AUTOMATIC DATA PROCESSING INC
Form 10-K
August 29, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

[X]	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended June 30, 2007
	OR
[ ]	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	Commission file number 1-5397

AUTOMATIC DATA PROCESSING, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**22-1467904** (I.R.S. Employer Identification No.)
One ADP Boulevard, Roseland, New Jersey (Address of principal executive offices)	**07068** (Zip Code)

Registrant's telephone number, including area code: **973-974-5000**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.10 Par Value (voting)	**New York Stock Exchange** **Chicago Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

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

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

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 the filing requirements for the past 90 days. Yes [**x**]   No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405) is not contained herein and will not be contained, to the best of Registrants 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 [**x**]   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 [**x**] No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant as of the last business day of the Registrants most recently completed second fiscal quarter was approximately $26,988,612,698. On August 22, 2007 there were 531,060,120 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s Proxy Statement for Annual Meeting of Stockholders to be held on November 13, 2007.	Part III

Part I

Item 1. Business

Automatic Data Processing, Inc., incorporated in Delaware in 1961 (together with its subsidiaries ADP or the Company), is one of the worlds largest providers of business outsourcing solutions. Leveraging more than 55 years of experience, ADP offers a wide range of HR, payroll, tax and benefits administration solutions from a single source. ADP is also a leading provider of integrated computing solutions to automotive, heavy truck, motorcycle, marine and recreational vehicle dealers throughout the world. For financial information by segment and by geographic area, see Note 19 of the Notes to Consolidated Financial Statements contained in this Form 10-K. *The Companys Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to those reports, the Proxy Statement for its Annual Meeting of Stockholders and its Annual Report to Stockholders are made available, free of charge, on its website at www.adp.com as soon as reasonably practicable after such reports have been filed with or furnished to the Securities and Exchange Commission.* The following summary describes ADPs activities.

Employer Services

Employer Services offers a comprehensive range of human resource (HR) information, payroll processing, tax and benefits administration products and services, including traditional and Web-based outsourcing solutions, that assist approximately 560,000 employers in the United States, Canada, Europe, South America (primarily Brazil), Australia and Asia to staff, manage, pay and retain their employees. Employer Services markets these products and services through its direct marketing salesforce and, on a limited basis, through indirect sales channels, such as marketing relationships with banks and accountants, among others. In fiscal 2007, 83% of Employer Services revenues were from the United States, 11% were from Europe, 5% were from Canada and 1% were from South America (primarily Brazil), Australia and Asia.

United States

Employer Services’ approach to the market is to match a client’s needs with the products and services that will best meet expectations. To facilitate this approach, in the United States, Employer Services is comprised of the following groups: Small Business Services (SBS) (serving primarily organizations with fewer than 50 employees); Major Account Services (serving primarily organizations with between 50 and 999 employees); and National Account Services (serving primarily organizations with 1,000 or more employees).

SBS processes payroll for smaller clients and provides them with market leading solutions, including a range of value-added services that are specifically designed for small business clients. Major Account Services and National Account Services offer a full suite of best-of-breed employer services solutions for clients ranging from mid-size through many of the world’s largest corporations.

ADP enables its largest clients to interface their major enterprise resource planning (ERP) applications with ADP’s outsourced payroll services. For those organizations that choose to process payroll in-house, ADP delivers stand-alone services such as payroll tax filing, check printing and distribution, year-end tax statements (i.e., form W-2) and wage garnishment services.

In order to address the growing business process outsourcing (BPO) market for clients seeking human resource information systems and benefit outsourcing solutions, ADP offers its integrated comprehensive outsourcing services (COS) solution that allows a client to outsource its HR, payroll, payroll administration, employee service center, benefits administration, and time and labor management functions to ADP. ADP also offers ADP Resource®, an integrated, flexible HR and payroll service offering that provides a menu of optional services, such as 401(k), FSA and pay-as-you go workers’ compensation.

ADP provides payroll services that include the preparation of client employee paychecks and electronic direct deposits, along with supporting journals, summaries and management reports. ADP also supplies the quarterly and annual social security, medicare and federal, state and local income tax withholding reports required to be filed by employers.

ADP’s Tax, Retirement, Insurance and Pre-Employment Services division includes the following businesses: Tax and Financial Services, Retirement Services, Insurance Services and Pre-Employment Services. These businesses primarily support SBS, Major Account Services and/or National Account Services, and their services are sold through those businesses, as well as dedicated salesforces and marketing arrangements with alliance partners.

- Tax and Financial Services processes and collects federal, state and local payroll taxes on behalf of, and from, ADP clients and remits these taxes to the appropriate taxing authorities. This business is also responsible for the efficient movement of information and funds from clients to third parties through service offerings such as new hire reporting, TotalPay® payroll check (ADPCheck™), full service direct deposit (FSDD) and stored value payroll card (TotalPay Card) products, and the collection and payment of wage garnishments. Tax and Financial Services also offers accounts payable, wage verification and sales and use tax services. This business provides an electronic interface between ADP clients and over 2,200 federal, state and local tax agencies, from the Internal Revenue Service to local governments. In fiscal 2007, Tax and Financial Services in the United States processed and delivered over 54 million year-end tax statements (*i.e.*, form W-2) to its clients’ employees and over 43.2 million remittances and employer payroll tax returns and deposits, and moved over $1 trillion in client funds to taxing authorities and its clients’ employees via electronic transfer, direct deposit and ADPCheck.

- Retirement Services provides recordkeeping and/or related administrative services with respect to various types of retirement (primarily 401(k)) plans, deferred compensation plans and “premium only” cafeteria plans.

- Insurance Services provides a pay as you go payment service for workers compensation and, through Automatic Data Processing Insurance Agency, Inc., offers workers compensation and group health insurance to small and mid-size clients.

- Pre-Employment Services includes three categories of services: Applicant Management Services, Screening and Selection Services, and Tax Credit Services. Applicant Management Services provides employers with a web-based solution to manage their talent throughout their lifecycle. Screening and Selection Services provides background checks, reference verifications and an HR help desk. Tax Credit Services provides job tax credit services that assist employers in the identification of, and filing for, federal, state and local tax credits and other incentives based on geography, demographics and other criteria, and includes negotiation of incentive packages with applicable governmental agencies.

ADPs HR services provide comprehensive HR recordkeeping services, including benefits administration and outsourcing, employee history and position control. ADPs Benefit Services business provides benefits administration across all market segments, including management of the open enrollment of benefits, COBRA and flexible spending account administration. ADPs time and labor management services business provides solutions for employers to capture, calculate and report employee time and attendance.

In fiscal 2007, ADP made several acquisitions to help expand its client base and reach into adjacent markets, including: Employease, Inc., a leading provider of web-based solutions for HR and benefits professionals; VirtualEdge Corporation, an innovator in the field of recruiting and talent lifecycle management solutions for HR organizations; the fully-outsourced payroll business of Intuit Inc.; the tax incentives business of Mintax, Inc.; and Taxware, LP, a leading provider of tax content and compliance solutions for sales, use and value added tax.

International

Employer Services has a growing presence outside of the United States, where it offers solutions on the basis of both geographic and specific client business needs. ADP offers in-country best of breed payroll and human resource outsourcing solutions to small and large clients alike in over a dozen countries outside of the United States. In each of Canada and Europe, ADP is the leading provider of payroll processing (including full departmental outsourcing) and human resource administration services. Within Europe, Employer Services has business operations in nine countries: France, Germany, Italy, the Netherlands, Poland, Spain, Switzerland, the Czech Republic and the United Kingdom. It also offers services in Ireland (from the United Kingdom) and in Portugal (from Spain). In South America (primarily Brazil), Australia and Asia, ADP provides traditional service bureau payroll and also offers full departmental outsourcing of payroll services. ADP also offers wage and tax collection and remittance services in Canada, and has developed wage collection and remittance services to be offered in the United Kingdom.

There is a steadily increasing demand from multinational companies for global payroll and human resource management services. In fiscal 2007, ADP continued to expand its GlobalView® offering, making it available in 32 countries. GlobalView is built on the SAP® ERP Human Capital Management and the SAP NetWeaver® platform and offers multinational and global companies an end-to-end outsourcing solution enabling standardized payroll processing and human resource administration. As of the end of fiscal 2007, 65 clients had contracted for GlobalView services, with approximately 250,000 employees being processed. Upon completing the implementation for all these clients, ADP expects to be providing GlobalView services to more than 730,000 employees in 45 different countries. In fiscal 2007, ADP established a wholly foreign owned entity in Shanghai, China, to better understand the developing market in China and serve the needs of multinational companies with operations in China.

Professional Employer Organization Services

In the United States, ADP TotalSource®, ADPs professional employer organization (PEO) business, provides clients with comprehensive employment administration outsourcing solutions through a co-employment relationship, including payroll, payroll tax filing, HR guidance, 401(k) plan administration, benefits administration, compliance services, health and workers compensation coverage and other supplemental benefits for employees. ADP TotalSource is the largest PEO in the United States based on the number of total paid worksite employees. PEO Services has 47 offices located in 18 states and serves approximately 159,000 worksite employees in all 50 states.

Dealer Services

Dealer Services provides integrated dealer management systems (such a system is also known in the industry as a "DMS") and business solutions to automotive, heavy truck, and powersports (*i.e.*, motorcycle, marine and recreational) vehicle retailers in the United States, Canada, South Africa, Asia and Europe. Over 25,000 automotive, heavy truck and powersports dealers in over 50 countries use ADP's DMS, other software based solutions, networking solutions, data integration, consulting and/or marketing services.

Clients use ADP's DMS products to manage business activities such as accounting, inventory management, factory communications, scheduling, vehicle financing and insurance, sales and service. In addition to its DMS products, Dealer Services also offers its clients a full suite of web-enabled business solutions to address each department and functional area of the dealership (including customer relationship management solutions (CRM) and "front-end" applications), and an IP telephony system that can help dealerships with their sales processes and business development initiatives. All of Dealer Services' business solutions are supported by comprehensive training offerings and business process consulting services. Dealer Services also offers its dealership clients computer hardware, hardware maintenance services, licensed software support, system design and network consulting services. ADP's DMS and other software products are available as "on-site" applications or through ADP's application service provider (ASP) managed services solution (in which clients license and outsource the information technology management to Dealer Services).

Dealer Services also designs, establishes and maintains communications networks for its dealership clients that allow interactive communications among multiple site locations as well as links between franchised dealers and their vehicle manufacturer franchisors. These networks are used for activities such as new vehicle ordering and status inquiry, warranty submission and validation, parts and vehicle locating, dealership customer credit application submission and decision-making, vehicle repair estimation and acquisition of vehicle registration and lien holder information.

In fiscal 2006, ADP established a wholly foreign owned entity in Shanghai, China to facilitate Dealer Services' expanding business opportunities within China in the automotive market segment.

Spin-off of the Brokerage Services Group and Sale of Travel Clearing Business

On March 30, 2007, ADP completed the tax free spin-off of its former Brokerage Services Group business, comprised of Brokerage Services and Securities Clearing and Outsourcing Services, into an independent publicly traded company called Broadridge Financial Solutions, Inc. On July 6, 2007, ADP completed the sale of its Travel Clearing business for approximately $116 million in cash. The Travel

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Clearing business was previously reported in the "Other" segment. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) and Note 5 of the "Notes to Consolidated Financial Statements" contained in this Form 10-K.

Markets and Marketing Methods

Employer Services offers services in the United States, Canada, Europe, South America (primarily Brazil), Australia and Asia. Dealer Services has offerings in the United States, Canada, South Africa, Asia and Europe. PEO Services are offered in the United States.

None of ADP's major business groups have a single homogenous client base or market. For example, Dealer Services primarily serves automotive dealers, but also serves heavy truck, powersports (*i.e.*, motorcycle, marine and recreational), and agricultural equipment dealers, auto repair shops, used car lots, state departments of motor vehicles and manufacturers of automobiles, trucks and agricultural equipment. Employer Services and PEO Services have clients from a large variety of industries and markets. Within this client base are concentrations of clients in specific industries. Employer Services also sells to auto dealers. While concentrations of clients exist, no one client or industry group is material to ADP's overall revenues.

ADP’s businesses are not overly sensitive to price changes, although economic conditions among selected clients and groups of clients may and do have a temporary impact on demand for ADP’s services. In fiscal 2007, Employer Services continued to grow, primarily due to the increase in its United States payroll and payroll tax businesses, including new business started in the fiscal year, an increase in the number of employees on our clients’ payrolls, price increases, an increase in client funds balances and improved client retention; Dealer Services grew due to both internal revenue growth and growth from acquisitions, primarily the acquisition of Kerridge Computer Company, Ltd. in December 2005 and BZ Results LLC; and PEO Services grew primarily due to an increase in the number of worksite employees and higher administrative revenues as a result of an increase in the average number of worksite employees.

ADP enjoys a leadership position in each of its major service offerings and does not believe any major service or business unit in ADP is subject to unique market risk.

Competition

The industries in which ADP operates are highly competitive. ADP knows of no reliable statistics by which it can determine the number of its competitors, but it believes that it is one of the largest providers of business outsourcing solutions in the world. Employer Services and PEO Services compete with other independent business outsourcing companies, companies providing enterprise resource planning services, software companies and financial institutions. Captive in-house functions, whereby a company installs and operates its own business processing systems, are another competitive factor in the industries in which Employer Services and PEO Services operate. Dealer Services’ competitors include full service DMS providers such as The Reynolds & Reynolds Company, Dealer Service’s largest DMS competitor in the United States and Canada, and companies providing applications and services that compete with Dealer Service’s non-DMS applications and services.

Competition in ADP’s industries is primarily based on service responsiveness, product quality and price. ADP believes that it is very competitive in each of these areas and that there are no material negative factors impacting ADP’s competitive position.

Clients and Client Contracts

ADP provides its services to approximately 585,000 clients. In fiscal 2007, no single client or group of affiliated clients accounted for revenues in excess of 2% of annual consolidated revenues.

Our business is typically characterized by long-term customer relationships that result in recurring revenue. ADP is continuously in the process of performing implementation services for our clients. Depending on the service agreement and/or the size of the client, the installation or conversion period for new clients could vary from a short period of time (up to two weeks) for an SBS client to a longer period (generally six to twelve months) for a National Account Services or Dealer Services client with multiple deliverables, and in some cases may exceed two years for a large GlobalView client or other large, complicated implementation. Although we monitor sales that have not yet been billed or installed, we do not view this metric as material in light of the recurring nature of our business. This is not a reported number, but it is used by management as a planning tool relating to resources needed to install services, and a means of assessing our performance against the installation timing expectations of our clients.

ADP’s average client retention is estimated at more than 10 years in Employer Services, more than 5 years in PEO Services and 10 or more years in Dealer Services, and has not varied significantly from period to period.

ADP’s services are provided under written price quotations or service agreements having varying terms and conditions. No one price quotation or service agreement is material to ADP. Discounts, rebates and promotions offered by ADP to clients are not material.

Systems Development and Programming

During the fiscal years ended June 30, 2007, 2006 and 2005, ADP invested $609 million, $551 million, and $491 million, respectively, from continuing operations, in systems development and programming, migration to new computing technologies and the development of new products and maintenance of our existing technologies, including purchases of new software and software licenses.

Product Development

ADP continually upgrades, enhances and expands its existing products and services. Generally, no new product or service has a significant effect on ADPs revenues or negatively impacts its existing products and services, and ADPs products and services have significant remaining life cycles.

Licenses

ADP is the licensee under a number of agreements for computer programs and databases. ADPs business is not dependent upon a single license or group of licenses. Third-party licenses, patents, trademarks and franchises are not material to ADPs business as a whole.

Number of Employees

ADP employed approximately 46,000 persons as of June 30, 2007.

Item 1A. Risk Factors

Our businesses routinely encounter and address risks, some of which may cause our future results to be different than we currently anticipate. Risk factors described below represent our current view of some of the most important risks facing our businesses and are important to understanding our business. The following information should be read in conjunction with MD&A, Quantitative and Qualitative Disclosures About Market Risk and the consolidated financial statements and related notes included in this Form 10-K. This discussion includes a number of forward-looking statements. You should refer to the description of the qualifications and limitations on forward-looking statements in the first paragraph under MD&A included in this Form 10-K. Unless otherwise indicated or the context otherwise requires, reference in this section to we, ours, us or similar terms means ADP, together with its subsidiaries. The level of importance of each of the following risks may vary from time to time.

Changes in laws and regulations may decrease our revenues and earnings

Portions of ADPs business are subject to governmental regulations. Changes in governmental regulations may decrease our revenues and earnings and may require us to change the manner in which we conduct some of the aspects of our business. For example, a change in regulations either decreasing the amount of taxes to be withheld or allowing less time to remit taxes to government authorities would adversely impact interest income from investing funds that we collect from clients but have not yet remitted to the applicable taxing authorities or client employees, thus reducing our revenues and income from this source.

Security and privacy breaches may hurt our business

We store electronically personal information, including social security numbers, about our clients and employees of our clients. In addition, our retirement services systems maintain investor account information for retirement plans. There is no guarantee that the systems and procedures that we maintain to protect against unauthorized access to such information are adequate to protect against all security breaches. Any significant violations of data privacy could result in the loss of business, litigation and regulatory investigations and penalties that could damage our reputation and the growth of our business could be materially adversely affected.

Our systems may be subject to disruptions that could adversely affect our business and reputation

Many of our businesses are highly dependent on our ability to process, on a daily basis, a large number of complicated transactions. We rely heavily on our payroll, financial, accounting and other data processing systems. If any of these systems fail to operate properly or become disabled even for a brief period of time, we could suffer financial loss, a disruption of our businesses, liability to clients, regulatory intervention or damage to our reputation. We have disaster recovery plans in place to protect our businesses against natural disasters, security breaches, military or terrorist actions, power or communication failures or similar events. Despite our preparations, in the event of a catastrophic occurrence, our disaster recovery plans may not be successful in preventing the loss of customer data, service interruptions, disruptions to our operations, or damage to our important facilities.

If we fail to adapt our technology to meet customer needs and preferences, the demand for our services may diminish

Our businesses operate in industries that are subject to rapid technological advances and changing customer needs and preferences. In order to remain competitive and responsive to customer demands, we continually upgrade, enhance and expand our existing products and services. If we fail to respond successfully to the technology challenges, the demand for our services may diminish.

Political and economic factors may adversely affect our business and financial results

Trade, monetary and fiscal policies, and political and economic conditions may substantially change. When there is a slowdown in the economy, employment levels and interest rates may decrease with a corresponding impact on our businesses. Customers may react to worsening conditions by reducing their spending on payroll and other outsourcing services or renegotiating their contracts with us. If any of these circumstances remain in effect for an extended period of time, there could be a material adverse effect on our financial results.

Change in our credit ratings could adversely impact our operations and lower our profitability

The major credit rating agencies periodically evaluate our creditworthiness and have consistently given us their highest long-term debt and commercial paper ratings. Failure to maintain high credit ratings on long-term and short-term debt could increase our cost of borrowing, reduce our ability to obtain intra-day borrowing required by our Employer Services business, and ultimately reduce our client interest revenue.

We may be unable to attract and retain qualified personnel

Our ability to grow and provide our customers with competitive services is partially dependent on our ability to attract and retain highly motivated people with the skills to serve our customers. Competition for skilled employees in the outsourcing and other markets in which we operate is intense and if we are unable to attract and retain highly skilled and motivated personnel, expected results from our operations may suffer.

Item 1B. Unresolved Staff Comments

None

Item 2. Properties

ADP leases space for some of its processing centers, other operational offices and sales offices. All of these leases, which aggregate approximately 6,083,000 square feet in North America, Europe, South America (primarily Brazil), Asia, Australia and South Africa, expire at various times up to the year 2036. ADP owns 43 of its processing centers, other operational offices, sales offices and its corporate headquarters complex in Roseland, New Jersey, which aggregate approximately 4,090,000 square feet. None of ADP's owned facilities is subject to any material encumbrances. ADP believes its facilities are currently adequate for their intended purposes and are adequately maintained.

Item 3. Legal Proceedings

In the normal course of business, the Company is subject to various claims and litigation. While the outcome of any litigation is inherently unpredictable, the Company believes it has valid defenses with respect to the legal matters pending against it and the Company believes that the ultimate resolution of these matters will not have a material adverse impact on its financial condition, results of operations or cash flows.

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

None

Part II

Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market for the Registrant’s Common Equity

The principal market for the Company’s common stock (symbol: ADP) is the New York Stock Exchange. The following table sets forth the reported high and low sales prices of the Company’s common stock based on the NYSE composite transactions, and the cash dividends per share of common stock declared during the past two fiscal years. As of June 30, 2007, there were 40,788 holders of record of the Company’s common stock. As of such date, 363,899 additional holders held their common stock in “street name.”

	Price Per Share		Dividends
	High	Low	Per Share
Fiscal 2007 quarter ended			
June 30	$50.30	$43.89	$0.230
March 31	$51.50	$46.85	$0.230
December 31	$49.94	$46.26	$0.230
September 30	$48.30	$42.50	$0.185
Fiscal 2006 quarter ended			
June 30	$46.93	$43.31	$0.185
March 31	$47.95	$43.25	$0.185
December 31	$48.11	$42.19	$0.185
September 30	$45.07	$41.21	$0.155

On March 30, 2007, ADP completed the spin-off of its former Brokerage Services Group business. In the table above, market prices include the value of the Brokerage Services Group business through the date of the spin-off.

Issuer Purchases of Equity Securities

(a)	(b)	(c)	(d)
		Total Number of Shares Purchased as Part	Maximum Number of Shares

Period	Total Number of Shares Purchased	Average Price Paid per Share (3)	of the Publicly Announced Common Stock Repurchase Plan (1)	that may yet be Purchased under the Common Stock Repurchase Plan (1)
April 1, 2007 to April 30, 2007	2,060,623	$45.51	2,000,000	63,909,440
May 1, 2007 to May 31, 2007	10,183,138	$48.08	10,150,900	53,758,540
June 1, 2007 to June 30, 2007	9,982,976	$48.86	9,982,000	43,776,540
Total	22,226,737 (2)		22,132,900	

(1) In March 2001, the Company received the Board of Directors’ approval to repurchase up to 50 million shares of the Company’s common stock. In November 2002, November 2005 and August 2006, the Company received the Board of Directors’ approval to repurchase an additional 35 million, 50 million and 50 million shares, respectively, of the Company’s common stock. There is no expiration date for the common stock repurchase plan.

(2) During 2007, pursuant to the terms of the Company’s restricted stock program, the Company (i) made repurchases of 2,313 shares during May 2007 and 976 shares during June 2007 at the then market value of the shares in connection with the exercise by employees of their option under such program to satisfy certain tax withholding requirements through the delivery of shares to the Company instead of cash and (ii) made purchases of 60,623 shares during April 2007 and 29,925 shares during May 2007 at a price of $.10 per share under the terms of such program to repurchase stock granted to employees who have left the Company.

(3) The average price per share does not include the repurchases described in clause (ii) of the preceding footnote.

Performance Graph

The following graph compares the cumulative return on the Company’s common stock[a] for the most recent five years with the cumulative return on the S&P 500 Index, a Peer Group Index[b] and an Old Peer Group Index[c], assuming an initial investment of $100 on June 30, 2002, with all dividends reinvested.

(a) On March 30, 2007, the Company completed the spin-off of its former Brokerage Services Group business, comprised of Brokerage Services and Securities Clearing and Outsourcing Services, into an independent publicly traded company called Broadridge Financial Solutions, Inc. The cumulative returns of the Company’s common stock have been adjusted to reflect the spin-off.

(b) The Peer Group Index is comprised of the following companies:

Ceridian Corporation	First Data Corporation
Computer Sciences Corporation	Paychex, Inc.
Electronic Data Systems Corporation	Total Systems Services, Inc.

(c) The Old Peer Group Index is comprised of the companies in the Peer Group Index as well as Fiserv, Inc. and DST Systems, Inc., which provide services to the brokerage industry and were removed from the Peer Group Index in connection with the spin-off of the Brokerage Services Group business.

Item 6. Selected Financial Data

The following selected financial data is derived from our consolidated financial statements and should be read in conjunction with the consolidated financial statements and related notes, MD&A and Quantitative and Qualitative Disclosures About Market Risk included in this Form 10-K.

(Dollars and shares in millions, except per share amounts) Years ended June 30,	2007	2006	2005	2004	2003
Total revenues	$ 7,800.0	$ 6,835.6	$ 6,131.3	$ 5,575.7	$ 5,078.8
Total cost of revenues	$ 4,087.3	$ 3,603.7	$ 3,165.3	$ 2,794.7	$ 2,339.9
Gross profit	$ 3,712.7	$ 3,231.9	$ 2,966.0	$ 2,781.0	$ 2,738.9
Earnings from continuing operations before income taxes	$ 1,623.5	$ 1,361.2	$ 1,237.8	$ 1,117.8	$ 1,303.0
Net earnings from continuing operations	$ 1,021.2	$ 841.9	$ 780.6	$ 702.4	$ 813.3
Basic earnings per share from continuing operations	$ 1.86	$ 1.46	$ 1.34	$ 1.19	$ 1.36
Diluted earnings per share from continuing operations	$ 1.83	$ 1.45	$ 1.32	$ 1.18	$ 1.34
Basic weighted average shares outstanding	549.7	574.8	583.2	591.7	600.1
Diluted weighted average shares outstanding	557.9	580.3	590.0	598.7	605.9
Cash dividends declared per share	$ 0.8750	$ 0.7100	$ 0.6050	$ 0.5400	$ 0.4750
Return on equity (Note 1)	23.7%	17.4%	15.5%	13.8%	15.8%
At year end:					
Cash, cash equivalents and marketable securities	$ 1,884.6	$ 2,461.3	$ 1,716.0	$ 1,918.2	$ 2,169.6
Total assets before funds held for clients	$ 8,159.7	$ 10,006.2	$ 9,717.9	$ 8,217.0	$ 8,025.9
Total assets	$ 26,648.9	$ 27,490.1	$ 27,615.4	$ 21,120.6	$ 19,833.7
Long-term debt	$ 43.5	$ 74.3	$ 75.7	$ 76.2	$ 84.7
Stockholders equity	$ 5,147.9	$ 6,011.6	$ 5,783.9	$ 5,417.7	$ 5,371.5

Note 1. U.S. GAAP requires net earnings of discontinued operations to be displayed separately in the Statements of Consolidated Earnings. As a result, we believe the numerator of net earnings that is used in our calculation of return on equity should exclude those net earnings from discontinued operations. Further, we believe it is appropriate to exclude from the denominator of average total stockholders equity, the average cumulative net earnings from discontinued operations for each of the five years since fiscal 2003 for which such returns are presented, as well as the equity impact of the spin-off of the Brokerage Services Group business, which was classified as a discontinued operation. As a result, return on equity, excluding the effects of discontinued

operations has been calculated as net earnings from continuing operations divided by average stockholders equity, excluding the effects of discontinued operations as noted below.

(In millions) June 30,	2007	2006	2005	2004	2003
Average total equity	$ 5,579.8	$ 5,897.7	$ 5,600.7	$ 5,394.6	$ 5,242.9
Less:					
Cumulative effect of discontinued operations	1,266.3	1,069.1	575.6	321.6	102.5
Average total equity, excluding effects of discontinued operations	$ 4,313.5	$ 4,828.6	$ 5,025.1	$ 5,073.0	$ 5,140.4

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

FORWARD-LOOKING STATEMENTS

This report and other written or oral statements made from time to time by Automatic Data Processing, Inc. ("ADP") may contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature and which may be identified by the use of words like "expects," "assumes," "projects," "anticipates," "estimates," "we believe," "could be" and other words of similar meaning, are forward-looking statements. These statements are based on management's expectations and assumptions and are subject to risks and uncertainties that may cause actual results to differ materially from those expressed. Factors that could cause actual results to differ materially from those contemplated by the forward-looking statements include: ADP's success in obtaining, retaining and selling additional services to clients; the pricing of products and services; changes in laws regulating payroll taxes, professional employer organizations and employee benefits; overall market and economic conditions, including interest rate and foreign currency trends; competitive conditions; auto sales and related industry changes; employment and wage levels; changes in technology; availability of skilled technical associates and the impact of new acquisitions and divestitures. ADP disclaims any obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. These risks and uncertainties, along with the risk factors discussed above under "Item 1A. Risk Factors," should be considered in evaluating any forward-looking statements contained herein.

DESCRIPTION OF THE COMPANY AND BUSINESS SEGMENTS

ADP is one of the world's largest providers of business outsourcing solutions. Leveraging more than 55 years of experience, ADP offers a wide range of HR, payroll, tax and benefits administration solutions from a single source. ADP is also a leading provider of integrated computing solutions to automotive, heavy truck, motorcycle, marine and recreational vehicle dealers throughout the world. In fiscal 2007, the Company implemented several key changes to its operations, including the spin-off of its former Brokerage Services Group business on March 30, 2007. In addition, there were changes in the Company's executive management team. As a result of these changes, the Company reassessed its reportable segments under SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," and determined that Professional Employer Organization ("PEO") Services should be a reportable segment in addition to Employer Services and Dealer Services. Based upon similar economic characteristics and operational characteristics, the Company's strategic business units are aggregated into the following three reportable segments: Employer Services, PEO Services and Dealer Services. The Company has restated its previously reported segment results for all periods presented to reflect this change in the Company's reportable segments. A brief description of each segment's operations is provided below.

Employer Services

Employer Services offers a comprehensive range of human resource ("HR") information, payroll processing, tax and benefits administration products and services, including traditional and Web-based outsourcing solutions, that assist approximately 560,000 employers in the United States, Canada, Europe, South America (primarily Brazil), Australia and Asia to staff, manage, pay and retain their employees. Employer Services categorizes its services between traditional payroll and payroll tax, and "beyond payroll." The traditional payroll and payroll tax business represents the Company's core payroll processing and payroll tax filing business. The "beyond payroll" business represents the services that extend beyond the traditional payroll and payroll tax filing services, such as Time and

Labor Management and benefit and retirement administration. Within Employer Services, the Company collects client funds and remits such funds to tax authorities for payroll tax filing and payment services, and to employees of payroll services clients.

PEO Services

PEO Services provides over 4,500 small and medium sized businesses with comprehensive employment administration outsourcing solutions through a co-employment relationship, including payroll, payroll tax filing, HR guidance, 401(k) plan administration, benefits administration, compliance services, health and workers compensation coverage and other supplemental benefits for employees.

Dealer Services

Dealer Services provides integrated dealer management systems (such a system is also known in the industry as a DMS) and business solutions to automotive, heavy truck and powersports (*i.e.*, motorcycle, marine and recreational) vehicle retailers in the United States, Canada, South Africa, Asia and Europe. Over 25,000 automotive, heavy truck and powersports dealers in over 50 countries use our DMS, other software-based solutions, networking solutions, data integration, consulting and/or marketing services.

EXECUTIVE OVERVIEW

Consolidated revenues from continuing operations in the fiscal year ended June 30, 2007 (fiscal 2007) grew 14%, to $7,800.0 million, as compared to $6,835.6 million in the fiscal year ended June 30, 2006 (fiscal 2006). Earnings from continuing operations before income taxes and net earnings from continuing operations increased 19% and 21%, respectively. Diluted earnings per share from continuing operations increased 26%, to $1.83 in fiscal 2007, from $1.45 per share in fiscal 2006, on fewer shares outstanding.

We are pleased with our strong results in each of our business segments in fiscal 2007. Employer Services revenues increased 11% and PEO Services revenues increased 26% in fiscal 2007. Employer Services and PEO Services new business sales, which represent annualized recurring revenues anticipated from sales orders to new and existing clients, grew 11% worldwide, to approximately $1,055.1 million in fiscal 2007. This represents the third straight year of double-digit sales growth. In fiscal 2007, Employer Services grew average client funds balances 8% as a result of new business and growth in our existing client base. The increase in average client funds balances resulted in an increase in interest revenues within Employer Services, which accounted for approximately 1% growth in Employer Services revenues as compared to fiscal 2006. The number of employees on our clients payrolls, pays per control, increased in all market segments with 2.3% overall growth in the United States, and client retention improved 0.1 percentage point worldwide over last years record level. PEO Services revenues grew 26% in fiscal 2007 primarily due to a 22% increase in the average number of worksite employees. Dealer Services revenues grew 14% in fiscal 2007 due to internal revenue growth and the effect of acquisitions.

Additionally, we were very pleased to have completed the tax-free spin-off of our former Brokerage Services Group business, as well as the sales of certain non-strategic, slow-growing businesses. The new ADP is a more focused company, which we believe has excellent growth potential for revenue and pretax earnings.

On March 30, 2007, we completed the tax-free spin-off of our former Brokerage Services Group business, comprised of our former Brokerage Services and Securities Clearing and Outsourcing Services segments, into an independent publicly traded company called Broadridge Financial Solutions, Inc. (Broadridge). As a result of the spin-off, ADP stockholders of record on March 23, 2007 (the record date) received one share of Broadridge common stock for every four shares of ADP common stock held by them on the record date and cash for any fractional shares of Broadridge common stock. We have classified the results of operations of the spun-off business as discontinued operations for all periods presented. Additionally, we recorded a decrease to retained earnings of $1,125.2 million for the non-cash reduction in net assets of Broadridge related to the spin-off, offset by an increase to retained earnings of $690.0 million related to the cash dividend received from Broadridge as part of the spin-off.

On January 23, 2007, the Company completed the sale of Sandy Corporation, a business within the Dealer Services segment that specializes in sales and marketing training, for approximately $4.0 million in cash and the assumption of certain liabilities by the buyer, plus an additional earn-out payment if certain revenue targets are achieved. The Company reported a gain of $11.2 million, or $6.9 million after tax within earnings from discontinued operations on the Statements of Consolidated Earnings. The Company has classified the results of operations of this business as discontinued operations for all periods presented.

On June 30, 2007, we entered into a definitive agreement to sell our Travel Clearing business for approximately $116 million in cash. We completed the sale of this business on July 6, 2007. The Travel Clearing business was previously reported in the Other segment. In connection with the disposal of this business, we have classified the results of operations of this business as discontinued operations for all periods presented. We expect to record a gain of approximately $55 million to $65 million, after taxes, which we will classify as discontinued operations in fiscal 2008. Such gain is exclusive of a working capital adjustment to the original purchase price. This working capital adjustment is expected to be finalized in fiscal 2008 and will increase or decrease the gain accordingly.

With the cash dividend from the spin-off of our former Brokerage Services Group business and our cash flows from operations, we continued our accelerated share buyback program and acquired over 40 million of our shares for treasury for over $1.9 billion. These share repurchases, along with our repurchase of over 29 million shares in fiscal 2006, demonstrate our confidence in ADPs future growth opportunities.

Our financial condition and balance sheet remain solid with cash and marketable securities of $1,884.6 million at June 30, 2007. Our net cash flows provided by operating activities decreased $514.5 million, to $1,298.0 million in fiscal 2007, from $1,812.5 million in fiscal 2006 as a result of a decrease in the operating activities of discontinued operations of $186.1 million, as well as an increase of $247.2 million in accounts receivable and an increase of $116.2 million in other assets. The increase in accounts receivable was related to our increased revenues and the timing of collections. The increase in other assets was largely due to a $17.4 million increase in our pension plan cash contributions and a $62.3 million increase in other current assets due to the timing of certain payments for prepaid insurance and software maintenance contracts in fiscal 2007 as compared to fiscal 2006.

RESULTS OF OPERATIONS
ANALYSIS OF CONSOLIDATED OPERATIONS

Fiscal 2007 Compared to Fiscal 2006

(Dollars in millions, except per share amounts)

	Years ended June 30,		Change
	2007	2006	2007 vs 2006
Total revenues	$ 7,800.0	$ 6,835.6	14%
Costs of revenues:			
Operating expenses	3,392.3	2,970.5	14%
Systems development and programming costs	486.1	472.3	3%
Depreciation and amortization	208.9	160.9	30%
Total cost of revenues	4,087.3	3,603.7	13%
Selling, general and administrative expenses	2,206.2	1,933.7	14%

Interest expense	94.9	72.8	30%
Total expenses	6,388.4	5,610.2	14%
Other income, net	211.9	135.8	56%
Earnings from continuing operations before income taxes	$ 1,623.5	$ 1,361.2	19%
Margin	21%	20%	
Provision for income taxes	$ 602.3	$ 519.3	16%
Effective tax rate	37.1%	38.2%	
Net earnings from continuing operations	$ 1,021.2	$ 841.9	21%
Diluted earnings per share from continuing operations	$ 1.83	$ 1.45	26%

Total Revenues

Our consolidated revenues in fiscal 2007 grew 14%, to $7,800.0, million due to increases in Employer Services of 11%, or $539.0 million, to $5,615.4 million, PEO Services of 26%, or $181.1 million, to $884.8 million, and Dealer Services of 14%, or $153.0 million, to $1,225.8 million. Our consolidated revenues, excluding the impact of acquisitions and divestitures, grew 12% in fiscal 2007 as compared to the prior year. Revenue growth was also favorably impacted by $81.1 million, or 1%, due to fluctuations in foreign currency rates.

Our consolidated revenues in fiscal 2007 include interest on funds held for clients of $653.6 million as compared to $549.8 million in the prior year. The increase in the consolidated interest earned on funds held for clients resulted from the increase of 8% in our average client funds balances to $14.7 billion, as well as the increase in the average interest rate earned to approximately 4.5% in fiscal 2007 as compared to 4.1% in fiscal 2006.

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Total Expenses

Our consolidated expenses increased $778.2 million, from $5,610.2 million in fiscal 2006, to $6,388.4 million in fiscal 2007. The percentage increase in our consolidated expenses was proportionate to the increase in our revenues. Additionally, the increase was due to higher pass-through costs associated with our PEO business revenues, which have pass-through operating expenses, an increase in our salesforce and implementation personnel, higher expenses associated with our Employer Services new business sales and implementation and the impact of acquisitions. Consolidated expenses also increased $79.8 million, or 1%, due to fluctuations in foreign currency exchange rates.

Our total cost of revenues increased $483.6 million, to $4,087.3 million in fiscal 2007, from $3,603.7 million in fiscal 2006, due to increases in our operating expenses. Operating expenses increased $421.8 million, due to the increase in revenues described above, including the increases in PEO revenues, which have pass-through costs that are re-billable, and higher compensation expenses associated with additional implementation and service personnel. The pass-through costs for our PEO revenues were $640.7 million in fiscal 2007, as compared to $511.0 million in fiscal 2006. In addition, operating expenses in fiscal 2007 increased approximately $136.0 million as a result of higher compensation expenses associated with additional implementation and service personnel, including approximately $47.0 million of spending on new business opportunities in Employer Services and PEO Services. Our new business opportunities relate to our Human Resource Business Process Outsourcing (HR BPO) opportunities, which focus on the outsourcing of integrated multiple processes such as payroll, HR, and benefits administration. This spending was targeted at expanding our Comprehensive Outsourcing Services (COS) product for larger employers, our PEO Services business, our ADP Resource® product, which is an integrated, flexible HR and payroll-based service offering, and GlobalView®, which is our outsourcing offering for multi-national and global organizations. Lastly, our operating expenses increased $30.0 million due to fluctuations in foreign currency rates and increased approximately $64.6 million due to the operating costs of new businesses acquired. Systems development and programming costs increased $20.4 million due to the increase in headcount and the additional expenses associated with our new businesses acquired and increased $6.1 million due to fluctuations in foreign currency exchange rates. These increases in systems development and programming costs were offset by lower compensation expenses of approximately $16.0 million associated with the increased resources at our off-shore locations and smartshoring facilities. In addition, depreciation and amortization expenses increased $48.0 million due to increased amortization expenses of $28.2 million resulting from the intangible assets acquired with new businesses and the purchases of software and software licenses in fiscal 2007. In addition, depreciation and amortization expenses increased due to fiscal 2006 capital expenditures of approximately $100 million related to the consolidation of our data center facilities.

Selling, general and administrative expenses increased $272.5 million, to $2,206.2 million in fiscal 2007, due to higher selling expenses in Employer Services and PEO Services, which resulted in an increase in expenses of approximately $97.5 million and $18.3 million, respectively. The $97.5 million increase in expenses in Employer Services includes approximately $13 million for expenses relating to our HR BPO opportunities discussed above. Selling, general and administrative expenses also increased approximately $73.8 million due to the selling, general and administrative expenses related to our business acquisitions in fiscal 2007 and increased $20.1 million due to fluctuations in foreign currency rates. Additionally, we had an increase in restructuring charges of $21.5 million, which primarily related to severance.

Interest expense increased $22.1 million in fiscal 2007 as a result of higher average borrowings and higher interest rates on our short-term commercial paper program. In fiscal 2007 and 2006, the Company's average borrowings under the commercial paper program were $1.5 billion and $1.4 billion, respectively, at a weighted average interest rate of 5.3% and 4.1%, respectively.

Other Income, net

Other income, net, increased $76.1 million in fiscal 2007 due to a gain of $38.6 million on the sale of a minority investment, an increase of $7.5 million of realized gains on our available-for-sale securities and a decrease of $5.4 million of realized losses on our available-for-sale securities. Additionally, other income, net, included an increase in interest income on corporate funds of $24.6 million as a result of the higher average interest rates earned on our corporate balances, which increased to 4.6% in fiscal 2007 as compared to 4.0% in the prior year and our average corporate balances increased to $3.6 billion in fiscal 2007 as compared to $3.5 billion in the prior year.

Earnings from Continuing Operations before Income Taxes

Earnings from continuing operations before income taxes increased $262.3 million, or 19%, to $1,623.5 million in fiscal 2007 due to the increase in revenues and expenses discussed above. Overall margin increased from 20% in fiscal 2006 to 21% in fiscal 2007.

Provision for Income Taxes

Our effective tax rate in fiscal 2007 was 37.1%, as compared to 38.2% in fiscal 2006. The decrease in the effective tax rate is attributable to a favorable mix in income among tax jurisdictions and to $10.0 million of income tax expense recorded in fiscal 2006 for the repatriation in fiscal 2006 of approximately $250.0 million of eligible dividends from non-U.S. subsidiaries.

Net Earnings from Continuing Operations and Diluted Earnings per Share from Continuing Operations

Net earnings from continuing operations in fiscal 2007 increased 21%, to $1,021.2 million, from $841.9 million in fiscal 2006, and the related diluted earnings per share from continuing operations increased 26%, to $1.83. The diluted earnings per share from continuing operations of $1.83 includes a net one-time gain of approximately $20.3 million, net of taxes, from the sale of a Dealer Services non-core minority investment, offset by restructuring charges, which was accretive to diluted earnings per share from continuing operations by approximately $0.03 per share. The increase in net earnings from continuing operations in fiscal 2007 reflects the increase in earnings from continuing operations before income taxes as a result of increased revenues offset by expenses and a lower effective tax rate. The increase in diluted earnings per share from continuing operations in fiscal 2007 reflects the increase in net earnings from continuing operations and the impact of fewer shares outstanding due to the repurchase of 40.2 million shares in fiscal 2007 and 29.6 million shares in fiscal 2006.

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Fiscal 2006 Compared to Fiscal 2005

(Dollars in millions, except per share amounts)

	Years ended June 30, 2006-As Reported	2005-As Reported	2005-As Adjusted	Change 2006 vs 2005-As Reported	Change 2006 vs 2005-As Adjusted
Total revenues	$6,835.6	$ 6,131.3	$ 6,131.3	11%	11%
Costs of revenues:					
Operating expenses	2,970.5	2,588.1	2,619.9	15%	13%
Systems development and programming costs	472.3	426.6	458.8	11%	3%
Depreciation and amortization	160.9	150.6	150.6	7%	7%
Total cost of revenues	3,603.7	3,165.3	3,229.3	14%	12%
Selling, general and administrative expenses	1,933.7	1,758.6	1,839.6	10%	5%
Interest expense	72.8	32.3	32.3	125%	125%
Total expenses	5,610.2	4,956.2	5,101.2	13%	10%
Other income, net	135.8	62.7	62.7	117%	117%
Earnings from continuing operations before income taxes	$1,361.2	$ 1,237.8	$ 1,092.8	10%	25%
Margin	20%	20%	18%		
Provision for income taxes	$ 519.3	$ 457.2	$ 415.7	14%	25%
Effective tax rate	38.2%	36.9%	38.0%		
Net earnings from continuing operations	$ 841.9	$ 780.6	$ 677.1	8%	24%
Diluted earnings per share from continuing operations	$ 1.45	$ 1.32	$ 1.15	10%	26%

The comparison between the results of operations in fiscal 2006 and 2005 is affected by the impact of our adoption of Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS No. 123R), effective July 1, 2005, using the modified prospective method. Accordingly, prior period amounts have not been restated. We believe the inclusion of the 2005 As Adjusted amounts provides a useful additional perspective to compare the results of operations in fiscal 2006 and 2005 as a result of our adoption of SFAS No. 123R. We use both generally accepted accounting principles (GAAP) and non-GAAP measures to manage and evaluate the Companys performance and consider it appropriate to disclose these non-GAAP measures to assist investors with analyzing business performance and trends. However, these measures should not be considered in isolation or as a substitute for the results of operations and diluted earnings per share prepared in accordance with GAAP.

The adoption of SFAS No. 123R requires the recognition of stock-based compensation expense in the consolidated financial statements. Prior to July 1, 2005, we followed Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), and related interpretations. Under APB No. 25, no stock-based compensation expense was recognized related to our stock option program and employee stock purchase plan, as all options granted under the stock option program had an exercise price equal to the market value of the underlying common stock on the date of grant and, with respect to the employee stock purchase plan, the discount did not exceed fifteen percent. Stock-based compensation expense for our restricted stock program has historically been recognized in our results of operations in accordance with APB No. 25. The following table summarizes the stock-based compensation expense related to our stock option program, the employee stock purchase plan and restricted stock program that have been recorded in earnings from continuing operations in each respective period:

(In millions)

Years ended June 30,	2006	2005
Operating expenses	$ 23.7	$ --
Selling, general and administrative expenses	95.7	11.8
Systems development and programming costs	23.3	--
Total stock-based compensation expense reported in net earnings from continuing operations	$ 142.7	$ 11.8
Income tax benefit on stock-based compensation expense reported in net earnings from continuing operations	$ (41.7)	$ (4.6)

In order to provide a comparable basis between the results of operations in fiscal 2006 and the fiscal year ended June 30, 2005 ("fiscal 2005"), we have provided pro forma information, reflected under the heading "2005 – As Adjusted", to provide fiscal 2005 results as if stock-based compensation expense related to our stock option program and employee stock purchase plan had been expensed. The "2005 – As Adjusted" amounts include the following pro forma stock-based compensation expense related to our stock option program and employee stock purchase plan, which are based on the pro forma amounts disclosed in Note 14 to the consolidated financial statements included with this Annual Report on Form 10-K:

(In millions)

Year ended June 30,	2005
Operating expenses	$ 31.8
Selling, general and administrative expenses	81.0
Systems development and programming costs	32.2
Total pro forma stock-based compensation expense	$ 145.0
Pro forma income tax benefit on stock-based compensation expense	$ (41.5)

Total Revenues

Our consolidated revenues in fiscal 2006 grew 11%, to $6,835.6 million, as compared to our consolidated revenues in fiscal 2005, due to increases in Employer Services of 8%, or $376.7 million, to $5,076.4 million, PEO Services of 22%, or $126.7 million, to $703.7 million, and Dealer Services of 15%, or $136.2 million, to $1,072.8 million. Our consolidated revenues, excluding the impact of acquisitions and divestitures, grew 10% in fiscal 2006 as compared to the prior year.

Our consolidated revenues in fiscal 2006 include interest on funds held for clients of $549.8 million, as compared to $421.4 million in fiscal 2005. The increase in the consolidated interest earned on funds held for clients was due to the increase of 11% in our average client funds balances in fiscal 2006 to $13.6 billion as a result of new business and growth in our existing client base, as well as the increase in the average interest rate earned on client funds from 3.4% in fiscal 2005 to 4.1% in fiscal 2006.

Total Expenses, As Reported

Our consolidated expenses in fiscal 2006 increased $654.0 million, to $5,610.2 million, from $4,956.2 million in fiscal 2005, as reported, due to an increase in our revenues described above, an increase in our stock-based compensation expense, and increases in our cost of revenues and selling, general and administrative expenses. The increase in our stock-based compensation expense in our results of operations as of July 1, 2005 is associated with the adoption of SFAS No. 123R. Total stock-based compensation expense included in continuing operations increased $130.9 million, to $142.7 million, in fiscal 2006, from $11.8 million, as reported, in fiscal 2005 due to the recording of expenses within our results of operations for our stock option program and employee stock purchase plan.

Our total cost of revenues increased $438.4 million, to $3,603.7 million in fiscal 2006, from $3,165.3 million in fiscal 2005, due to increases in our operating expenses and systems development and programming costs. Operating expenses increased $382.4 million, or 15%, due to the increase in revenues described above, including the increase in PEO revenues, which have pass-through costs. The pass-through costs associated with our PEO revenues increased $88.4 million in fiscal 2006, to $511.0 million. In addition, operating expenses increased approximately $95.3 million as a result of higher compensation expenses associated with additional implementation and service personnel. Lastly, our operating expenses increased $23.7 million due to the increase in stock-based compensation expense in fiscal 2006. Systems development and programming costs increased $45.7 million, to $472.3 million, due to stock-based compensation expense of $23.3 million recorded in fiscal 2006 and increased compensation expenses associated with personnel to support and maintain our products and services.

Selling, general and administrative expenses increased $175.1 million in fiscal 2006, to $1,933.7 million, attributable to the increase in stock-based compensation expense of $83.9 million in fiscal 2006 and increased compensation costs of $77.8 million associated with our continued investment in our sales personnel to drive our revenue growth.

Interest expense increased $40.5 million in fiscal 2006 as a result of higher interest rates and higher average borrowings on our short-term commercial paper program. In fiscal 2006 and 2005, the Company's average borrowings under the commercial paper program were $1.4 billion and $1.0 billion, respectively, at a weighted average interest rate of 4.1% and 2.1%, respectively.

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Total Expenses, As Adjusted

Our consolidated expenses in fiscal 2006 increased $509.0 million, to $5,610.2 million, from $5,101.2 million in fiscal 2005, as adjusted, due to increases in our costs of revenues and selling, general and administrative expenses. Total stock-based compensation expense included in continuing operations decreased $14.1 million, to $142.7 million in fiscal 2006, from $156.8 million, as adjusted, in fiscal 2005. This decrease was driven by the reduction in the number of stock options granted to associates, which began in fiscal 2006.

Our total cost of revenues increased $374.4 million, to $3,603.7 million in fiscal 2006, from $3,229.3 million in fiscal 2005, due to increases in our operating expenses and systems development and programming costs. Operating expenses increased $350.6 million, or 13%, due to the increase in revenues described above, including the increase in PEO revenues, which have pass-through costs. The pass-through costs associated with our PEO revenues increased $88.4 million in fiscal 2006, to $511.0 million. In addition, operating expenses increased approximately $95.3 million as a result of higher compensation expenses associated with additional implementation and service personnel. Systems development and programming costs increased $13.5 million, to $472.3 million, due to increased compensation expenses associated with personnel to support and maintain our products and services.

Selling, general and administrative expenses increased $94.1 million in fiscal 2006, to $1,933.7 million, attributable to increased compensation costs of $77.8 million associated with our continued investment in our sales personnel to drive our revenue growth.

Interest expense increased $40.5 million in fiscal 2006 as a result of higher interest rates and higher average borrowings on our short-term commercial paper program. In fiscal 2006 and 2005, the Company's average borrowings under the commercial paper program were $1.4 billion and $1.0 billion, respectively, at a weighted average interest rate of 4.1% and 2.1%, respectively.

Other Income, net

Other income, net, increased $73.1 million in fiscal 2006 due to the increase in interest income on corporate funds of $49.2 million as a result of the increase in the average interest rate earned on our corporate investments from 3.0% in fiscal 2005 to 4.0% in fiscal 2006 and a decrease in the net realized losses on available-for-sale securities of $23.9 million.

Earnings from Continuing Operations before Income Taxes, As Reported

Earnings from continuing operations before income taxes increased $123.4 million, or 10%, from $1,237.8 million, as reported, in fiscal 2005 to $1,361.2 million in fiscal 2006 due to the increase in revenues and expenses discussed above. Overall margin remained flat at 20%. We leveraged our expense levels with the increasing revenues, in order to improve margins on our services. The improved margins on our services were offset by the increase in stock compensation expenses of $130.9 million due to the recording of stock-based compensation expense associated with our stock option program and employee stock purchase plan in fiscal 2006. Additionally, our margin was negatively impacted by increasing PEO revenues, which have pass-through operating expenses and therefore lower margins.

Earnings from Continuing Operations before Income Taxes, As Adjusted

Earnings from continuing operations before income taxes increased $268.4 million, or 25%, from $1,092.8 million, as adjusted, in fiscal 2005 to $1,361.2 million in fiscal 2006 due to the increase in revenues and expenses discussed above. Overall margin improved from 18% to 20%. We leveraged our expense levels with the increasing revenues in order to improve margins on our services and total stock-based compensation expense decreased due to the reduction in the number of stock options granted to associates. In addition, our margin was negatively impacted by the increasing PEO revenues, which have pass-through operating expenses and therefore lower margins.

Provision for Income Taxes, As Reported

Our effective tax rate in fiscal 2006 was 38.2% as compared to 36.9%, as reported, in fiscal 2005. The increase in the effective tax rate is attributable to the expensing of stock-based compensation, as certain components of our stock-based compensation programs are non-deductible, resulting in a higher effective tax rate. In addition, the effective tax rate increased due to the application of the provisions of the American Jobs Creation Act (the "AJCA") to our repatriation of approximately $250.0 million of eligible dividends from non-U.S. subsidiaries, which resulted in income tax expense of approximately $10.0 million in fiscal 2006. These increases in the effective tax rate were partially offset by a favorable mix in income among tax jurisdictions.

Provision for Income Taxes, As Adjusted

Our effective tax rate was 38.2% and 38.0% in fiscal 2006 and fiscal 2005, respectively, as adjusted. The increase in our effective tax rate was due to additional income tax expense of approximately $10.0 million in fiscal 2006 associated with the repatriation of approximately $250.0 million of eligible dividends from non-U.S. subsidiaries under the AJCA. Certain components of our stock-based compensation programs are non-deductible, which results in a higher effective tax rate. In fiscal 2006, our non-deductible stock-based compensation expense decreased and our overall earnings from continuing operations before income taxes increased, both of which offset the increase in the effective tax rate. In addition, the increase in the effective tax rate was partially offset by a favorable mix in income among tax jurisdictions.

Net Earnings from Continuing Operations and Diluted Earnings per Share from Continuing Operations, As Reported

Net earnings from continuing operations increased 8%, to $841.9 million, in fiscal 2006, from $780.6 million, as reported, in fiscal 2005 and the related diluted earnings per share from continuing operations increased 10%, to $1.45. The increase in net earnings from continuing operations reflects the increase in earnings from continuing operations before income taxes as a result of increased revenues offset by the additional expense associated with stock-based compensation and a higher effective tax rate as described above. The increase in diluted earnings per share from continuing operations reflects the increase in net earnings from continuing operations and the impact of fewer shares outstanding due to the repurchase of 29.6 million shares in fiscal 2006 and 14.1 million shares in fiscal 2005.

Net Earnings from Continuing Operations and Diluted Earnings per Share from Continuing Operations, As Adjusted

Net earnings from continuing operations increased 24%, to $841.9 million, in fiscal 2006, from $677.1 million, as adjusted, in fiscal 2005. Diluted earnings per share from continuing operations increased 26%, to $1.45 in fiscal 2006 from $1.15, as adjusted, in fiscal 2005. The increase in net earnings from continuing operations reflects the increase in earnings from continuing operations before income taxes as a result of our higher revenues and improved margin, as described above. The increase in diluted earnings per share from continuing operations reflects the increase in net earnings from continuing operations and the impact of fewer shares outstanding due to the repurchase of 29.6 million shares in fiscal 2006 and 14.1 million shares in fiscal 2005.

ANALYSIS OF REPORTABLE SEGMENTS

Revenues

(Dollars in millions)

	Years ended June 30,			Change		
	2007	2006	2005	2007	2006	2005
Employer Services	$5,615.4	$5,076.4	$4,699.7	11%	8%	6%
PEO Services	884.8	703.7	577.0	26%	22%	24%
Dealer Services	1,225.8	1,072.8	936.6	14%	15%	11%
Other	(1.7)	36.6	35.0	(100)+%	5%	(16)%
Reconciling items:						
Foreign exchange	78.6	2.9	9.4			
Client funds interest	(2.9)	(56.8)	(126.4)			
Total revenues	$7,800.0	$6,835.6	$6,131.3	14%	11%	10%

Earnings from Continuing Operations before Income Taxes

(Dollars in millions)

	Years ended June 30,			Change		
	2007	2006	2005	2007	2006	2005
Employer Services	$1,408.1	$1,254.3	$1,113.7	12%	13%	14%

PEO Services	80.4	54.9	39.8	46%	38%	40%
Dealer Services	200.0	157.9	148.8	27%	6%	5%
Other	(183.7)	(150.0)	(29.8)	(22)%	(100)+%	(100)+%
Reconciling items:						
Foreign exchange	8.3	0.8	(2.6)			
Client funds interest	(2.9)	(56.8)	(126.4)			
Cost of Capital Charge	113.3	100.1	94.3			
Total earnings from continuing operations before income taxes	$1,623.5	$1,361.2	$1,237.8	19%	10%	11%

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Certain revenues and expenses are charged to the reportable segments at a standard rate for management reasons. Other costs are charged to the reportable segments based on management's responsibility for the applicable costs. Lastly, various income and expense items, including certain non-recurring gains and losses and stock-based compensation expenses of $130.5 million, $142.7 million and $11.8 million in fiscal 2007, 2006 and 2005, respectively, are recorded in "Other".

The fiscal 2006 and 2005 reportable segments' revenues and earnings from continuing operations before income taxes have been adjusted to reflect updated fiscal 2007 budgeted foreign exchange rates. This adjustment is made for management purposes so that the reportable segments' revenues are presented on a consistent basis without the impact of fluctuations in foreign currency exchange rates. This adjustment is a reconciling item to revenues and earnings from continuing operations before income taxes and results in the elimination of this adjustment in consolidation.

In addition, the reconciling items include an adjustment for the difference between actual interest income earned on invested funds held for clients and interest credited to Employer Services and PEO Services at a standard rate of 4.5%. This allocation is made for management reasons so that the reportable segments' results are presented on a consistent basis without the impact of fluctuations in interest rates. This allocation is a reconciling item to our reportable segments' revenues and earnings from continuing operations before income taxes and results in the elimination of this allocation in consolidation.

The reportable segments' results also include a cost of capital charge related to the funding of acquisitions and other investments. This charge is a reconciling item to earnings from continuing operations before income taxes and results in the elimination of this charge in consolidation.

Employer Services

Fiscal 2007 Compared to Fiscal 2006

Revenues

Employer Services' revenues increased 11% in fiscal 2007 due to new business started in the period, an increase in the number of employees on our clients' payrolls in the United States, increased client retention, the impact of pricing increases, which contributed approximately 2% to our revenue growth, and an increase in client funds balances, which increased interest revenues. Internal revenue growth, which represents revenue growth excluding the impact of acquisitions and divestitures, was approximately 9% for fiscal 2007. Revenue from our traditional payroll and payroll tax filing business grew 9%. The number of employees on our clients' payrolls, "pays per control," increased 2.3% in the United States. This employment metric represents over 141,000 payrolls of small to large businesses and reflects a broad range of U.S. geographic regions. Our worldwide client retention improved 0.1 percentage point over last year's record level. Revenues from our "beyond payroll" services, excluding PEO Services, which is disclosed as a separate reportable segment, increased 18% in fiscal 2007, due to an increase in our Time and Labor Management services revenues of 22%, as well as the impact of certain business acquisitions in fiscal 2007. The increase in revenues related to our Time and Labor Management services was due to an increase in the number of clients utilizing these services.

We credit Employer Services with interest on client funds at a standard rate of 4.5%; therefore, Employer Services results are not influenced by changes in interest rates. Interest on client funds recorded within the Employer Services segment increased $48.8 million in fiscal 2007, which represented 1% growth in Employer Services revenues, due to the increase in the average client funds balances as a

result of increased Employer Services new business and growth in our existing client base. The average client funds balances were $14.6 billion in fiscal 2007 as compared to $13.5 billion in fiscal 2006, an increase of 8%.

Earnings from Continuing Operations before Income Taxes

Earnings from continuing operations before income taxes increased $153.8 million, or 12%, to $1,408.1 million, in fiscal 2007. Earnings from continuing operations before income taxes in fiscal 2007 grew at a faster rate than revenues due to the improvement in margins for our services from the leveraging of our expense structure with the increased revenues. This was offset, in part, by higher operating expenses from the increase of approximak Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full term of the Remote Power Patent, which expires in March 2020. In addition, D-Link paid the Company $100,000 upon signing of the Settlement Agreement. The royalty rate is subject to adjustment to a rate consistent with other similarly situated licensees of the Remote Power Patent based on units of shipments of licensed products. In June 2009, based upon several licenses issued to third parties under the Company's Special Licensing Program, the Company agreed with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

[3] On November 16, 2005 the Company entered into a Settlement Agreement with PowerDsine, Inc and PowerDsine Ltd. which dismissed, with prejudice, a civil action brought by PowerDsine in the United States District Court for the Southern District of New York that sought a declaratory judgment that U.S. Patent No. 6,218,930 (the "Remote Power Patent") owned by the Company was invalid and not infringed by PowerDsine and/or its customers. Under the terms of the Settlement Agreement, the Company agreed that it will not initiate litigation against PowerDsine for its sale of Power over Ethernet (PoE) integrated circuits. In addition, the Company agreed that it will not seek damages for infringement from customers that incorporate PowerDsine integrated circuit products in PoE capable Ethernet switches manufactured on or before April 30, 2006. PowerDsine agreed that it will not initiate, assist or cooperate in any legal action relating to the Remote Power Patent.

In June 2008, the Company entered into a new agreement with Microsemi Corp-Analog Mixed Signal Group Ltd ("Microsemi Analog"), previously PowerDsine Ltd, a subsidiary of Microsemi Corporation ("Microsemi"), a leading manufacturer of high performance analog mixed-signal integrated circuits and high reliability semiconductors, which, among other things, amended the prior Settlement Agreement entered into between the parties in November 2005. As part of the Company's Special Licensing Program and its agreement with Microsemi Analog entered into in June 2008, Microsemi entered into a license agreement, dated August 13, 2008, with the Company with respect to the Remote Power Patent. The license agreement provides that Microsemi is obligated to pay the Company quarterly royalty payments of 2% of the sales price for certain of Microsemi's Midspan PoE products for the full term of the Remote Power Patent (March 2020).

NOTE E – SUBSEQUENT EVENTS

On July 19, 2010, the Company announced that it agreed to settle its patent litigation against Adtran, Inc, Cisco Systems, Inc. and Cisco-Linksys, LLC, (collectively, "Cisco"), Enterasys Networks, Inc., Extreme Networks, Inc., Foundry Networks, Inc., and 3Com Corporation, Inc., pending in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of the Company's Remote Power Patent, U.S. Patent No. 6,218,930 ("Remote Power Patent"). As part of the settlement, Adtran, Cisco, Enterasys, Extreme Networks and Foundry Networks each entered into a settlement agreement with the Company and agreed to enter into non-exclusive licenses for the Remote Power Patent (the "Licensed Defendants"). Under the terms of the licenses, the Licensed Defendants agreed to pay to the Company an aggregate upfront payment of approximately $32 million and have also agreed to license the Remote Power Patent for its full term, which expires in March 2020. In addition, Cisco agreed to pay royalties (beginning in 2011) based on its sales of Power over Ethernet ("PoE") products up to maximum royalty payments per year of $8 million through 2015 and $9 million per year thereafter for the remaining term of the patent. The royalty payments are subject to certain conditions including the continued validity of the Company's Remote Power Patent, and the actual royalty amounts received may be less than the caps stated above. The settlement with 3Com provides for a dismissal of the litigation without prejudice. The release covers sales of certain 3Com Power over Ethernet products sold through the date of the settlement. In addition, the Company and 3Com's parent, Hewlett Packard Corporation, agreed that the dismissal does not apply to Hewlett-Packard Power over Ethernet products and that any future litigation involving the Company and Hewlett Packard concerning the Remote Power Patent will be in the United States District Court for the Eastern District of Texas. For more details about the settlement, please see our Current Report on Form 8-K filed with the Securities and Exchange Commission on July 20, 2010.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS WHICH ARE STATEMENTS THAT INCLUDE INFORMATION BASED UPON BELIEF OF OUR MANAGEMENT, AS WELL AS ASSUMPTIONS MADE BY AND INFORMATION AVAILABLE TO MANAGEMENT. STATEMENTS CONTAINING TERMS SUCH AS "BELIEVES", "EXPECTS", "ANTICIPATES", "INTENDS" OR SIMILAR WORDS ARE INTENDED TO IDENTIFY FORWARD LOOKING STATEMENTS. ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED BEGINNING ON PAGES 9-14 OF OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR 2009 AND AS DISCUSSED IN THIS QUARTERLY REPORT ON FORM 10-Q.

OVERVIEW

Our principal business is the acquisition, development, licensing and protection of our intellectual property. We presently own six patents covering various telecommunications and data networking technologies (the "Patent Portfolio") including, among others, patents covering the delivery of power over Ethernet for the purpose of remotely powering network devices, and the transmission of audio, video and data over computer and telephony networks. Our strategy is to pursue licensing and strategic business alliances with companies in the industries that manufacture and sell products that make use of the technologies underlying our patents as well as with other users of the technology who benefit directly from the technology including corporate, educational and governmental entities.

To date, our efforts with respect to our Patent Portfolio have focused on licensing our patent (U.S. Patent No. 6,218,930) covering the control of power delivery over Ethernet cables (the "Remote Power Patent"). As of June 30, 2010, we had entered into 6 license agreements with respect to our Remote Power Patent which, among others, included license agreements with D-Link, Microsemi Corporation and Netgear, Inc. (See Note D to our financial statements included as part of this quarterly report). In addition, in July 2010 we reached 5 additional licenses with respect to settlements achieved concerning our litigation in the Eastern District of Texas. (See Note E to our financial statements included as part of this quarterly report). We may seek to acquire additional patents in the future. We continually review opportunities to acquire or license additional intellectual property for the purpose of pursuing licensing opportunities.

Through June 30, 2010 we incurred significant losses and at June 30, 2010 had an accumulated deficit of $(55,288,000). For the year ended December 31, 2009 and for the three and six months ended June 30, 2010, we incurred net losses of $(2,758,000), $(1,157,000) and $(1,815,000), respectively. We achieved revenue of $811,000 for the year ended December 31, 2009 and $292,000 for the six months ended June 30, 2010 with respect to royalties pertaining to our Remote Power Patent. As a result of achieving settlements in July 2010 with the remaining defendants in our patent litigation in the Eastern District of Texas (See Note E to our financial statements included as part of this quarterly report), we will receive upfront payments of approximately $32 million and Cisco is obligated to pay us ongoing royalties based on its sales of PoE products. Such payments will substantially improve our financial condition and satisfy our operational and capital requirements for the foreseeable future.

In February 2008, we commenced litigation against eight major data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent. The complaint named as defendants Cisco Systems, Inc., Cisco Linksys, LLC, Enterasys Networks, Inc., 3COM Corporation, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Netgear, Inc. and Adtran, Inc. We sought injunctive relief and monetary damages for infringement based upon reasonable royalties as well as treble damages for the defendant's continued willful infringement of our Remote Power Patent.

On May 29, 2009 we announced that we had agreed to settle this litigation with respect to Netgear, Inc. ("Netgear"). As part of the settlement and under our Special Licensing Program, Netgear entered into a license agreement with us for our Remote Power Patent. Under the terms of the license, Netgear will license the Remote Power Patent for its full term (which expires in March 2020), and pay quarterly royalties (beginning as of April 1, 2009) based on its sales of Power over Ethernet products, including those Power over Ethernet products which comply with the Institute of Electrical and Electronic Engineers 802.3af and 802.3at Standards. Licensed products include Netgear's Power over Ethernet enabled switches and wireless access points. The royalty rates included in the license are 1.7% of the sales price of Power Sourcing Equipment, which includes Ethernet switches, and 2% of the sales price of Powered Devices, which includes wireless access points. The royalty rates are subject to adjustment, under certain circumstances, if we grant a license to other licensees with lower royalty rates and Netgear is able to and agrees to assume all material terms and conditions of the other license. In addition, Netgear made a payment to us of $350,000 with respect to the settlement.

On July 19, 2010, we announced that we had agreed to settle this litigation with respect to Adtran, Inc, Cisco Systems, Inc. and Cisco-Linksys, LLC, (collectively, "Cisco"), Enterasys Networks, Inc., Extreme Networks, Inc., Foundry Networks, Inc., and 3Com Corporation, Inc. As part of the settlement, Adtran, Cisco, Enterasys, Extreme Networks and Foundry Networks each entered into a settlement agreement with us and agreed to enter into non-exclusive licenses for the Remote Power Patent (the "Licensed Defendants"). Under the terms of the licenses, the Licensed Defendants agreed to pay us an aggregate upfront payment of approximately $32 million and have also agreed to license the Remote Power Patent for its full term, which expires in March 2020. In addition, Cisco agreed to pay royalties (beginning in 2011) based on its sales of Power over Ethernet ("PoE") products up to maximum royalty payments per year of $8 million through 2015 and $9 million per year thereafter for the remaining term of the patent. The royalty payments are subject to certain conditions including the continued validity of our Remote Power Patent, and the actual royalty amounts received may be less than the caps stated above. For more details about the settlement, please see our Current Report on Form 8-K filed with the Securities and Exchange Commission on July 20, 2010.

In August 2008, as part of our Special Licensing Program and our agreement with Microsemi Corp-Analog Mixed Signal Group Ltd. ("Microsemi-Analog") entered into in June 2008, Microsemi Corporation ("Microsemi"), the parent company of Microsemi-Analog, entered into a license agreement with us with respect to the Remote Power Patent. The license agreement provides that Microsemi is obligated to pay us quarterly royalty payments of 2% of the sales price for certain of Microsemi's Midspan PoE products for the full term of the Remote Power Patent (through March 2020).

In August 2007 we finalized the settlement of our patent litigation against D-Link in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent (U.S. Patent No. 6,218,930). Under the terms of the settlement, D-Link licenses our Remote Power Patent the terms of which include monthly royalty payments of 3.25% (as adjusted as noted below) of the net sales of D-Link branded Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full life of our Remote Power Patent, which expires in March 2020. The royalty rate is subject to adjustment to a rate consistent with other similarly situated licensees of our Remote Power Patent based on units of shipments of licensed products. In addition, D-Link paid us $100,000 upon signing the settlement agreement. In June 2009, based upon several licenses issued to third parties under our Special Licensing Program, we agreed in principle with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

Notwithstanding the above referenced license agreements, there is no assurance that we will achieve significant royalty revenue from such licenses, that we will be able to achieve additional material license agreements with third parties relating to our Remote Power Patent or our other patents, or that such license arrangements will result in material revenue to us.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2010 Compared To Three Months Ended June 30, 2009

We had revenue of $174,000 and $487,000 for the three months ended June 30, 2010 and 2009, respectively, which were related to the receipt of royalties from licensees of our Remote Power Patent. The decreased revenue of $313,000 for the three months ended June 30, 2010 as compared to the three month period ended June 30, 2009 was due primarily to the $350,000 payment in 2009 from the settlement of our litigation with Netgear, Inc.

We had a cost of revenue of $9,000 and $64,000 for the three months ended June 30, 2010 and 2009, respectively, which decrease of $55,000 was related to the payment in 2009 of additional bonus compensation payable to our Chairman and Chief Executive Officer pursuant to his employment agreement, and contingent legal fees paid to Dovel & Luner, LLP, our patent litigation counsel in 2009.

The gross profit decreased $258,000 from $423,000 for the three months ended June 30, 2009 to $165,000 for the three months ended June 30, 2010. Such decreased gross profit was the result of increased revenue for the three months ended June 30, 2009 due to the $350,000 payment from settlement of our litigation with Netgear, Inc.

General and administrative expenses include overhead expenses, and finance, accounting, legal and other professional services incurred by us. General and administrative expenses increased by $524,000, from $529,000 for the three months ended June 30, 2009 to $1,053,000 for the three months ended June 30, 2010 due primarily to increased legal fees and expenses with respect to litigation involving our Remote Power Patent.

We incurred an operating loss of ($1,157,000) for the three months ended June 30, 2010 compared with an operating loss of ($297,000) for the three months ended June 30, 2009. Included in the operating loss for the three months ended June 30, 2010 was $269,000 in charges relating to non-cash compensation expenses, primarily related to the issuance of options to our Chairman and Chief Executive Officer, the extension of expiration dates of options held by our Chairman and Chief Executive Officer and a consultant and the issuance of 200,000 options to certain consultants as compared to $191,000 for such non-cash compensation expenses for the three months ended June 30, 2009.

No provision for or benefit from federal, state or local income taxes was recorded for the three months ended June 30, 2010 and June 30, 2009 because we incurred net operating losses and fully reserved our deferred tax assets as their future realization could not be determined.

As a result of the foregoing, we incurred a net loss of $(1,157,000) for the three months ended June 30, 2010 compared with a net loss of $(297,000) for the three months ended June 30, 2009.

Six Months Ended June 30, 2010 Compared To Six Months Ended June 30, 2009

We had revenue of $292,000 and $514,000 for the six months ended June 30, 2010 and 2009, respectively, which were related to the receipt of royalties from licensees of our Remote Power Patent. The revenue decrease of $222,000 for the six months ended June 30, 2010 as compared to the six month period ended June 30, 2009 was due primarily to the $350,000 payment from settlement of our litigation with Netgear, Inc. offset by increased royalties from other licensees in 2009.

We had a cost of royalties of $15,000 and $65,000 for the six months ended June 30, 2010 and 2009, respectively, which decrease of $50,000 was related to additional bonus compensation payable to our Chairman and Chief Executive Officer pursuant to his employment agreement, and contingent legal fees paid to Dovel & Luner, our patent litigation counsel in the six months ended June 30, 2009.

The gross profit for the six months ended June 30, 2010 decreased $172,000 from $449,000 for the six months ended June 30, 2009 to $277,000 for the six months ended June 30, 2010. Such decreased gross profit was the result of decreased revenue for the six months ended June 30, 2010 due primarily to the $350,000 payment from settlement of our litigation with Netgear, Inc. received in the six months ended June 30, 2009.

General and administrative expenses include overhead expenses, and finance, accounting, legal and other professional services incurred by us. General and administrative expenses increased by $810,000 from $966,000 for the six months ended June 30, 2009 to $1,776,000 for the six months ended June 30, 2010 due primarily to increased fees and expenses from our patent litigation.

We incurred an operating loss of ($1,815,000) for the six months ended June 30, 2010 compared with an operating loss of ($1,262,000) for the six months ended June 30, 2009. Included in the operating loss for the six months ended June 30, 2010 was $316,000 in charges relating to non-cash compensation expenses primarily related to extension of expiration dates of outstanding options and warrants and the issuance of new options to certain consultants (see Note A[3] to our financial statements included in this quarterly report) as compared to $746,000 for such non-cash compensation expenses for the six months ended June 30, 2009.

No provision for or benefit from federal, state or local income taxes was recorded for six months ended June 30, 2010 and June 30, 2009 because we incurred net operating losses and fully reserved our deferred tax assets as their future realization could not be determined.

As a result of the foregoing, we incurred a net loss of $(1,815,000) for the six months ended June 30, 2010 compared with a net loss of $(1,262,000) for the six months ended June 30, 2009.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations primarily from royalty revenue from licensing our Remote Power Patent and the sale of equity securities. In accordance with the settlement agreements achieved in July 2010 with Adtran, Cisco, Enterasys, Extreme Networks, and Foundry Networks, we will receive aggregate upfront payments of approximately $32 million and Cisco has agreed to pay royalties (beginning in 2011) based on its sales of Power over Ethernet ("PoE") products (See Note E to our Financial Statements included in this quarterly report). As a result of the July 2010 settlements, we will have sufficient cash to satisfy our operational and capital requirements for the foreseeable future.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

CONTRACTUAL OBLIGATIONS

We do not have any long-term debt, capital lease obligations, operating lease obligations, purchase obligations or other long-term liabilities.

Critical Accounting Policies:

Patents:

The Company owns a patent portfolio that relates to various telecommunications and data networking technologies. The Company capitalizes the costs associated with acquisition, registration and maintenance of the patents and amortizes these assets over their remaining useful lives on a straight-line basis. Any further payments made to maintain or develop the patents would be capitalized and amortized over the balance of the useful life for the patents.

Impairment of long-lived assets:

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", we record impairment losses on long-lived assets used in operations or expected to be disposed of when indicators of impairment exist and the cash flows expected to be derived from those assets are less than carrying amounts of those assets.

Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon this review, these officers concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports we file or submit under Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls

There was no change in our internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

Pending Litigation Against Major Data Networking Equipment Manufacturers

In February 2008, we commenced litigation against eight major data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent. The complaint named as defendants Cisco Systems, Inc., Cisco Linksys, LLC, Enterasys Networks, Inc., 3COM Corporation, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Netgear, Inc. and Adtran, Inc. We sought injunctive relief and monetary damages for infringement based upon reasonable royalties as well as treble damages for the defendants' continued willful infringement of our Remote Power Patent.

On May 29, 2009 we announced that we had agreed to settle this litigation with respect to Netgear, Inc. ("Netgear"). As part of the settlement and under our Special Licensing Program, Netgear entered into a license agreement with us for our Remote Power Patent and we agreed that all claims and counterclaims involving Netgear in the litigation would be dismissed with prejudice. Under the terms of the license, Netgear will license the Remote Power Patent for its full term (which expires in March 2020), and pay quarterly royalties (beginning as of April 1, 2009) based on its sales of Power over Ethernet products, including those Power over Ethernet products which comply with the Institute of Electrical and Electronic Engineers 802.3af and 802.3at Standards. Licensed products include Netgear's Power over Ethernet enabled switches and wireless access points. The royalty rates included in the license are 1.7% of the sales price of Power Sourcing Equipment, which includes Ethernet switches, and 2% of the sales price of Powered Devices, which includes wireless access points.   The royalty rates are subject to adjustment, under certain circumstances, if we grant a license to other licensees with lower royalty rates and Netgear is able to and agrees to assume all material terms and conditions of such other license. In addition, Netgear made a payment of $350,000 to us with respect to the settlement.

On July 19 , 2010, we announced that we had agreed to settle this litigation with respect to Adtran, Inc, Cisco Systems, Inc. and Cisco-Linksys, LLC, (collectively, “Cisco”), Enterasys Networks, Inc., Extreme Networks, Inc., Foundry Networks, Inc., and 3Com Corporation, Inc. As part of the settlement, Adtran, Cisco, Enterasys, Extreme Networks and Foundry Networks each entered into a settlement agreement with us and agreed to enter into non-exclusive licenses for the Remote Power Patent (the “Licensed Defendants”). Under the terms of the licenses, the Licensed Defendants agreed to pay us an aggregate upfront payment of approximately $32 million and have also agreed to license the Remote Power Patent for its full term, which expires in March 2020. In addition, Cisco agreed to pay royalties (beginning in 2011) based on its sales of Power over Ethernet (“PoE”) products up to maximum royalty payments per year of $8 million through 2015 and $9 million per year thereafter for the remaining term of the patent. The royalty payments are subject to certain conditions including the continued validity of our Remote Power Patent, and the actual royalty amounts received may be less than the caps stated above. The settlement with 3Com provides for a dismissal of the litigation without prejudice. The release covers sales of certain 3Com Power over Ethernet products sold through the date of the settlement. In addition, we and 3Com’s parent, Hewlett Packard Corporation, agreed that the dismissal does not apply to Hewlett-Packard Power over Ethernet products and that any future litigation involving us and Hewlett Packard concerning the Remote Power Patent will be in the United States District Court for the Eastern District of Texas. For more details about the settlement, please see our Current Report on Form 8-K filed with the Securities and Exchange Commission on July 20, 2010.

ITEM 1A.   RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties that could adversely affect our business, financial condition, results of operations and trading price of our common stock.

Our Annual Report on Form 10-K for the year ended December 31, 2009 includes a detailed discussion of our risk factors and should be carefully considered by investors. There were no material changes to the risk factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2009 except as otherwise disclosed in this Quarterly Report on Form 10-Q.

ITEM 2.   UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3.   DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

(a) Exhibits

31.1 Controls and Procedure Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Controls and Procedure Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NETWORK-1 SECURITY SOLUTIONS, INC.

By: /s/ Corey M. Horowitz
Corey M. Horowitz
Chairman and Chief Executive Officer

By: /s/ David C. Kahn
David C. Kahn
Chief Financial Officer

Date: August 16, 2010