PAYCHEX INC
Form 10-Q
March 28, 2018
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended February 28, 2018

Commission file number 0-11330

PAYCHEX, INC.

911 Panorama Trail South

Rochester, New York 14625-2396

(585) 385-6666

A Delaware Corporation

IRS Employer Identification Number: 16-1124166

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

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

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

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

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

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

The number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date:

Common Stock, $0.01 Par Value	359,275,368	Shares
CLASS	OUTSTANDING AS OF	February 28, 2018

PAYCHEX, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

In millions, except per share amounts

	For the three months ended February 28,		For the nine months ended February 28,	
	2018	2017	2018	2017
Revenue:				
Service revenue	$ 848.4	$ 782.6	$ 2,464.0	$ 2,316.1
Interest on funds held for clients	18.1	13.2	45.8	36.6
Total revenue	866.5	795.8	2,509.8	2,352.7
Expenses:				
Operating expenses	270.7	236.8	751.5	688.2
Selling, general and administrative expenses	303.3	252.4	788.6	723.8
Total expenses	574.0	489.2	1,540.1	1,412.0
Operating income	292.5	306.6	969.7	940.7
Investment income, net	2.3	1.2	6.1	3.6
Income before income taxes	294.8	307.8	975.8	944.3
Income taxes	34.4	105.3	270.6	322.3
Net income	$ 260.4	$ 202.5	$ 705.2	$ 622.0
Other comprehensive (loss)/income, net of tax:				
Unrealized (losses)/gains on securities, net of tax	(17.5)	21.4	(46.7)	(24.6)
Total other comprehensive (loss)/income, net of tax	(17.5)	21.4	(46.7)	(24.6)
Comprehensive income	$ 242.9	$ 223.9	$ 658.5	$ 597.4
Basic earnings per share	$ 0.72	$ 0.56	$ 1.96	$ 1.73
Diluted earnings per share	$ 0.72	$ 0.56	$ 1.95	$ 1.71
Weighted-average common shares outstanding	359.2	359.0	359.1	360.0
Weighted-average common shares outstanding, assuming dilution	362.0	361.8	361.6	362.8
Cash dividends per common share	$ 0.50	$ 0.46	$ 1.50	$ 1.38

See Notes to Consolidated Financial Statements.

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PAYCHEX, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

In millions, except per share amount

	February 28, 2018	May 31, 2017
Assets		
Cash and cash equivalents	$ 323.9	$ 184.6
Corporate investments	97.3	138.8
Interest receivable	31.5	35.9
Accounts receivable, net of allowance for doubtful accounts	550.5	507.5
Prepaid income taxes	22.9	45.0
Prepaid expenses and other current assets	77.9	58.3
Current assets before funds held for clients	1,104.0	970.1
Funds held for clients	3,944.7	4,301.9
Total current assets	5,048.7	5,272.0
Long-term corporate investments	405.4	454.0
Property and equipment, net of accumulated depreciation	397.2	337.2
Intangible assets, net of accumulated amortization	105.1	57.6
Goodwill	827.4	657.1
Prepaid income taxes	24.9	24.9
Other long-term assets	34.1	30.9
Total assets	$ 6,842.8	$ 6,833.7
Liabilities		
Accounts payable	$ 71.9	$ 57.2
Accrued compensation and related items	356.3	280.5
Short-term borrowings	57.7	—
Deferred revenue	23.7	22.9
Other current liabilities	142.2	91.9
Current liabilities before client fund obligations	651.8	452.5
Client fund obligations	3,971.9	4,272.6
Total current liabilities	4,623.7	4,725.1
Accrued income taxes	51.8	45.6
Deferred income taxes	41.9	33.9
Other long-term liabilities	79.9	73.8
Total liabilities	4,797.3	4,878.4
Commitments and contingencies — Note L		
Stockholders' equity		
	3.6	3.6

Common stock, $0.01 par value; Authorized: 600.0 shares; Issued and outstanding: 359.3 shares as of February 28, 2018 and 359.4 shares as of May 31, 2017		
Additional paid-in capital	1,107.2	1,030.0
Retained earnings	961.4	901.7
Accumulated other comprehensive (loss)/income	(26.7)	20.0
Total stockholders' equity	2,045.5	1,955.3
Total liabilities and stockholders' equity	$ 6,842.8	$ 6,833.7

See Notes to Consolidated Financial Statements.

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PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

In millions

	For the nine months ended February 28, 2018	2017
Operating activities		
Net income	$ 705.2	$ 622.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	102.3	90.7
Amortization of premiums and discounts on available-for-sale securities, net	50.1	55.0
Stock-based compensation costs	29.4	26.5
Provision for deferred income taxes	6.5	—
Provision for allowance for doubtful accounts	3.3	3.4
Net realized gains on sales of available-for-sale securities	(0.1)	(0.1)
Changes in operating assets and liabilities:		
Interest receivable	4.4	4.1
Accounts receivable	(6.2)	(24.6)
Prepaid expenses and other current assets	9.7	(32.1)
Accounts payable and other current liabilities	80.9	37.5
Net change in other long-term assets and liabilities	3.4	(13.1)
Net cash provided by operating activities	988.9	769.3
Investing activities		
Purchases of available-for-sale securities	(36,422.2)	(36,029.5)
Proceeds from sales and maturities of available-for-sale securities	37,162.9	35,617.4
Net change in funds held for clients' money market securities and other cash equivalents	(409.1)	(459.8)
Purchases of property and equipment	(122.0)	(66.8)
Acquisition of businesses, net of cash acquired	(178.5)	—
Purchases of other assets	(6.7)	(8.4)
Net cash provided by/(used in) investing activities	24.4	(947.1)
Financing activities		
Net change in client fund obligations	(300.7)	819.8
Net proceeds from short-term borrowings	57.7	55.4
Dividends paid	(538.7)	(496.9)
Repurchases of common shares	(94.1)	(166.2)

Activity related to equity-based plans	1.8	24.1
Net cash (used in)/provided by financing activities	(874.0)	236.2
Increase in cash and cash equivalents	139.3	58.4
Cash and cash equivalents, beginning of fiscal year	184.6	131.5
Cash and cash equivalents, end of period	$ 323.9	$ 189.9

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

February 28, 2018

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

Description of business: Paychex, Inc. and its wholly owned subsidiaries (collectively, the "Company" or "Paychex") is a leading provider of integrated human capital management ("HCM") solutions for payroll, human resource ("HR"), retirement, and insurance services for small- to medium-sized businesses in the United States ("U.S."). The Company also has operations in Europe. Effective February 28, 2018, the Company acquired Lessor Group ("Lessor"), headquartered in Denmark and serving clients in Northern Europe. Refer to Note C for further details.

Paychex, a Delaware corporation formed in 1979, reports as one segment. Substantially all of the Company's revenue is generated within the U.S. The Company also generates revenue within Europe, which represented less than one percent of the Company's total revenue for each of the three and nine months ended February 28, 2018 and February 28, 2017. Long-lived assets in Europe were approximately 13% of total long-lived assets of the Company as of February 28, 2018 and were insignificant as of May 31, 2017.

Basis of presentation: The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statement presentation. The consolidated financial statements include the consolidated accounts of the Company with all intercompany transactions eliminated. In the opinion of management, the information furnished herein reflects all adjustments (consisting of items of a normal recurring nature), which are necessary for a fair statement of the results for the interim period. These financial statements should be read in conjunction with the Company's consolidated financial statements and related Notes to Consolidated Financial Statements presented in the Company's Annual Report on Form 10-K ("Form 10-K") for the fiscal year ended May 31, 2017 ("fiscal 2017"). Operating results and cash flows for the period ended February 28, 2018 are not necessarily indicative of the results that may be expected for other interim periods or for the fiscal year ending May 31, 2018 ("fiscal 2018").

Subsequent event: During the three months ended February 28, 2018, the Company began negotiations to terminate certain license agreements and acquire rights to certain client lists in order to resolve a contractual dispute with certain licensees. The negotiations were completed in March 2018. The Company recorded $32.6 million on its Consolidated Balance Sheets within other current liabilities as of February 28, 2018, and $24.7 million, net of tax, in its Consolidated Statements of Income and Comprehensive Income for the three months ended February 28, 2018 related to the termination of these license agreements. In addition, the Company acquired rights to certain client lists as it relates to this agreement in March 2018 for a cost of approximately $30.0 million.

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

Under the minimum premium insurance plan offering within the PEO, the Company's health benefits insurance reserves are established to provide for the payment of claims liability charges in accordance with its service contract with the insurance carrier. The Company's maximum individual claims liability is $0.3 million under both its calendar 2018 and calendar 2017 minimum premium insurance plan policies.

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and actuarial loss projections, and is subject to change due to multiple factors, including economic trends, changes in legal liability law, and damage awards, all of which could materially impact the reserves as reported in the consolidated financial statements. Accordingly, final claim settlements may vary from the present estimates, particularly with workers' compensation insurance where those payments may not occur until well into the future. The Company regularly reviews the adequacy of its estimated insurance reserves. Adjustments to previously established insurance reserves are reflected in the results of operations for the period in which such adjustments are identified. Such insurance reserve adjustments could be significant, reflecting any combination of new and adverse or favorable trends.

Stock-based compensation costs: The Company has issued stock-based awards to employees and directors consisting of stock options, restricted stock awards, restricted stock units, performance shares, performance-based restricted stock, and performance stock options. The Company accounts for all stock-based awards to employees and directors as compensation costs in the consolidated financial statements based on their fair values measured as of the date of grant. These costs are recognized over the requisite service period. Stock-based compensation costs recognized were $10.3 million and $29.4 million for the three and nine months ended February 28, 2018, respectively, as compared with $8.9 million and $26.5 million for the three and nine months ended February 28, 2017, respectively. The methods and assumptions used in the determination of the fair value of stock-based awards are consistent with those described in the Company's fiscal 2017 Form 10-K.

Recently adopted accounting pronouncements: In January 2018, the Company early adopted Accounting Standards Update ("ASU") No. 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business." ASU No. 2017-01 clarifies the definition of a business in order to allow for the evaluation of whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The adoption of ASU 2017-01 did not have a material impact on the Company's consolidated financial statements.

Recently issued accounting pronouncements: In February 2018, the Financial Accounting Standards Board ("FASB") issued ASU No. 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU No. 2018-02 allows entities to reclassify certain stranded income tax effects from accumulated other comprehensive income to retained earnings resulting from the Tax Cuts and Jobs Act (the "Tax Act"), enacted on December 22, 2017. The guidance also requires additional financial statement disclosures to clarify the effects of adoption. ASU No. 2018-02 should be applied either in the period of adoption or retrospectively to each period or periods in which the effect of the change in the U.S. Federal corporate income tax rate in the Tax Act is recognized. This guidance is effective for fiscal years beginning after December 15, 2018, and for interim periods within those fiscal years, with early adoption permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2019. The Company is currently evaluating the potential effects of this guidance on its consolidated financial statements.

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

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

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

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

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Other recent authoritative guidance issued by the FASB (including technical corrections to the ASC), the American Institute of Certified Public Accountants, and the Securities Exchange Commission ("SEC") during the nine months ended February 28, 2018 did not, or are not expected to, have a material effect on the Company's consolidated financial statements.

Note B: Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In millions, except per share amounts	For the three months ended February 28, 2018	2017	For the nine months ended February 28, 2018	2017
Basic earnings per share:				
Net income	$ 260.4	$ 202.5	$ 705.2	$ 622.0
Weighted-average common shares outstanding	359.2	359.0	359.1	360.0
Basic earnings per share	$ 0.72	$ 0.56	$ 1.96	$ 1.73
Diluted earnings per share:				
Net income	$ 260.4	$ 202.5	$ 705.2	$ 622.0
Weighted-average common shares outstanding	359.2	359.0	359.1	360.0
Dilutive effect of common share equivalents	2.8	2.8	2.5	2.8
Weighted-average common shares outstanding, assuming dilution	362.0	361.8	361.6	362.8
Diluted earnings per share	$ 0.72	$ 0.56	$ 1.95	$ 1.71
Weighted-average anti-dilutive common share equivalents	—	0.7	0.8	0.7

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

For the three months ended February 28, 2018 and February 28, 2017, 0.1 million and 0.4 million shares, respectively, of the Company's common stock were issued in connection with the exercise or vesting of stock-based awards. For the nine months ended February 28, 2018 and February 28, 2017, 0.9 million and 1.8 million shares, respectively, of the Company's common stock were issued in connection with the exercise or vesting of stock-based awards. In addition, for the nine months ended February 28, 2018, 0.6 million shares of the Company's common stock were issued in relation to a business acquisition completed in August 2017. Refer to Note C for further details.

In July 2016, the Company announced that its Board of Directors approved a program to repurchase up to $350.0 million of the Company's common stock, with authorization expiring in May 2019. The purpose of the program is to manage common stock dilution. No shares were repurchased during the three months ended February 28, 2018 and February 28, 2017. During the nine months ended February 28, 2018 and February 28, 2017, the Company repurchased 1.6 million shares for $94.1 million and 2.9 million shares for $166.2 million, respectively. Of the shares repurchased during the nine months ended February 28, 2017, $59.7 million were repurchased under a previously authorized common stock repurchase program. All shares repurchased were retired.

Note C: Business Combinations

Effective February 28, 2018, the Company completed its acquisition of Lessor. Upon closing, Lessor became a wholly owned subsidiary of the Company. Lessor is a market-leading provider of payroll and HCM software solutions headquartered in Denmark and serving clients in Northern Europe. The Company believes that the acquisition will provide additional opportunities for growth in Europe. The purchase price was $160.6 million, net of cash acquired. Goodwill in the amount of $119.2 million was recorded as a result of the acquisition, which is not tax-deductible. The goodwill recorded is provisional and subject to change, pending completion of a final valuation of Lessor. However, further changes to goodwill resulting from the acquisition are not anticipated to be material to the Company's Consolidated Balance Sheets.

Effective August 18, 2017, the Company acquired HR Outsourcing Holdings, Inc. ("HROI") and all of its operating subsidiaries. HROI is a national PEO that provides HR solutions to small- and medium-sized businesses in more than 35 states. The acquisition expands the Company's presence in the PEO industry. The purchase price was $75.4 million and was comprised of $42.2 million of cash plus $33.2 million issued in the form of Paychex common stock. Goodwill in the amount of $51.1 million was recorded as a result of the acquisition, which is not tax-deductible.

The financial results of both Lessor and HROI are included in the Company's consolidated financial statements from the respective dates of acquisition. The Company concluded that these acquisitions were not material to its results of operations and financial position. Therefore, pro-forma financial information has been excluded.

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Note D: Investment Income, Net

Investment income, net, consisted of the following items:

In millions	For the three months ended February 28, 2018	2017	For the nine months ended February 28, 2018	2017
Interest income on corporate funds	$ 3.1	$ 2.4	$ 8.7	$ 7.2
Interest expense	(1.1)	(0.6)	(3.2)	(1.9)
Net gain/(loss) from equity-method investments	0.3	(0.6)	0.6	(1.7)
Investment income, net	$ 2.3	$ 1.2	$ 6.1	$ 3.6

Note E: Funds Held for Clients and Corporate Investments

Funds held for clients and corporate investments are as follows:

In millions	February 28, 2018 Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Type of issue:				
Funds held for clients' money market securities and other cash equivalents	$ 673.9	$ —	$ —	$ 673.9
Available-for-sale securities:				
Corporate bonds	305.8	0.1	(6.5)	299.4
General obligation municipal bonds	1,303.8	2.6	(10.6)	1,295.8

Pre-refunded municipal bonds(1)