

PAYCHEX INC
Form 10-Q
September 23, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended August 31, 2009
Commission file number 0-11330**

PAYCHEX, INC.

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

IRS Employer Identification Number: 16-1124166

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

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

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

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

Common Stock, \$0.01 Par Value
CLASS

361,381,805 Shares
OUTSTANDING AS OF AUGUST 31, 2009

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

	For the three months ended	
	August 31, 2009	August 31, 2008
Revenue:		
Service revenue	\$ 486,491	\$ 509,867
Interest on funds held for clients	13,723	24,218
Total revenue	500,214	534,085
Expenses:		
Operating expenses	163,346	168,468
Selling, general and administrative expenses	147,001	144,032
Total expenses	310,347	312,500
Operating income	189,867	221,585
Investment income, net	905	3,051
Income before income taxes	190,772	224,636
Income taxes	67,152	75,927
Net income	\$ 123,620	\$ 148,709
Basic earnings per share	\$ 0.34	\$ 0.41
Diluted earnings per share	\$ 0.34	\$ 0.41
Weighted-average common shares outstanding	361,208	360,629
Weighted-average common shares outstanding, assuming dilution	361,362	361,040
Cash dividends per common share	\$ 0.31	\$ 0.31

See Notes to Consolidated Financial Statements.

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PAYCHEX, INC.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)

In thousands, except per share amount

	August 31, 2009	May 31, 2009
ASSETS		
Cash and cash equivalents	\$ 315,323	\$ 472,769
Corporate investments	13,853	19,710
Interest receivable	23,189	27,722
Accounts receivable, net of allowance for doubtful accounts	201,330	177,958
Deferred income taxes	4,099	10,180
Prepaid income taxes		2,198
Prepaid expenses and other current assets	28,564	27,913
Current assets before funds held for clients	586,358	738,450
Funds held for clients	3,017,511	3,501,376
Total current assets	3,603,869	4,239,826
Long-term corporate investments	304,874	82,234
Property and equipment, net of accumulated depreciation	268,317	274,530
Intangible assets, net of accumulated amortization	75,510	76,641
Goodwill	433,316	433,316
Deferred income taxes	17,706	16,487
Other long-term assets	4,151	4,381
Total assets	\$ 4,707,743	\$ 5,127,415
LIABILITIES		
Accounts payable	\$ 33,301	\$ 37,334
Accrued compensation and related items	125,102	135,064
Deferred revenue	9,596	9,542
Accrued income taxes	58,223	
Deferred income taxes	17,794	17,159
Litigation reserve	20,378	20,411
Other current liabilities	43,020	44,704
Current liabilities before client fund obligations	307,414	264,214
Client fund obligations	2,952,240	3,437,679
Total current liabilities	3,259,654	3,701,893
Accrued income taxes	26,155	25,730
Deferred income taxes	13,041	12,773
Other long-term liabilities	44,031	45,541
Total liabilities	3,342,881	3,785,937

COMMITMENTS AND CONTINGENCIES NOTE I**STOCKHOLDERS EQUITY**

Common stock, \$0.01 par value; Authorized: 600,000 shares;

Issued and outstanding: 361,382 shares as of August 31, 2009

and 360,976 shares as of May 31, 2009, respectively

Additional paid-in capital

Retained earnings

Accumulated other comprehensive income

3,614 3,610

478,681 466,427

839,366 829,501

43,201 41,940

Total stockholders equity**1,364,862 1,341,478****Total liabilities and stockholders equity****\$ 4,707,743 \$ 5,127,415**

See Notes to Consolidated Financial Statements.

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PAYCHEX, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
In thousands

	For the three months ended	
	August 31, 2009	August 31, 2008
OPERATING ACTIVITIES		
Net income	\$ 123,620	\$ 148,709
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	21,627	20,687
Amortization of premiums and discounts on available-for-sale securities	7,974	6,537
Stock-based compensation costs	6,725	6,922
Provision for deferred income taxes	4,222	6,422
Provision for allowance for doubtful accounts	945	464
Net realized gains on sales of available-for-sale securities	(285)	(300)
Changes in operating assets and liabilities:		
Interest receivable	4,533	4,906
Accounts receivable	(24,317)	(12,906)
Prepaid expenses and other current assets	1,547	10,782
Accounts payable and other current liabilities	41,324	23,275
Net change in other assets and liabilities	(1,297)	(947)
Net cash provided by operating activities	186,618	214,551
INVESTING ACTIVITIES		
Purchases of available-for-sale securities	(336,555)	(13,140,530)
Proceeds from sales and maturities of available-for-sale securities	175,244	12,508,552
Net change in funds held for clients money market securities and other cash equivalents	423,092	599,586
Purchases of property and equipment	(10,139)	(16,207)
Purchases of other assets	(4,118)	(1,274)
Net cash provided by/(used in) investing activities	247,524	(49,873)
FINANCING ACTIVITIES		
Net change in client fund obligations	(485,439)	(160,536)
Dividends paid	(112,112)	(111,904)
Proceeds from and excess tax benefit related to exercise of stock options	5,963	5,107
Net cash used in financing activities	(591,588)	(267,333)
Decrease in cash and cash equivalents	(157,446)	(102,655)
Cash and cash equivalents, beginning of period	472,769	164,237
Cash and cash equivalents, end of period	\$ 315,323	\$ 61,582

See Notes to Consolidated Financial Statements.

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PAYCHEX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
August 31, 2009

Note A: Description of Business and Significant Accounting Policies

Description of business: Paychex, Inc. and its wholly owned subsidiaries (collectively, the Company or Paychex) is a leading provider of payroll, human resource, and benefits outsourcing solutions for small- to medium-sized businesses in the United States (U.S.). The Company also has a subsidiary in Germany.

Paychex, a Delaware corporation formed in 1979, reports as one segment. Substantially all of the Company s revenue is generated within the U.S. The Company also generates revenue within Germany, which was less than one percent of its total revenue for the three months ended August 31, 2009 and 2008. Long-lived assets in Germany are insignificant in relation to total long-lived assets of the Company as of August 31, 2009 and May 31, 2009.

Basis of presentation: The accompanying Consolidated Financial Statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statement presentation. The Consolidated Financial Statements include the consolidated accounts of the Company with all significant intercompany transactions eliminated. In the opinion of management, the information furnished herein reflects all adjustments (consisting of items of a normal recurring nature), which are necessary for a fair presentation of the results for the interim period. These financial statements should be read in conjunction with the Company s Consolidated Financial Statements and related Notes to Consolidated Financial Statements presented in the Company s Annual Report on Form 10-K as of and for the year ended May 31, 2009 (fiscal 2009). Operating results and cash flows for the three months ended August 31, 2009 are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year ending May 31, 2010 (fiscal 2010). The Company has evaluated subsequent events for potential recognition and/or disclosure through September 23, 2009, the date of issuance of these financial statements.

PEO revenue recognition: Professional Employer Organization (PEO) revenue is included in service revenue and is reported net of direct costs billed and incurred which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred were \$708.4 million and \$635.7 million for the three months ended August 31, 2009 and 2008, respectively.

PEO workers compensation insurance: Workers compensation insurance for PEO worksite employees is provided under a deductible workers compensation policy with a national insurance company. Claims are paid as incurred and the Company s maximum individual claims liability is \$1.0 million under both its fiscal 2010 and fiscal 2009 policies.

Table of Contents**Note A: Description of Business and Significant Accounting Policies** *continued*

The Company has recorded the following amounts on its Consolidated Balance Sheets for workers' compensation claims as of:

In thousands	August 31, 2009	May 31, 2009
Prepaid expense	\$ 2,723	\$ 2,500
Current liability	\$ 8,404	\$ 7,911
Long-term liability	\$ 16,839	\$ 17,881

The amounts included in prepaid expense on the Consolidated Balance Sheets relate to the policy for the fiscal year ended May 31, 2004, which was a pre-funded policy.

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and actuarial loss projections, and is subject to change due to multiple factors, including economic trends, changes in legal liability law, and damage awards, all of which could materially impact the reserves as reported. Adjustments to previously established reserves are reflected in the results of operations for the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

Stock-based compensation costs: The Company has issued stock-based awards to employees consisting of stock options, restricted stock awards, and restricted stock units (RSUs). The Company typically makes grants to its officers, directors, and management in July. The grants approved by the Board of Directors (the Board) were as follows:

In thousands, except per share amounts	For the three months ended August 31,			
	2009		2008	
	Shares granted	Weighted- average fair value per share	Shares granted	Weighted- average fair value per share
Stock options	1,037	\$ 4.23	536	\$ 7.29
Restricted stock	141	\$ 24.21	134	\$ 31.95
RSUs	567	\$ 20.62	606	\$ 28.30

The Company accounts for all stock-based awards to employees and directors, including grants of stock options, as compensation costs in the Consolidated Financial Statements based on the fair value measured as of the date of grant. These costs are recognized as an expense in the Consolidated Statements of Income over the requisite service period and increase additional paid-in capital. Stock-based compensation costs recognized were \$6.7 million and \$6.9 million for the three months ended August 31, 2009 and 2008, respectively. As of August 31, 2009, the total unrecognized compensation cost related to all unvested stock-based awards was \$71.0 million and is expected to be recognized over a weighted-average period of 2.3 years.

The fair value of restricted stock awards is equal to the closing market price of the underlying common stock as of the date of grant. The fair value of RSUs is equal to the closing market price of the underlying common stock as of the date of grant, adjusted for the present value of expected dividends over the vesting period, as these awards do not earn dividend equivalents.

Table of Contents**Note A: Description of Business and Significant Accounting Policies *continued***

The fair value of stock option grants is estimated as of the date of grant using a Black-Scholes option pricing model. The weighted-average assumptions used for valuation under the Black-Scholes model were as follows:

	For the three months ended August 31,	
	2009	2008
Risk-free interest rate	3.0%	3.5%
Dividend yield	4.5%	3.3%
Volatility factor	.28	.28
Expected option life in years	6.4	6.5

Risk-free interest rates are yields for zero-coupon U.S. Treasury notes maturing approximately at the end of the expected option life. The estimated volatility factor is based on a combination of historical volatility using weekly stock prices and implied market volatility, both over a period equal to the expected option life. The expected option life is based on historical exercise behavior.

The Company has determined that the Black-Scholes option pricing model, as well as the underlying assumptions used in its application, is appropriate in estimating the fair value of its stock option grants. The Company periodically assesses its assumptions as well as its choice of valuation model, and will reconsider use of this model if additional information becomes available in the future indicating that another model would provide a more accurate estimate of fair value, or if characteristics of future grants would warrant such a change.

Newly adopted accounting pronouncements: On June 1, 2009, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 141 (revised 2007) (SFAS No. 141R), Business Combinations. SFAS No. 141R provides guidance on how an entity recognizes and measures the identifiable assets acquired (including goodwill), liabilities assumed, and noncontrolling interests, if any, acquired in a business combination. SFAS No. 141R also requires that acquisition-related costs and costs associated with restructuring or exiting activities of an acquired entity will be expensed as incurred. The Company cannot anticipate if the adoption of SFAS No. 141R will have a material effect on its results of operations or financial position as the impact is solely dependent on whether the Company enters into any business combination, and the terms of any such transaction.

On June 1, 2009, the Company adopted SFAS No. 165, Subsequent Events. This statement establishes guidance related to accounting for and disclosure of events that happen after the date of the balance sheet but before the release of the financial statements. The adoption of this statement had no material effect on the Company's results of operations or financial position.

On June 1, 2009, the Company adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) No. FAS 142-3, Determination of the Useful Life of Intangible Assets. This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets. The adoption of this FSP had no material effect on the Company's results of operations or financial position.

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Note A: Description of Business and Significant Accounting Policies *continued*

On June 1, 2009, the Company adopted the following three FASB staff positions which provide additional accounting guidance and enhanced disclosures regarding fair value measurements and impairments of debt securities:

FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, requiring publicly traded companies to disclose the fair value of financial instruments in interim financial statements; FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, providing guidance for determining fair value when there is no active market or where price inputs being used represent distressed sales; and

FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, providing guidance for measurement and recognition of impaired debt securities along with expanded disclosures with respect to impaired debt securities.

The adoption of these FSPs did not have a material effect on the Company's results of operations or financial position. Refer to Notes C and D of the Notes to Consolidated Financial Statements for additional disclosures related to these FSPs.

Recently issued accounting pronouncements: In June 2009, the FASB issued the following statements:

SFAS No. 166, Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140.

SFAS No. 166 makes several amendments to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, including the removal of the concept of a qualifying special-purpose entity; and

SFAS No. 167, Amendments to FASB Interpretation No. 46(R). SFAS No. 167 will require a qualitative rather than a quantitative analysis to determine the primary beneficiary of a variable interest entity for consolidation purposes.

Both standards are effective for annual periods beginning after November 15, 2009, and are applicable to the Company's fiscal year beginning June 1, 2010. The Company does not expect the adoption of these standards to have a material effect on its results of operations or financial position.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles – a replacement of FASB Statement No. 162 (the Codification). The Codification, released on July 1, 2009, became the single source of authoritative non-governmental U.S. GAAP. The Codification eliminates the GAAP hierarchy contained in SFAS No. 162 and establishes one level of authoritative GAAP. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company will adopt this statement during its fiscal quarter ending November 30, 2009, and does not anticipate any material effect on its results of operations or financial position.

Table of Contents**Note A: Description of Business and Significant Accounting Policies *continued***

In August 2009, the FASB issued the following Accounting Standards Updates (ASUs):

Update No. 2009-03, SEC Update Amendments to Various Topics Containing SEC Staff Accounting Bulletins; and

Update No. 2009-05, Fair Value Measurements and Disclosures Measuring Liabilities at Fair Value.

Update No. 2009-03 has not had a material effect on the Company's results of operations or financial position. The Company is currently evaluating Update No. 2009-05, but does not expect the adoption of the update to have a material effect on its results of operations or financial position.

Other recent accounting pronouncements issued by the FASB (including ASUs), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not, or are not, expected to have a material effect on the Company's results of operations or financial position.

Note B: Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In thousands, except per share amounts	For the three months ended August 31,	
	2009	2008
Basic earnings per share:		
Net income	\$ 123,620	\$ 148,709
Weighted-average common shares outstanding	361,208	360,629
Basic earnings per share	\$ 0.34	\$ 0.41
Diluted earnings per share:		
Net income	\$ 123,620	\$ 148,709
Weighted-average common shares outstanding	361,208	360,629
Dilutive effect of common share equivalents at average market price	154	411
Weighted-average common shares outstanding, assuming dilution	361,362	361,040
Diluted earnings per share	\$ 0.34	\$ 0.41
Weighted-average anti-dilutive common share equivalents	14,572	11,387

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

For the three months ended August 31, 2009, 0.5 million shares of the Company's common stock were issued for stock option exercises and vesting of restricted stock and RSUs compared with 0.3 million shares for the three months ended August 31, 2008.

Table of Contents**Note C: Funds Held for Clients and Corporate Investments**

Funds held for clients and corporate investments consisted of the following:

In thousands	Amortized cost	August 31, 2009		Fair value
		Gross unrealized gains	Gross unrealized losses	
Type of issue:				
Money market securities and other cash equivalents	\$ 1,393,187	\$	\$	\$ 1,393,187
Available-for-sale securities:				
General obligation municipal bonds	964,079	34,848	(319)	998,608
Pre-refunded municipal bonds ⁽¹⁾	565,008	20,825	(158)	585,675
Revenue municipal bonds	338,667	13,472	(80)	352,059
Other equity securities	20	48		68
Total available-for-sale securities	\$ 1,867,774	69,193	(557)	1,936,410
Other	7,309	33	(701)	6,641
Total funds held for clients and corporate investments	\$ 3,268,270	\$ 69,226	\$ (1,258)	\$ 3,336,238

In thousands	Amortized cost	May 31, 2009		Fair value
		Gross unrealized gains	Gross unrealized losses	
Type of issue:				
Money market securities and other cash equivalents	\$ 1,816,278	\$	\$	\$ 1,816,278
Available-for-sale securities:				
General obligation municipal bonds	849,594	32,698	(136)	882,156
Pre-refunded municipal bonds ⁽¹⁾	527,864	21,334	(24)	549,174
Revenue municipal bonds	336,675	12,818	(32)	349,461
Other equity securities	20	42		62
Total available-for-sale securities	1,714,153	66,892	(192)	1,780,853
Other	7,477		(1,288)	6,189
Total funds held for clients and corporate investments	\$ 3,537,908	\$ 66,892	\$ (1,480)	\$ 3,603,320

⁽¹⁾ Pre-refunded municipal bonds are secured by an escrow fund of U.S.

government
obligations.

Included in money market securities and other cash equivalents as of August 31, 2009 and May 31, 2009 are U.S. agency discount notes, government money market funds, and bank demand deposit accounts.

Table of Contents**Note C: Funds Held for Clients and Corporate Investments *continued***

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

In thousands	August 31, 2009	May 31, 2009
Funds held for clients	\$ 3,017,511	\$ 3,501,376
Corporate investments	13,853	19,710
Long-term corporate investments	304,874	82,234
Total funds held for clients and corporate investments	\$ 3,336,238	\$ 3,603,320

The Company is exposed to credit risk in connection with these investments through the possible inability of borrowers to meet the terms of their bonds. In addition, the Company is exposed to interest rate risk, as rate volatility will cause fluctuations in the fair value of held investments and in the earnings potential of future investments. The Company maintains a conservative investment strategy within its investment portfolios to maximize liquidity and protect principal. The Company attempts to mitigate the risks associated with its investment activities by investing primarily in high credit quality securities with AAA and AA ratings and short-term securities with A-1/P-1 ratings, limiting amounts that can be invested in any single issuer, and by investing in short- to intermediate-term instruments whose fair value is less sensitive to interest rate changes. All the investments held as of August 31, 2009 are traded in active markets.

In the current investment market, the Company's primary short-term investment vehicle is U.S. agency discount notes. The Company has no exposure to variable rate demand notes, prime money market funds, auction rate securities, sub-prime mortgage securities, asset-backed securities or asset-backed commercial paper, collateralized debt obligations, enhanced cash or cash plus mutual funds, or structured investment vehicles (SIVs). The Company has not and does not utilize derivative financial instruments to manage interest rate risk.

The Company's available-for-sale securities reflected a net unrealized gain of \$68.6 million as of August 31, 2009 compared with a net unrealized gain of \$66.7 million as of May 31, 2009. The gross unrealized losses of \$0.6 million, included in the net unrealized gain as of August 31, 2009, were comprised of 43 available-for-sale securities, which had a total fair value of \$182.8 million. The gross unrealized losses of \$0.2 million, included in the net unrealized gain as of May 31, 2009, were comprised of 14 available-for-sale securities, which had a total fair value of \$39.4 million.

Table of Contents**Note C: Funds Held for Clients and Corporate Investments-continued**

The securities in an unrealized loss position were as follows:

In thousands	August 31, 2009			
	Less than 12 months Gross unrealized loss	Fair value	More than 12 months Gross unrealized loss	Fair value
Type of issue:				
General obligation municipal bonds	\$ (319)	88,077	\$	\$
Pre-refunded municipal bonds	(158)	59,557		
Revenue municipal bonds	(79)	32,111	(1)	3,008
Total	\$ (556)	\$ 179,745	\$ (1)	\$ 3,008

In thousands	May 31, 2009			
	Less than 12 months Gross unrealized loss	Fair value	More than 12 months Gross unrealized loss	Fair value
Type of issue:				
General obligation municipal bonds	\$ (136)	28,915	\$	\$
Pre-refunded municipal bonds	(24)	4,490		
Revenue municipal bonds	(21)	2,943	(11)	3,010
Total	\$ (181)	\$ 36,348	\$ (11)	\$ 3,010

The Company regularly reviews its investment portfolios to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns. The Company believes that the investments it held as of August 31, 2009 were not other-than-temporarily impaired. While \$182.8 million of available-for-sale securities had fair values that were below amortized cost, the Company believes that it is probable that the principal and interest will be collected in accordance with contractual terms, and that the decline in the fair value to \$0.6 below amortized cost was due to changes in interest rates and was not due to increased credit risk. As of August 31, 2009 and May 31, 2009, the majority of the securities with an unrealized loss held an AA rating or better. The Company intends to hold these investments until the recovery of their amortized cost basis or maturity and further believes that it is more-likely-than-not that it will not be required to sell these investments prior to that time. The Company's assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in the Company's strategies or assumptions related to any particular investment.

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Note C: Funds Held