PAYCHEX INC
Form 10-Q
October 06, 2017
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 Q

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

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 31, 2017

Commission file number 0-11330

PAYCHEX, INC.

911 Panorama Trail South

Rochester, New York 14625-2396

(585) 385-6666

A Delaware Corporation

IRS Employer Identification Number: 16-1124166

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

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

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

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

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

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

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

Common Stock, $0.01 Par Value	358,994,637	Shares
CLASS	OUTSTANDING AS OF	September 29, 2017

PAYCHEX, INC.

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

In millions, except per share amounts

	For the three months ended August 31, 2017	2016
Revenue:		

Service revenue	$ 803.1	$ 773.5
Interest on funds held for clients	13.7	12.0
Total revenue	816.8	785.5
Expenses:		
Operating expenses	232.1	225.1
Selling, general and administrative expenses	239.7	237.4
Total expenses	471.8	462.5
Operating income	345.0	323.0
Investment income, net	2.1	1.5
Income before income taxes	347.1	324.5
Income taxes	119.3	107.1
Net income	$ 227.8	$ 217.4
Other comprehensive income, net of tax:		
Unrealized gains on securities, net of tax	4.4	10.0
Total other comprehensive income, net of tax	4.4	10.0
Comprehensive income	$ 232.2	$ 227.4
Basic earnings per share	$ 0.63	$ 0.60
Diluted earnings per share	$ 0.63	$ 0.60
Weighted-average common shares outstanding	358.9	361.0
Weighted-average common shares outstanding, assuming dilution	361.3	364.1
Cash dividends per common share	$ 0.50	$ 0.46

See Notes to Consolidated Financial Statements.

1

Table of Contents

PAYCHEX, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

In millions, except per share amount

	August 31, 2017	May 31, 2017
Assets		
Cash and cash equivalents	$ 234.4	$ 184.6
Corporate investments	133.8	138.8
Interest receivable	32.0	35.9
Accounts receivable, net of allowance for doubtful accounts	538.6	507.5
Prepaid income taxes	—	45.0
Prepaid expenses and other current assets	81.6	58.3
Current assets before funds held for clients	1,020.4	970.1
Funds held for clients	4,953.1	4,301.9
Total current assets	5,973.5	5,272.0
Long-term corporate investments	483.2	454.0
Property and equipment, net of accumulated depreciation	328.6	337.2
Intangible assets, net of accumulated amortization	79.2	57.6
Goodwill	698.0	657.1
Prepaid income taxes	24.9	24.9
Other long-term assets	32.1	30.9
Total assets	$ 7,619.5	$ 6,833.7
Liabilities		
Accounts payable	$ 74.6	$ 57.2
Accrued compensation and related items	277.0	280.5
Accrued income taxes	4.1	—
Short-term borrowings	57.2	—
Deferred revenue	24.7	22.9
Other current liabilities	100.0	91.9
Current liabilities before client fund obligations	537.6	452.5
Client fund obligations	4,918.1	4,272.6
Total current liabilities	5,455.7	4,725.1
Accrued income taxes	47.9	45.6
Deferred income taxes	95.4	33.9
Other long-term liabilities	76.7	73.8
Total liabilities	5,675.7	4,878.4
Commitments and contingencies — Note L		
Stockholders' equity		

Common stock, $0.01 par value; Authorized: 600.0 shares; Issued and outstanding: 358.9 shares as of August 31, 2017 and 359.4 shares as of May 31, 2017, respectively.	3.6	3.6
Additional paid-in capital	1,072.1	1,030.0
Retained earnings	843.7	901.7
Accumulated other comprehensive income	24.4	20.0
Total stockholders’ equity	1,943.8	1,955.3
Total liabilities and stockholders’ equity	$ 7,619.5	$ 6,833.7

See Notes to Consolidated Financial Statements.

Table of Contents

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

In millions

	For the three months ended August 31, 2017	2016
Operating activities		
Net income	$ 227.8	$ 217.4
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	32.0	29.7
Amortization of premiums and discounts on available-for-sale securities	17.1	18.6
Stock-based compensation costs	8.7	9.1
Provision for deferred income taxes	59.2	14.1
Provision for allowance for doubtful accounts	0.7	1.2
Net realized gains on sales of available-for-sale securities	—	(0.1)
Changes in operating assets and liabilities:		
Interest receivable	3.9	4.4
Accounts receivable	(15.4)	(78.1)
Prepaid expenses and other current assets	28.2	6.6
Accounts payable and other current liabilities	(19.2)	60.9
Net change in other long-term assets and liabilities	0.6	10.9
Net cash provided by operating activities	343.6	294.7
Investing activities		
Purchases of available-for-sale securities	(8,646.7)	(14,777.0)
Proceeds from sales and maturities of available-for-sale securities	8,892.0	14,920.3
Net change in funds held for clients' money market securities and other cash equivalents	(929.7)	257.3
Purchases of property and equipment	(18.0)	(20.3)
Acquisition of businesses, net of cash acquired	(8.2)	—
Purchases of other assets	(0.4)	—
Net cash (used in)/provided by investing activities	(711.0)	380.3
Financing activities		
Net change in client fund obligations	645.5	(567.8)
Net proceeds from short-term borrowings	57.2	51.3
Dividends paid	(179.1)	(166.3)

Repurchases of common shares	(94.1)	—
Activity related to equity-based plans	(12.3)	6.3
Net cash provided by/(used in) financing activities	417.2	(676.5)
Increase/(decrease) in cash and cash equivalents	49.8	(1.5)
Cash and cash equivalents, beginning of fiscal year	184.6	131.5
Cash and cash equivalents, end of period	$ 234.4	$ 130.0

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

August 31, 2017

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

Description of business: Paychex, Inc. and its wholly owned subsidiaries (collectively, the “Company” or “Paychex”) is a leading provider of integrated human capital management solutions for payroll, human resource (“HR”), retirement, and insurance services for small- to medium-sized businesses in the United States (“U.S.”). The Company also has operations in Germany.

Paychex, a Delaware corporation formed in 1979, reports as one segment. Substantially all of the Company’s revenue is generated within the U.S. The Company also generates revenue within Germany, which represented less than one percent of the Company's total revenue for each of the three months ended August 31, 2017 and August 31, 2016. Long-lived assets in Germany are insignificant in relation to total long-lived assets of the Company as of August 31, 2017 and May 31, 2017. The Company disposed of equity-method investments for a joint-venture in Brazil and a minority investment in a Canadian entity during the fiscal year ended May 31, 2017 (“fiscal 2017”), neither of which was significant.

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 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 fiscal 2017. Operating results and cash flows for the three months ended August 31, 2017 are not necessarily indicative of the results that may be expected for other interim periods or for the full fiscal year ending May 31, 2018 ("fiscal 2018").

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

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

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

Stock-based compensation costs: The Company has issued stock-based awards to employees and directors consisting of stock options, restricted stock awards, restricted stock units, performance shares, performance-based restricted stock, and performance stock options. The Company accounts for all stock-based awards to employees and directors as compensation costs in the consolidated financial statements based on their fair values measured as of the date of grant. These costs are recognized over the requisite service period. Stock-based compensation costs recognized were $8.7 million for the three months ended August 31, 2017, as compared with $9.1 million for the three months ended August 31, 2016. The methods and assumptions used in the determination of the fair value of stock-based awards are consistent with those described in the Company's fiscal 2017 Form 10-K.

Recently adopted accounting pronouncements: There were no recently adopted accounting pronouncements during the three months ended August 31, 2017.

Recently issued accounting pronouncements: In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, "Leases (Topic 842)." ASU No. 2016-02 improves transparency and comparability among companies by recognizing lease assets and lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU No. 2016-02 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2018, with early application permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2019. The Company is currently evaluating this guidance to determine the potential impact on its consolidated financial statements.

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, with early adoption permitted for the annual reporting periods beginning after December 15, 2016.

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

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

Other recent authoritative guidance issued by the FASB (including technical corrections to the ASC), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission during the three months ended August 31, 2017 did not, or are not expected to, have a material effect on the Company's consolidated financial statements.

Note B: Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In millions, except per share amounts	For the three months ended August 31, 2017	2016
Basic earnings per share:		
Net income	$ 227.8	$ 217.4
Weighted-average common shares outstanding	358.9	361.0
Basic earnings per share	$ 0.63	$ 0.60
Diluted earnings per share:		
Net income	$ 227.8	$ 217.4
Weighted-average common shares outstanding	358.9	361.0
Dilutive effect of common share equivalents	2.4	3.1
Weighted-average common shares outstanding, assuming dilution	361.3	364.1
Diluted earnings per share	$ 0.63	$ 0.60
Weighted-average anti-dilutive common share equivalents	1.1	0.5

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

For the three months ended August 31, 2017 and August 31, 2016, 0.5 million and 1.3 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 three months ended August 31, 2017, 0.6 million shares of the Company’s common stock were issued in relation to an immaterial business acquisition completed in August 2017. Refer to Note C below for further details.

In July 2016, the Company announced that its Board of Directors approved a program to repurchase up to $350.0 million of the Company’s common stock, with authorization expiring in May 2019. The purpose of the program is to manage common stock dilution. During the three months ended August 31, 2017, the Company repurchased 1.6 million shares for $94.1 million under this program. The Company did not repurchase any of its common stock during the three months ended August 31, 2016. All shares repurchased were retired.

Note C: Business Combination

Effective August 18, 2017, the Company acquired HR Outsourcing Holdings, Inc. (“HROI”) and all of its operating subsidiaries. HROI is a national PEO that provides HR solutions to small- and medium-sized businesses in more than 35 states. The acquisition expands the Company’s presence in the PEO industry. The purchase price was $75.4 million and was comprised of $42.2 million of cash plus $33.2 million issued in the form of Paychex common stock. Goodwill in the amount of $40.9 million was recorded as a result of the acquisition, which is not tax-deductible. The goodwill recorded is provisional and subject to change, pending completion of the valuation of the assets acquired and liabilities assumed. However, further changes to goodwill as a result of the acquisition are not anticipated to be material to the Company's Consolidated Balance Sheets.

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

Note D: Investment Income, Net

Investment income, net, consisted of the following items:

In millions	For the three months ended August 31, 2017	2016
Interest income on corporate funds	$ 2.9	$ 2.4
Interest expense	(0.8)	(0.7)
Net loss from equity-method investments	—	(0.2)
Investment income, net	$ 2.1	$ 1.5

Note E: Funds Held for Clients and Corporate Investments

Funds held for clients and corporate investments are as follows:

	August 31, 2017			
In millions	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value

Type of issue:				
Funds held for clients money market securities and other cash equivalents	$ 1,194.6	$ —	$ —	$ 1,194.6
Available-for-sale securities:				
Corporate bonds	263.9	3.6	(0.3)	267.2
General obligation municipal bonds	1,407.4	23.2	(0.4)	1,430.2
Pre-refunded municipal bonds(1)	60.9	1.1	—	62.0
Revenue municipal bonds	921.3	13.5	(0.2)	934.6
U.S. government agency securities	368.6	0.8	(2.7)	366.7
Variable rate demand notes	1,296.8	—	—	1,296.8
Total available-for-sale securities	4,318.9	42.2	(3.6)	4,357.5
Other	15.8	2.2	—	18.0
Total funds held for clients and corporate investments	$ 5,529.3	$ 44.4	$ (3.6)	$ 5,570.1

	May 31, 2017			
In millions	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Type of issue:				
Funds held for clients money market securities and other cash equivalents	$ 264.8	$ —	$ —	$ 264.8
Available-for-sale securities:				
Corporate bonds	208.6	2.7	(0.5)	210.8
General obligation municipal bonds	1,422.0	21.2	(0.9)	1,442.3
Pre-refunded municipal bonds(1)	54.6	0.9	—	55.5
Revenue municipal bonds	929.2	12.5	(0.8)	940.9
U.S. government agency securities	328.9	0.5	(3.6)	325.8
Variable rate demand notes	1,637.9	—	—	1,637.9
Total available-for-sale securities	4,581.2	37.8	(5.8)	4,613.2
Other	14.8	1.9	—	16.7
Total funds held for clients and corporate investments	$ 4,860.8	$ 39.7	$ (5.8)	