....	\$464,914	\$368,849	\$302,950
Weighted-average common shares outstanding .....	379,465	378,337	377,371
<b>Basic earnings per share .....</b>	<b>\$ 1.23</b>	<b>\$ 0.97</b>	<b>\$ 0.80</b>
<b>Diluted earnings per share:</b>			
Net income .....	\$464,914	\$368,849	\$302,950
Weighted-average common shares outstanding .....	379,465	378,337	377,371
Effect of dilutive stock options at average market price .....	1,886	1,426	2,153
Weighted-average common shares outstanding, assuming dilution .....	381,351	379,763	379,524
<b>Diluted earnings per share .....</b>	<b>\$ 1.22</b>	<b>\$ 0.97</b>	<b>\$ 0.80</b>
<b>Weighted-average anti-dilutive stock options .....</b>	<b>2,711</b>	<b>4,918</b>	<b>1,907</b>

Weighted-average anti-dilutive stock options to purchase shares of common stock were excluded from the computation of diluted earnings per share. These options had an exercise price that was greater than the average market price of the common shares for the period; therefore, the effect would have been anti-dilutive.

Note D — Funds Held for Clients and Corporate Investments

Funds held for clients and corporate investments at May 31, 2006 and 2005 are as follows:

In thousands	May 31, 2006			
	Cost	Gross unrealized gains	Gross unrealized losses	Market value
<b>Type of issue:</b>				
Money market securities and other cash equivalents .....	\$ 557,074	\$ —	\$ —	\$ 557,074
Available-for-sale securities:				
General obligation municipal bonds .....	796,543	229	(12,201)	784,571
Pre-refunded municipal bonds .....	215,491	153	(3,015)	212,629
Revenue municipal bonds .....	423,922	12	(6,099)	417,835
Auction rate securities and variable rate demand notes .....	2,136,906	94	—	2,137,000
U.S. government securities .....	301,573	—	(1,272)	300,301
Other equity securities .....	20	57	—	77
Total available-for-sale securities .....	3,874,455	545	(22,587)	3,852,413
Other .....	6,148	515	(51)	6,612
<b>Total funds held for clients and corporate investments .....</b>	<b>\$4,437,677</b>	<b>\$1,060</b>	<b>\$(22,638)</b>	<b>\$4,416,099</b>

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In thousands	May 31, 2005			
	Cost	Gross unrealized gains	Gross unrealized losses	Market value
<b>Type of issue:</b>				
Money market securities and other cash equivalents .....	\$ 36,571	\$ —	\$ —	\$ 36,571
Available-for-sale securities:				
General obligation municipal bonds .....	730,571	1,497	(7,042)	725,026
Pre-refunded municipal bonds .....	196,321	612	(1,112)	195,821
Revenue municipal bonds .....	414,358	697	(3,806)	411,249
Auction rate securities and variable rate demand notes .....	2,060,037	2	—	2,060,039
U.S. government securities .....	175,792	14	(762)	175,044
Other equity securities .....	20	48	—	68
Total available-for-sale securities .....	3,577,099	2,870	(12,722)	3,567,247
Other .....	5,169	254	(22)	5,401
<b>Total funds held for clients and corporate investments .....</b>	<b><u>\$3,618,839</u></b>	<b><u>\$3,124</u></b>	<b><u>\$(12,744)</u></b>	<b><u>\$3,609,219</u></b>

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

In thousands	May 31, 2006	May 31, 2005
Funds held for clients .....	\$3,591,611	\$2,979,348
Corporate investments .....	440,007	225,719
Long-term corporate investments .....	384,481	404,152
<b>Total funds held for clients and corporate investments .....</b>	<b><u>\$4,416,099</u></b>	<b><u>\$3,609,219</u></b>

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. In addition, the Company is exposed to interest rate risk, as rate volatility will cause fluctuations in the market value of held investments and in the earnings potential of future investments. The Company attempts to limit these risks by investing primarily in AAA- and AA-rated securities and A-1- rated short-term securities, limiting amounts that can be invested in any single issuer, and by investing in short- to intermediate-term instruments whose market value is less sensitive to interest rate changes.

The Company's available-for-sale securities reflected a net unrealized loss position of \$22.0 million at May 31, 2006 compared with \$9.9 million at May 31, 2005. The change in the net unrealized loss position of the Company's available-for-sale securities from May 31, 2005 to May 31, 2006 resulted from increases in long-term market interest rates. The gross unrealized losses at May 31, 2006 were comprised of 441 available-for-sale securities, which had a total market value of \$1,625.7 million. The gross unrealized losses at May 31, 2005 were comprised of 327 available-for-sale securities with a total market value of \$1,211.5 million. The securities in an unrealized loss position were in a loss position as follows as of May 31, 2006 and 2005:

In thousands	Less than 12 Months		More than 12 Months	
	Gross unrealized loss	Market value	Gross unrealized loss	Market value
2006 .....	<u>\$(7,724)</u>	<u>\$735,610</u>	<u>\$(14,863)</u>	<u>\$890,076</u>
2005 .....	<u>\$(6,474)</u>	<u>\$818,782</u>	<u>\$(6,248)</u>	<u>\$392,748</u>

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company periodically 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. At May 31, 2006, the Company believed that the investments it held were not other-than-temporarily impaired. While certain available-for-sale securities had market values that were below cost, the Company believed that it was probable that the principal and interest would be collected in accordance with contractual terms, and that the decline in the market value was due to changes in interest rates and was not due to increased credit risk. At May 31, 2006 and May 31, 2005, substantially all of the securities in an unrealized loss position held an AA rating or better. The Company currently believes that it has the ability and intent to hold these investments until the earlier of market price recovery or maturity. 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. As of May 31, 2006, the Company had separately reported its long-term corporate investments on its Consolidated Balance Sheets as the Company has the ability to hold these investments for a period in excess of one year. To conform to the current period presentation, the Company has also reclassified its investments at May 31, 2005.

Realized gains and losses are as follows:

<u>In thousands</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Gross realized gains .....	\$1,036	\$1,114	\$19,808
Gross realized losses .....	(61)	(891)	(675)
<b>Net realized gains</b> .....	<b><u>\$ 975</u></b>	<b><u>\$ 223</u></b>	<b><u>\$19,133</u></b>

The cost and market value of available-for-sale securities that have stated maturities at May 31, 2006 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

<u>In thousands</u>	<u>May 31, 2006</u>	
	<u>Cost</u>	<u>Market value</u>
<b>Maturity date:</b>		
Due in one year or less .....	\$ 545,046	\$ 542,178
Due after one year through three years .....	688,411	678,728
Due after three years through five years .....	282,107	276,241
Due after five years .....	<u>2,356,196</u>	<u>2,352,513</u>
<b>Total available-for-sale securities</b> .....	<b><u>\$3,871,760</u></b>	<b><u>\$3,849,660</u></b>

VRDNs and auction rate securities are primarily categorized as due after five years in the table above as the contractual maturities on these securities is typically twenty to thirty years. Although these securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Note E — Property and Equipment, Net of Accumulated Depreciation**

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

<u>In thousands</u>	<u>May 31,</u>	
	<u>2006</u>	<u>2005</u>
Land and improvements .....	\$ 3,552	\$ 3,402
Buildings and improvements .....	79,875	66,019
Data processing equipment .....	134,636	116,465
Software .....	66,945	58,463
Furniture, fixtures, and equipment .....	112,733	98,312
Leasehold improvements .....	47,627	35,958
Construction in progress .....	<u>36,350</u>	<u>29,470</u>
Total property and equipment, gross .....	481,718	408,089
Less: Accumulated depreciation and amortization .....	<u>247,054</u>	<u>202,770</u>
<b>Property and equipment, net of accumulated depreciation .....</b>	<b><u>\$234,664</u></b>	<b><u>\$205,319</u></b>

Depreciation expense was \$51.6 million, \$46.2 million, and \$39.2 million for fiscal years 2006, 2005, and 2004, respectively.

Within construction in progress, there are costs for software being developed for internal use of \$29.4 million and \$18.9 million at May 31, 2006 and May 31, 2005, respectively. Capitalization of costs ceases when the software is ready for its intended use, at which time the Company begins amortization of the costs.

**Note F — Intangible Assets, Net of Accumulated Amortization**

The Company accounts for certain intangible assets with finite lives in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." The components of intangible assets, at cost, consisted of the following:

<u>In thousands</u>	<u>May 31,</u>	
	<u>2006</u>	<u>2005</u>
Client lists and associate offices license agreements .....	\$122,909	\$118,749
Other intangible assets .....	<u>4,165</u>	<u>4,166</u>
Total intangible assets, gross .....	127,074	122,915
Less: Accumulated amortization .....	<u>66,370</u>	<u>51,457</u>
<b>Intangible assets, net of accumulated amortization .....</b>	<b><u>\$ 60,704</u></b>	<b><u>\$ 71,458</u></b>

Amortization expense for intangible assets was \$14.9 million, \$15.8 million, and \$16.6 million for fiscal years 2006, 2005, and 2004, respectively.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The estimated amortization expense for the next five fiscal years relating to intangible asset balances as of May 31, 2006, is as follows:

<u>In thousands</u> <u>Fiscal year ended May 31,</u>	<u>Estimated</u> <u>amortization</u> <u>expense</u>
2007 .....	\$13,475
2008 .....	\$11,736
2009 .....	\$ 9,995
2010 .....	\$ 8,367
2011 .....	\$ 6,592

**Note G — Stock Option Plans**

The Paychex, Inc. 2002 Stock Incentive Plan, as amended and restated (the “2002 Plan”), became effective on October 12, 2005 upon its approval by the Company’s stockholders. The 2002 Plan authorizes the granting of options to purchase up to 29.1 million shares of the Company’s common stock. At May 31, 2006, there were 20.5 million shares available for future grants under the 2002 Plan.

No future grants will be made pursuant to the Paychex, Inc. 1998 or 1995 Stock Incentive Plans, which expired in August 2002 and 1998, respectively. However, options to purchase an aggregate of 4.5 million shares under these two plans remain outstanding at May 31, 2006.

The exercise price for the shares subject to options of the Company’s common stock is equal to the fair market value on the date of the grant. All stock option grants have a contractual life of ten years from the date of the grant. Non-qualified stock option grants since July 2005 vest 20% per annum, with previously granted stock options vesting at 33.3% after two years of service from the date of the grant, with annual vesting at 33.3% thereafter.

The Company has granted stock options to employees in the following broad-based incentive stock option grants:

<u>Date of broad-based grant</u>	<u>Shares</u> <u>granted</u>	<u>Exercise</u> <u>price</u>	<u>Shares</u> <u>outstanding at</u> <u>May 31, 2006</u>	<u>Vesting schedule</u>
November 1996 .....	3,157,000	\$11.53	180,000	50% on May 3, 1999, 50% on May 1, 2001
July 1999 .....	1,381,000	\$21.46	328,000	25% each July in 2000 through 2003
October 2001 .....	1,295,000	\$33.17	579,000	25% each October in 2002 through 2005
April 2004.....	1,655,000	\$37.72	1,173,000	25% each April in 2005 through 2008

Historically, each April and October, the Company has granted options to newly hired employees who met certain criteria. Beginning with grants issued in July 2005, such grants of options vest 20% per annum.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes stock option activity for the three years ended May 31, 2006:

<u>In thousands, except per share amounts</u>	<u>Shares subject to options</u>	<u>Weighted-average exercise price</u>
<b>Outstanding at May 31, 2003</b> .....	<b>8,871</b>	<b>\$23.77</b>
Granted .....	3,429	\$34.29
Exercised .....	(1,270)	\$14.38
Cancelled .....	<u>(424)</u>	<u>\$32.89</u>
<b>Outstanding at May 31, 2004</b> .....	<b>10,606</b>	<b>\$27.93</b>
Granted .....	2,729	\$31.54
Exercised .....	(661)	\$13.65
Cancelled .....	<u>(745)</u>	<u>\$34.19</u>
<b>Outstanding at May 31, 2005</b> .....	<b>11,929</b>	<b>\$29.15</b>
Granted .....	3,860	\$34.32
Exercised .....	(1,674)	\$19.19
Cancelled .....	<u>(605)</u>	<u>\$34.72</u>
<b>Outstanding at May 31, 2006</b> .....	<b><u>13,510</u></b>	<b><u>\$31.61</u></b>
<b>Exercisable at May 31, 2004</b> .....	<b><u>5,000</u></b>	<b><u>\$21.31</u></b>
<b>Exercisable at May 31, 2005</b> .....	<b><u>5,622</u></b>	<b><u>\$25.50</u></b>
<b>Exercisable at May 31, 2006</b> .....	<b><u>5,482</u></b>	<b><u>\$29.49</u></b>

Stock options granted during fiscal 2005 include a grant of 650,000 options, at an exercise price of \$30.68 per share, to the Company's current President and Chief Executive Officer on October 1, 2004. Of these stock options, 100,000 were granted under the 2002 Plan and the remaining 550,000 were granted under a non-qualified stock option agreement.

Historically, the Company has granted options to purchase common stock in an annual aggregate amount that is less than one percent of the outstanding common shares. With the July 2005 grant of options to purchase common stock, the Company has increased the annual amount to approximately one percent of outstanding common shares.

The following table summarizes information about stock options outstanding and exercisable at May 31, 2006:

<u>Range of exercise prices per share</u>	<u>Options outstanding</u>			<u>Options exercisable</u>	
	<u>Shares subject to options (in thousands)</u>	<u>Weighted-average exercise price per share</u>	<u>Weighted-average remaining contractual life in years</u>	<u>Shares subject to options (in thousands)</u>	<u>Weighted-average exercise price per share</u>
\$ 8.71 — \$17.24	719	\$11.59	1.0	719	\$11.59
\$17.25 — \$25.78	1,191	\$20.85	2.8	1,191	\$20.85
\$25.79 — \$34.32	8,465	\$31.85	8.0	1,622	\$30.56
\$34.33 — \$42.86	3,006	\$39.14	6.8	1,821	\$39.76
\$42.87 — \$51.38	<u>129</u>	<u>\$50.53</u>	4.3	<u>129</u>	<u>\$50.53</u>
\$ 8.71 — \$51.38	<u>13,510</u>	<u>\$31.61</u>	6.8	<u>5,482</u>	<u>\$29.49</u>

**PAYCHEX, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**Note H — Income Taxes**

The components of deferred tax assets and liabilities are as follows:

<u>In thousands</u>	<u>May 31,</u>	
	<u>2006</u>	<u>2005</u>
<b>Deferred tax assets:</b>		
Legal reserve .....	\$ 4,481	\$ 8,973
Captive loss reserve .....	2,364	1,826
Compensation and employee benefit liabilities .....	9,522	7,471
PEO workers' compensation claims reserve .....	3,589	6,400
Unrealized losses on available-for-sale securities .....	7,717	3,431
Other current liabilities .....	5,667	3,501
Tax credit carry forward .....	11,242	—
Depreciation .....	3,120	658
Other .....	<u>2,265</u>	<u>2,301</u>
<b>Gross deferred tax assets</b> .....	<b><u>49,967</u></b>	<b><u>34,561</u></b>
<b>Deferred tax liabilities:</b>		
Capitalized software .....	11,609	8,684
Intangible assets .....	12,704	10,316
Revenue not subject to current taxes .....	8,973	7,985
Depreciation .....	711	3,549
Other .....	<u>354</u>	<u>413</u>
<b>Gross deferred tax liabilities</b> .....	<b><u>34,351</u></b>	<b><u>30,947</u></b>
<b>Net deferred tax asset</b> .....	<b><u>\$15,616</u></b>	<b><u>\$ 3,614</u></b>

The components of the provision for income taxes are as follows:

<u>In thousands</u>	<u>Year ended May 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
<b>Current:</b>			
Federal .....	\$209,659	\$159,007	\$140,130
State .....	<u>7,909</u>	<u>8,720</u>	<u>14,708</u>
<b>Total current</b> .....	<b><u>217,568</u></b>	<b><u>167,727</u></b>	<b><u>154,838</u></b>
<b>Deferred:</b>			
Federal .....	(7,872)	9,155	(7,657)
State .....	<u>156</u>	<u>435</u>	<u>(347)</u>
<b>Total deferred</b> .....	<b><u>(7,716)</u></b>	<b><u>9,590</u></b>	<b><u>(8,004)</u></b>
<b>Provision for income taxes</b> .....	<b><u>\$209,852</u></b>	<b><u>\$177,317</u></b>	<b><u>\$146,834</u></b>



PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

A reconciliation of the U.S. federal statutory tax rate to the effective rates reported for income before taxes for the three years ending May 31, 2006, is as follows:

	Year ended May 31,		
	2006	2005	2004
Federal statutory tax rate .....	35.0%	35.0%	35.0%
Increase/(decrease) resulting from:			
State income taxes, net of federal benefit .....	0.8	1.1	2.1
Tax-exempt municipal bond interest .....	(4.5)	(3.9)	(3.8)
Other items .....	(0.2)	0.3	(0.7)
<b>Effective income tax rate .....</b>	<b><u>31.1%</u></b>	<b><u>32.5%</u></b>	<b><u>32.6%</u></b>

**Note I — Other Comprehensive Loss**

The following table sets forth the related tax effects allocated to unrealized gains and losses on available-for-sale securities, which is the only component of other comprehensive loss:

In thousands	Year ended May 31,		
	2006	2005	2004
Unrealized holding losses .....	\$(11,216)	\$(5,445)	\$(30,011)
Income tax benefit related to unrealized holding losses .....	3,941	1,878	10,768
Reclassification adjustment for the net gain on sale of available-for-sale securities realized in net income .....	(975)	(223)	(19,133)
Income tax expense on reclassification adjustment for net gain on sale of available-for-sale securities .....	<u>345</u>	<u>78</u>	<u>6,972</u>
<b>Other comprehensive loss .....</b>	<b><u>\$ (7,905)</u></b>	<b><u>\$ (3,712)</u></b>	<b><u>\$ (31,404)</u></b>

At May 31, 2006, accumulated other comprehensive loss was \$14.3 million, net of tax of \$7.8 million. At May 31, 2005, accumulated other comprehensive loss was \$6.4 million, net of tax of \$3.4 million.

**Note J — Supplemental Cash Flow Information**

Supplemental disclosure of non-cash financing activities and cash flow information is as follows:

In thousands	Year ended May 31,		
	2006	2005	2004
Income taxes paid .....	\$207,632	\$166,903	\$145,710
Tax benefit from the exercise of stock options .....	\$ 11,587	\$ 4,516	\$ 10,194

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

**Note K — Employee Benefit Plans**

**401(k) Plans:** The Company maintains a contributory savings plan that qualifies under section 401(k) of the Internal Revenue Code. The Paychex, Inc. 401(k) Incentive Retirement Plan (the “Plan”) allows all employees to immediately participate in the salary deferral portion of the Plan, contributing up to a maximum of 50% of their salary. Employees who have completed one year of service are eligible to receive a company matching contribution. The Company currently matches 50% of an employee’s voluntary contribution up to 6% of a participant’s gross wages.

This Plan is 100% participant-directed. Plan participants can fully diversify their portfolios by choosing from any or all investment fund choices in the Plan. Transfers in and out of investment funds, including the Paychex, Inc. Employee Stock Ownership Plan (“ESOP”) Stock Fund, are not restricted in any manner. The Company match contribution follows the same fund elections as the employee compensation deferrals.

Company contributions to the 401(k) plan for fiscal 2006, 2005, and 2004 were \$9.1 million, \$7.9 million, and \$7.1 million, respectively.

**Deferred Compensation Plans:** The Company offers a non-qualified and unfunded Deferred Compensation Plan to a select group of key employees, executive officers, and Directors. Eligible employees are provided with the opportunity to defer up to 50% of their annual base salary and bonus and non-employee directors to defer 100% of their Board compensation. Gains and losses are credited based on the participant’s election of a variety of investment choices. The Company does not match any participant deferral or guarantee its return. The amounts accrued under this Plan were \$6.6 million and \$5.4 million at May 31, 2006 and 2005, respectively, and are reflected in other long-term liabilities in the accompanying Consolidated Balance Sheets.

Prior to the April 1, 2003 acquisition, InterPay, Inc. (“InterPay”) entered into various salary continuation agreements with certain former employees. These agreements provide for benefits to these retired employees, and in certain cases to their beneficiaries, for life or other designated periods through 2015. The amounts accrued under these agreements were \$1.6 million and \$1.8 million at May 31, 2006 and 2005, respectively, and represent the estimated present value of the benefits earned under these agreements.

**Employee Stock Purchase Plan:** The Company offers an Employee Stock Purchase Plan under which eligible employees may purchase common stock of the Company at current market prices with no look-back provision. All transactions occur directly through the Company’s transfer agent and no brokerage fees are charged to employees, except for when stock is sold.

**Note L — Commitments and Contingencies**

**Lines of credit:** The Company has unused borrowing capacity available under four uncommitted, secured, short-term lines of credit with financial institutions at market rates of interest as follows:

<u>Financial institution</u>	<u>Amount available</u>	<u>Expiration date</u>
JP Morgan Chase Bank, N.A. . . . .	\$350 million	February 2007
Fleet National Bank, a Bank of America company . . . . .	\$250 million	February 2007
PNC Bank, National Association . . . . .	\$150 million	February 2007
Wells Fargo Bank, National Association . . . . .	\$150 million	February 2007

The credit facilities are evidenced by Promissory Notes and are secured by separate Pledge Security Agreements by and between Paychex, Inc. and each of the financial institutions (the “Lenders”), pursuant to which the Company has granted each of the Lenders a security interest in certain investment securities accounts. The collateral is maintained in a pooled custody account pursuant to the terms of a Control Agreement and is to be administered under an Intercreditor Agreement among the Lenders. Under certain

## PAYCHEX, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

circumstances, individual Lenders may require that collateral be transferred from the pooled account into segregated accounts for the benefit of such individual Lenders.

The primary uses of the lines of credit would be to meet short-term funding requirements related to deposit account overdrafts and client fund deposit obligations arising from electronic payment transactions on behalf of clients in the ordinary course of business, if necessary. No amounts were outstanding against these lines of credit during fiscal 2006 or at May 31, 2006.

**Letters of credit:** The Company had standby letters of credit outstanding totaling \$53.4 million and \$53.1 million at May 31, 2006 and 2005, respectively, required to secure commitments for certain insurance policies. These letters of credit at May 31, 2006, expire at various dates between July 2006 and December 2008 and are secured by securities held in the Company's corporate investment portfolios, including a \$44.2 million letter of credit for which funds have been segregated into a separate account. Effective June 28, 2006, this \$44.2 million letter of credit was increased to \$50.9 million, bringing the total letters of credit outstanding to \$60.2 million. No amounts were outstanding on these letters of credit during fiscal 2006 or at May 31, 2006.

**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, employment-related claims, tax claims, and other matters.

The Company and its wholly owned subsidiary, Rapid Payroll, Inc. ("Rapid Payroll"), are currently defendants in three lawsuits pending in the United States Bankruptcy Court, Central District of California, thirteen lawsuits pending in the United States Court of Appeals for the Ninth Circuit, and one lawsuit pending in the California Court of Appeal, Second District, all brought in calendar years 2002 and 2003 by licensees of payroll processing software owned by Rapid Payroll.

In August 2001, Rapid Payroll informed seventy-six licensees that it intended to stop supporting the payroll processing software in August of 2002. Thereafter, lawsuits were commenced by licensees asserting various claims, including breach of contract and related tort and fraud causes of action. These lawsuits sought compensatory damages, punitive damages, and injunctive relief against Rapid Payroll, the Company, the Company's former Chief Executive Officer, and its Senior Vice President of Sales and Marketing. In accordance with the Company's indemnification agreements with its senior executives, the Company will defend and, if necessary, indemnify them in connection with these pending matters.

On July 5, 2002, the federal district court entered a preliminary injunction requiring that Rapid Payroll and the Company continue to support and maintain the subject software pursuant to the license agreements.

In 2005, judgment was entered in *Accuchex, Inc. v. Rapid Payroll, Inc., et al.* following a bench trial before a judge of the Los Angeles County Superior Court. The judgment provided that the limitation of liability clause in the parties' license agreement is valid and enforceable. The court awarded Accuchex damages of \$30.5 thousand plus a refund of approximately \$35.0 thousand in license fees. The court also ordered Rapid Payroll to support its software being used by Accuchex until such time as Rapid Payroll dissolves, which the court found Rapid Payroll was entitled to do without incurring any further liability to Accuchex. The court rejected all of the other causes of action asserted by the plaintiff. The case is pending on appeal with the California Court of Appeal, Second District.

On February 28 and March 1, 2005, the United States District Court, Central District of California entered judgment in thirteen of the cases pending before it. Those judgments provided that Rapid Payroll's liability is limited by the license fees paid to it by the plaintiff licensees, pursuant to express contractual provisions of the license agreements. Those judgments also extended the court's preliminary injunction, ordering that Rapid Payroll must support the licensed software through April 30, 2006, and, at that time, refund to each of the licensee plaintiffs the license fees paid by that plaintiff. The license fees received by

**PAYCHEX, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

Rapid Payroll under the agreements from these thirteen licensee plaintiffs total approximately \$2.5 million. The federal court also ordered the release of the source code pursuant to the escrow terms of the license agreements. The federal court judgments rejected the fraud and other tort claims brought by those plaintiffs against all of the defendants. Plaintiffs have appealed the federal court rulings and the Company has cross-appealed.

On May 4, 2006, following expiration of the federal district court's injunction, Rapid Payroll filed a petition under Chapter 11 of the U.S. Bankruptcy Code in order to develop a plan that allows Rapid Payroll to discontinue support for the software in a manner that deals fairly with its few remaining licensees. Rapid Payroll is continuing to operate as a debtor-in-possession, paying all of its post-petition debts as they become due.

Based on the application of SFAS No. 5, "Accounting for Contingencies," the Company is required to record a reserve if it believes an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated. The Company's legal reserve for all litigation totaled \$15.6 million at May 31, 2006, and is included in current liabilities on the Consolidated Balance Sheets. The legal reserve has been reduced in fiscal 2006 as actual settlements and incurred professional fees have been charged against it.

In light of the legal reserve recorded, the Company's management currently believes that resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations. However, these 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 the results of operations in the period in which any such effect is recorded.

**Lease commitments:** The Company leases office space and data processing equipment under terms of various operating leases, with most data processing equipment leases containing a purchase option at prices representing the fair value of the equipment at expiration of the lease term. Rent expense for fiscal 2006, 2005, and 2004 was \$37.6 million, \$35.9 million, and \$37.7 million, respectively. At May 31, 2006, future minimum lease payments under various non-cancelable operating leases with terms of more than one year are as follows:

<u>In thousands</u> <u>Fiscal year ended May 31,</u>	<u>Minimum lease payments</u>
2007 .....	\$37,902
2008 .....	\$33,687
2009 .....	\$27,019
2010 .....	\$19,859
2011 .....	\$12,100
Thereafter .....	\$ 5,104

The amounts shown above for operating leases include obligations under redundant leases related to Advantage and InterPay.

**Other commitments:** At May 31, 2006, the Company had outstanding commitments under purchase orders and legally binding contractual arrangements with minimum future payment obligations of approximately \$77.0 million, including \$8.2 million of commitments to purchase capital assets.

The Company guarantees performance of service on annual maintenance contracts for clients who financed their service contracts through a third party. In the normal course of business, the Company makes representations and warranties that guarantee the performance of services under service arrangements with clients. 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

**PAYCHEX, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

legal claims as they relate to their services to Paychex and its subsidiaries. Historically, there have been no material losses related to such guarantees and indemnifications.

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. Historically, the amounts accrued have not been material. The Company maintains insurance coverage in addition to its purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, and acts of terrorism, and capacity for deductibles and self-insured retentions through its captive insurance company.

**Note M — Related Parties**

During fiscal years 2006, 2005, and 2004, the Company purchased approximately \$4.6 million, \$2.5 million, and \$1.2 million, respectively, of data processing equipment and software from EMC Corporation, whose Chairman, President, and Chief Executive Officer is a member of the Board of Directors of Paychex.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note N — Quarterly Financial Data (Unaudited)

In thousands, except per share amounts

Fiscal 2006	Three Months Ended				Full Year
	August 31	November 30	February 28	May 31	
Service revenue	\$384,415	\$379,028	\$401,883	\$408,471	\$1,573,797
Interest on funds held for clients	19,300	20,787	28,703	32,009	100,799
Total revenue	403,715	399,815	430,586	440,480	1,674,596
Operating income	162,820	158,605	160,600	167,546	649,571
Investment income, net	4,859	5,552	6,358	8,426	25,195
Income before income taxes	167,679	164,157	166,958	175,972	674,766
Income taxes	52,651	51,545	52,424	53,232	209,852
Net income	\$115,028	\$112,612	\$114,534	\$122,740	\$ 464,914
Basic earnings per share(A)	\$ 0.30	\$ 0.30	\$ 0.30	\$ 0.32	\$ 1.23
Diluted earnings per share(A)	\$ 0.30	\$ 0.30	\$ 0.30	\$ 0.32	\$ 1.22
Weighted-average common shares outstanding	378,810	379,268	379,680	380,092	379,465
Weighted-average common shares outstanding, assuming dilution	380,180	381,256	381,751	382,207	381,351
Cash dividends per common share	\$ 0.13	\$ 0.16	\$ 0.16	\$ 0.16	\$ 0.61
Total net realized gains(B)	\$ 112	\$ 14	\$ 498	\$ 351	\$ 975
	Three Months Ended				
Fiscal 2005	August 31	November 30	February 28	May 31	Full Year
Service revenue	\$334,203	\$334,876	\$357,094	\$358,501	\$1,384,674
Interest on funds held for clients	10,772	12,409	16,767	20,521	60,469
Total revenue	344,975	347,285	373,861	379,022	1,445,143
Operating income	128,668	126,898	135,382	142,827	533,775
Investment income, net	2,259	2,751	3,099	4,282	12,391
Income before income taxes	130,927	129,649	138,481	147,109	546,166
Income taxes	43,206	42,784	45,699	45,628	177,317
Net income	\$ 87,721	\$ 86,865	\$ 92,782	\$101,481	\$ 368,849
Basic earnings per share(A)	\$ 0.23	\$ 0.23	\$ 0.25	\$ 0.27	\$ 0.97
Diluted earnings per share(A)	\$ 0.23	\$ 0.23	\$ 0.24	\$ 0.27	\$ 0.97
Weighted-average common shares outstanding	378,107	378,265	378,403	378,569	378,337
Weighted-average common shares outstanding, assuming dilution	379,706	379,696	379,814	379,831	379,763
Cash dividends per common share	\$ 0.12	\$ 0.13	\$ 0.13	\$ 0.13	\$ 0.51
Total net realized gains/(losses)(B)	\$ 177	\$ 92	\$ (170)	\$ 124	\$ 223

(A) Each quarter is a discrete period and the sum of the four quarters' basic and diluted earnings per share amounts may not equal the full year amount.

(B) Total net realized gains/(losses) on the combined funds held for clients and corporate investment portfolios, net of immaterial adjustments related to the reclassification of auction rate securities as described in Note A of the Notes to Consolidated Financial Statements.

Schedule II — Valuation and Qualifying Accounts

**PAYCHEX, INC.**  
**CONSOLIDATED FINANCIAL STATEMENT SCHEDULE**  
**FOR THE YEAR ENDED MAY 31,**  
**In thousands**

<u>Description</u>	<u>Balance at beginning of year</u>	<u>Additions charged to expenses</u>	<u>Additions/ (deductions) to other accounts (A)</u>	<u>Costs and deductions (B)</u>	<u>Balance at end of year</u>
<b>2006</b>					
Allowance for doubtful accounts . . . . .	\$2,472	\$2,173	\$ —	\$2,115	\$2,530
Reserve for client fund losses . . . . .	\$1,582	\$3,444	\$ —	\$2,505	\$2,521
<b>2005</b>					
Allowance for doubtful accounts . . . . .	\$3,262	\$2,179	\$ —	\$2,969	\$2,472
Reserve for client fund losses . . . . .	\$1,427	\$2,481	\$ —	\$2,326	\$1,582
<b>2004</b>					
Allowance for doubtful accounts . . . . .	\$2,208	\$2,941	\$ 702	\$2,589	\$3,262
Reserve for client fund losses . . . . .	\$2,168	\$2,943	\$(207)	\$3,477	\$1,427

(A) Reflects amounts acquired in purchase transactions or adjustments to purchase price allocations.

(B) Uncollectible amounts written off, net of recoveries.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

**Disclosure Controls and Procedures and Internal Control Over Financial Reporting:** Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in the Company's 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 Securities and Exchange Commission's rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

**Evaluation of Disclosure Controls and Procedures:** As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's 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 Company's Chief Executive Officer and Chief Financial Officer have concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective at meeting their objectives.

**Changes in Internal Controls:** There were no changes in the Company's internal controls over financial reporting that occurred during the Company's most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Report on Management's Assessment of Internal Control Over Financial Reporting and the Report of Independent Registered Public Accounting Firm on Effectiveness of Internal Control Over Financial Reporting are incorporated herein by reference from Part II, Item 8 of this Form 10-K.

**Item 9B. Other Information**

None.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

The following table shows the executive officers of the Company as of May 31, 2006, and information regarding their positions and business experience. Such executive officers maintain principal policy-making powers at the Company.

<u>Name</u>	<u>Age</u>	<u>Position and business experience</u>
Jonathan J. Judge . . . . .	52	Mr. Judge became President and Chief Executive Officer of the Company in October 2004. Prior to joining the Company, from October 2002 through December 2003, he served as President and Chief Executive Officer of Crystal Decisions, Inc., an information management software company. From 2001 to 2002, Mr. Judge was General Manager of IBM's Personal Computing Division. From 1998 to 2001, he headed up the worldwide sales, service, and support functions of IBM's Personal Computing Division and was a member of the worldwide management committee of IBM. Mr. Judge also serves as a director of the Company and is also a director of PMC-Sierra, Inc.



<u>Name</u>	<u>Age</u>	<u>Position and business experience</u>
John M. Morphy .....	58	Mr. Morphy joined the Company in October 1995 and was named Senior Vice President in October 2002. He was named Chief Financial Officer and Secretary in October 1996. He was Vice President, Director of Finance from July 1996 to October 2002. Prior to joining the Company, he served as Chief Financial Officer and in other senior management capacities for over ten years at Goulds Pumps, Incorporated, a pump manufacturer.
Martin Mucci .....	46	Mr. Mucci joined the Company in March 2002 as a consultant on operational issues of the Company, including responsibility for implementation of the Advantage Payroll Services, Inc. acquisition, and was appointed Senior Vice President, Operations in October 2002. Prior to joining the Company, he served as President of Telephone Operations for Frontier Communications, a telecommunications services provider, and Chief Executive Officer of Frontier Communications of Rochester, N.Y., a telecommunications services provider.
Walter Turek .....	53	Mr. Turek has served as Senior Vice President, Sales and Marketing, since October 2002. From 1989 to October 2002, he was Vice President, Sales. He has been with the Company since 1981 and has served in various sales and management capacities.
Melinda A. Janik .....	49	Ms. Janik joined the Company in March 2005 as Vice President and Controller. Prior to joining the Company, she was Senior Vice President and Chief Financial Officer for Glimcher Realty Trust, a publicly traded national mall Real Estate Investment Trust, for a number of years beginning in July 2002. Prior to July 2002, she was Vice President and Treasurer for NCR Corporation, a technology company.
William G. Kuchta, Ed. D ...	59	Mr. Kuchta joined the Company in February 1995 and was named Vice President, Organizational Development in April 1996. From 1993 to 1995, he was principal of his own consulting firm, and from 1989 to 1993, he served as Vice President of Human Resources of Fisons Corporation.

The additional information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders in the sections titled "PROPOSAL 1 — ELECTION OF DIRECTORS FOR A ONE-YEAR TERM," "CORPORATE GOVERNANCE," "CODE OF ETHICS," and "SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE," and is incorporated herein by reference thereto.

**Item 11. *Executive Compensation***

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders in the section titled "EXECUTIVE OFFICER COMPENSATION," and is incorporated herein by reference thereto.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this item is set forth below and in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT," and is incorporated herein by reference thereto.

The Company maintains equity compensation plans in the form of stock option incentive plans. Currently, stock options are granted to employees in the form of non-qualified or incentive stock options

(broad-based grants only) from the Paychex, Inc. 2002 Stock Incentive Plan, as amended and restated (the "2002 Plan"). The 2002 Plan was adopted on July 7, 2005, by the Board of Directors of the Company and became effective upon stockholder approval at the Company's Annual Meeting of Stockholders held on October 12, 2005. There are previously granted options to purchase shares under the Paychex, Inc. 1998 and 1995 Stock Incentive Plans that remain outstanding at May 31, 2006. There will not be any new grants under these expired plans. Refer to Note G in the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for more information on the Company's stock option plans.

The following table details information on securities authorized for issuance under the Company's stock incentive plans as of May 31, 2006:

<u>In thousands</u>	<u>Number of securities to be issued upon exercise of outstanding options</u>	<u>Weighted-average exercise price of outstanding options</u>	<u>Number of securities remaining available for future issuance under equity compensation plans</u>
Equity compensation plans approved by security holders .....	12,960	\$31.64	20,509
Equity compensation plans not approved by security holders.....	<u>550</u>	\$30.68	<u>—</u>
Total .....	<u>13,510</u>	\$31.61	<u>20,509</u>

**Item 13. *Certain Relationships and Related Transactions***

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "OTHER MATTERS AND INFORMATION," under the sub-heading "Certain Relationships and Related Transactions," and is incorporated herein by reference thereto.

**Item 14. *Principal Accountant Fees and Services***

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS," and is incorporated herein by reference thereto.

**PART IV**

**Item 15. *Exhibits and Financial Statement Schedules***

1. Financial Statements and Supplementary Data  
See Financial Statements and Supplementary Data Table of Contents at page 31.
2. Financial statement schedules required to be filed by Item 8 of this Form 10-K include Schedule II — Valuation and Qualifying Accounts. See Financial Statements and Supplementary Data Table of Contents at page 31.  
All other schedules are omitted as the required matter is not present, the amounts are not significant, or the information is shown in the financial statements or the notes thereto.
3. Exhibits
  - (3)(a) Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3(a) to the Company's Form 10-K filed with the Commission on July 20, 2004.
  - \* (3)(b) Bylaws, as amended.
  - # (10)(a) Paychex, Inc. 1995 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 33-64389.

- # (10) (b) Paychex, Inc. 1998 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-65191.
- # (10) (c) Paychex, Inc. 2002 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-101074.
- # (10) (d) Paychex, Inc. 2002 Stock Incentive Plan (as amended and restated), incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-129572.
- # (10) (e) Paychex, Inc. 2002 Stock Incentive Plan (as amended and restated effective October 12, 2005) Award Agreement for Non-Qualified Stock Options, incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed with the Commission on October 17, 2005.
- # (10) (f) Paychex, Inc. Non-Qualified Stock Option Agreement, incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-129571.
- # (10) (g) Form of Indemnification Agreement for Directors and Officers, incorporated herein by reference to Exhibit 10.1 to the Company's Form 10-Q filed with the Commission on March 21, 2003.
- # (10) (h) Paychex, Inc. Indemnification Agreement with B. Thomas Golisano, incorporated herein by reference to Exhibit 10(g) to the Company's Form 10-K filed with the Commission on July 20, 2004.
- # (10) (i) Paychex, Inc. Indemnification Agreement with Walter Turek, incorporated herein by reference to Exhibit 10(h) to the Company's Form 10-K filed with the Commission on July 20, 2004.
- # (10) (j) Paychex, Inc. Deferred Compensation Plan, incorporated herein by reference to Exhibit 10(i) to the Company's Form 10-K filed with the Commission on July 20, 2004.
- # (10) (k) Paychex, Inc. Employment Agreement with Jonathan J. Judge dated October 1, 2004, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed with the Commission on October 4, 2004.
- # (10) (l) Compensation arrangement with B. Thomas Golisano, effective October 1, 2004, for service as Chairman of the Board of Directors, incorporated by reference to Exhibit 10(j) to the Company's Form 10-K filed with the Commission on July 22, 2005.
- # (10) (m) Paychex, Inc. Indemnification Agreement with Jonathan J. Judge, incorporated by reference to Exhibit 10(k) to the Company's Form 10-K filed with the Commission on July 22, 2005.
- # (10) (n) Certain compensation information for Jonathan J. Judge, President and Chief Executive Officer of the Company, is incorporated herein by reference from the Company's Form 8-K filed with the Commission on February 10, 2006.
- \*# (10) (o) Paychex, Inc. Officer Performance Incentive Program for the year ended May 31, 2007.
- \* (21.1) Subsidiaries of the Registrant.
- \* (23.1) Consent of Independent Registered Public Accounting Firm.
- \* (24.1) Power of Attorney.
- \* (31.1) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- \* (31.2) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- \* (32.1) Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- \* (32.2) Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Exhibit filed with this report

# Management contract or compensatory plan

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on July 21, 2006.

### PAYCHEX, INC.

By: /s/ JONATHAN J. JUDGE

Jonathan J. Judge  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on July 21, 2006.

/s/ JONATHAN J. JUDGE

Jonathan J. Judge, President and  
Chief Executive Officer, and Director  
(Principal Executive Officer)

/s/ JOHN M. MORPHY

John M. Morphy, Senior Vice President,  
Chief Financial Officer, and Secretary  
(Principal Financial and Accounting Officer)

B. Thomas Golisano\*, Chairman of the Board

David J. S. Flaschen\*, Director

Phillip Horsley\*, Director

Grant M. Inman\*, Director

Pamela A. Joseph\*, Director

J. Robert Sebo\*, Director

Joseph M. Tucci\*, Director

\*By: /s/ JONATHAN J. JUDGE

Jonathan J. Judge, as Attorney-in-Fact

**PAYCHEX, INC.**  
**ELEVEN-YEAR SUMMARY OF SELECTED FINANCIAL DATA**

*In thousands, except per share amounts*  
Year ended May 31,

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Results of operations</b>				
Revenue:				
Service revenue . . . . .	\$1,573,797	\$1,384,674	\$1,240,093	\$1,046,029
Interest on funds held for clients . . . . .	<u>100,799</u>	<u>60,469</u>	<u>54,254</u>	<u>53,050</u>
Total revenue . . . . .	\$1,674,596	\$1,445,143	\$1,294,347	\$1,099,079
Total expenses . . . . .	<u>1,025,025</u>	<u>911,368</u>	<u>861,032</u>	<u>698,038</u>
Operating income . . . . .	\$ 649,571	\$ 533,775	\$ 433,315	\$ 401,041
As a % of total revenue . . . . .	39%	37%	33%	36%
Investment income, net . . . . .	\$ 25,195	\$ 12,391	\$ 16,469	\$ 30,503
Income before income taxes . . . . .	\$ 674,766	\$ 546,166	\$ 449,784	\$ 431,544
As a % of total revenue . . . . .	40%	38%	35%	39%
Net income . . . . .	\$ 464,914	\$ 368,849	\$ 302,950	\$ 293,452
As a % of total revenue . . . . .	28%	26%	23%	27%
Basic earnings per share . . . . .	\$ 1.23	\$ 0.97	\$ 0.80	\$ 0.78
Diluted earnings per share . . . . .	\$ 1.22	\$ 0.97	\$ 0.80	\$ 0.78
Weighted-average common shares outstanding . .	379,465	378,337	377,371	376,263
Weighted-average shares assuming dilution . . . .	381,351	379,763	379,524	378,083
Cash dividends per common share . . . . .	\$ 0.61	\$ 0.51	\$ 0.47	\$ 0.44
<b>Financial position</b>				
Purchases of property and equipment . . . . .	\$ 81,143	\$ 70,686	\$ 50,562	\$ 60,212
Total assets . . . . .	\$5,549,302	\$4,617,418	\$3,950,203	\$3,690,783
Total debt . . . . .	\$ —	\$ —	\$ —	\$ —
Stockholders' equity . . . . .	\$1,654,843	\$1,385,676	\$1,199,973	\$1,077,371
Return on stockholders' equity . . . . .	30%	28%	28%	29%

Note: Per share and weighted-average share amounts have been adjusted for three-for-two stock splits in May 2000, May 1999, May 1998, and May 1997.

<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
\$ 892,189	\$ 786,521	\$ 669,319	\$ 544,961	\$ 450,275	\$ 365,628	\$306,243
<u>62,721</u>	<u>83,336</u>	<u>58,800</u>	<u>52,335</u>	<u>43,429</u>	<u>34,105</u>	<u>27,065</u>
\$ 954,910	\$ 869,857	\$ 728,119	\$ 597,296	\$ 493,704	\$ 399,733	\$333,308
<u>591,216</u>	<u>533,155</u>	<u>469,226</u>	<u>409,734</u>	<u>359,004</u>	<u>303,108</u>	<u>263,386</u>
\$ 363,694	\$ 336,702	\$ 258,893	\$ 187,562	\$ 134,700	\$ 96,625	\$ 69,922
38%	39%	36%	31%	27%	24%	21%
\$ 31,315	\$ 27,279	\$ 16,479	\$ 12,581	\$ 9,473	\$ 7,031	\$ 5,467
\$ 395,009	\$ 363,981	\$ 275,372	\$ 200,143	\$ 144,173	\$ 103,656	\$ 75,389
41%	42%	38%	34%	29%	26%	23%
\$ 274,531	\$ 254,869	\$ 190,007	\$ 139,099	\$ 102,219	\$ 75,150	\$ 55,035
29%	29%	26%	23%	21%	19%	17%
\$ 0.73	\$ 0.68	\$ 0.51	\$ 0.38	\$ 0.28	\$ 0.21	\$ 0.15
\$ 0.73	\$ 0.68	\$ 0.51	\$ 0.37	\$ 0.28	\$ 0.20	\$ 0.15
374,747	372,777	370,603	368,282	366,771	364,503	360,885
378,002	377,510	375,081	373,182	370,829	368,454	364,926
\$ 0.42	\$ 0.33	\$ 0.22	\$ 0.15	\$ 0.10	\$ 0.07	\$ 0.05
\$ 54,378	\$ 45,250	\$ 34,154	\$ 22,116	\$ 28,386	\$ 18,536	\$ 17,806
\$2,953,075	\$2,907,196	\$2,455,577	\$1,873,101	\$1,549,787	\$1,201,323	\$831,585
\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
\$ 923,981	\$ 757,842	\$ 563,432	\$ 435,800	\$ 329,607	\$ 251,542	\$191,072
32%	38%	38%	36%	36%	34%	32%

## BOARD OF DIRECTORS

- B. Thomas Golisano  
Chairman, Retired President and Chief Executive Officer of Paychex, Inc.
- David J. S. Flaschen  
Operating Partner of Castanea Partners
- Phillip Horsley  
Managing Director of Horsley Bridge Partners
- Grant M. Inman  
General Partner of Inman Investment Management
- Pamela A. Joseph  
Vice Chairman of U.S. Bancorp,  
Chairman and Chief Executive Officer of NOVA Information Systems, Inc.
- Jonathan J. Judge  
President and  
Chief Executive Officer of Paychex, Inc.
- J. Robert Sebo  
Retired Senior Vice President/Director of Eastern Operations of Paychex, Inc.
- Joseph M. Tucci  
Chairman, President and Chief Executive Officer of EMC Corporation

## OFFICERS

- Jonathan J. Judge  
President and Chief Executive Officer
- John M. Morphy  
Senior Vice President, Chief Financial Officer, and Secretary
- Martin Mucci  
Senior Vice President, Operations
- Walter Turek  
Senior Vice President, Sales and Marketing
- Steve R. Beauchamp  
Vice President, Product Management
- Daniel A. Canzano  
Vice President, Information Technology
- Brad R. Flipse  
Vice President, Major Market Services Sales
- Clifford Gibson  
Vice President, Western U.S. Sales
- Melinda A. Janik  
Vice President and Controller
- William G. Kuchta, Ed.D.  
Vice President, Organizational Development
- Michael M. McCarthy  
Vice President, Eastern U.S. Sales
- Lynn J. Miley  
Vice President, Eastern Operations
- Leonard E. Redon  
Vice President, Western Operations
- Stephanie Schaeffer  
Vice President, Chief Legal Counsel
- Martin Stowe  
Vice President, Human Resource Services
- Anthony Tortorella  
Vice President, Human Resource Services, Sales
- Suzanne E. Vickery  
Vice President, Central U.S. Sales

## SHAREHOLDER INFORMATION

### Annual Meeting

The annual meeting of stockholders will be held Thursday, October 5, 2006 at 10:00 a.m. at the Rochester Riverside Convention Center, 123 East Main Street, Rochester, NY 14604.

### Common Stock

The Company's common stock trades on The NASDAQ Stock Market under the symbol PAYX.

### Dividends

The Company has paid a cash dividend each quarter since 1988. Dividends are normally paid in August, November, February, and May. The level and continuation of future dividends are dependent on the Company's future earnings and cash flow and are subject to the discretion of the Board of Directors.

### Transfer Agent and Registrar

Please send inquiries, certificates for transfer, address changes, and dividend reinvestment and stock purchase requests to:

American Stock Transfer & Trust Co.  
6201 15th Avenue, 2nd Floor  
Brooklyn, NY 11219  
1-800-937-5449

### Direct Reinvestment and Stock Purchase Plan

Stockholders can elect to have some or all of their dividends reinvested, and can make additional investments in common stock through American Stock Transfer & Trust Co.

### Independent Auditors

Ernst & Young LLP  
Suite 1300  
925 Euclid Avenue  
Cleveland, Ohio 44115-1476

### Investor Relations

Members of the financial community and the media should direct inquiries to John Morphy, Senior Vice President, Chief Financial Officer, and Secretary.

For more information about Paychex Investor Relations or to request financial documents, please contact:

Paychex Investor Relations  
911 Panorama Trail South  
Rochester, NY 14625-2396  
or call (585) 383-3406

Anyone with access to the Internet can view a wide variety of financial materials at [www.paychex.com](http://www.paychex.com).



## PRIMARY LOCATIONS

<b>Alabama</b> Birmingham	<b>Georgia</b> Atlanta	<b>New Jersey</b> Cherry Hill Parsippany Piscataway Woodcliff Lake	<b>Rhode Island</b> Providence
<b>Arizona</b> Phoenix Tucson	<b>Illinois</b> Chicago	<b>New Mexico</b> Albuquerque	<b>South Carolina</b> Greenville Rock Hill
<b>Arkansas</b> Little Rock	<b>Indiana</b> Indianapolis South Bend	<b>New York</b> Albany Binghamton Brooklyn Buffalo Lake Success Long Island Manhattan Mid Hudson Valley Rochester Syracuse	<b>Tennessee</b> Chattanooga Memphis Nashville
<b>California</b> Bakersfield Central Coast/ Monterey East Bay Fresno Inland Empire Los Angeles North Bay Orange County Palm Springs Pasadena Sacramento San Diego San Francisco San Jose San Luis Obispo Ventura Woodland Hills	<b>Kansas</b> Kansas City	<b>North Carolina</b> Charlotte Greensboro Raleigh/Durham Wilmington	<b>Texas</b> Austin Dallas/Forth Worth Houston San Antonio
<b>Colorado</b> Colorado Springs Denver	<b>Kentucky</b> Lexington Louisville	<b>Ohio</b> Akron Cincinnati Cleveland Columbus Dayton Toledo	<b>Utah</b> Salt Lake City
<b>Connecticut</b> Hartford Stamford	<b>Louisiana</b> Baton Rouge New Orleans	<b>Oklahoma</b> Oklahoma City Tulsa	<b>Virginia</b> Richmond Tidewater
<b>District of Columbia</b> Washington, D.C.	<b>Maine</b> Auburn Portland	<b>Oregon</b> Eugene Portland	<b>Washington</b> Seattle
<b>Florida</b> Deerfield Beach Fort Myers Jacksonville Lake Mary Miami Orlando Palm Beach Sarasota Tampa/ St. Petersburg	<b>Maryland</b> Baltimore Silver Spring	<b>Pennsylvania</b> Allentown Harrisburg Philadelphia Pittsburgh Scranton/ Wilkes-Barre	<b>Wisconsin</b> Appleton Madison Milwaukee
	<b>Massachusetts</b> Boston Foxboro West Springfield Worcester		<b>Germany</b> Berlin Hamburg
	<b>Michigan</b> Detroit Grand Rapids		
	<b>Minnesota</b> Minneapolis		
	<b>Missouri</b> St. Louis		
	<b>Nebraska</b> Omaha		
	<b>Nevada</b> Las Vegas Reno		
	<b>New Hampshire</b> Manchester Portsmouth		

## **PRODUCT AND SERVICE INQUIRIES**

Paychex products and services are available coast to coast.

Whether you live near one of our main office locations or elsewhere, call 1-800-322-7292 for information. Visit our Web site at [www.paychex.com](http://www.paychex.com) for shareholder information, press releases, product demonstrations, and other information about Paychex.

## **TRADEMARKS**

Paychex, Taxpay, Paylink, Preview, Readychex, Time In A Box, Paychex Premier, and Paychex Online Payroll are trademarks or service marks of Paychex, Inc.

ADP, AICPA, Crystal Decisions, EMC, Ernst & Young, Fisons, Frontier Communications, Goulds Pumps, IBM, NCR, NEBS, NOVA Information Systems, PMC-Sierra, The NASDAQ Stock Market, and Visa are trademarks or service marks of their respective registrants, as they appear in the Principal Register of the U.S. Patent and Trademark Office.

## **LICENSES**

Paychex Agency, Inc. is a licensed general insurance agency.

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**PAYCHEX<sup>®</sup>**

Corporate Headquarters

211 Panorama Trail South

Rochester, NY 14625-2396

[www.paychex.com](http://www.paychex.com)

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