Polymer Holdings LLC
Form 10-Q
November 14, 2005

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

OR

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

For the transition period from to

Polymer Holdings LLC
(Exact name of registrant as specified in its charter)
Commission file number 333-123749

Delaware (State or other jurisdiction of incorporation)	**20-0411521** (I.R.S. Employer Identification No.)
700 Milam Street, 13th Floor, North Tower **Houston, TX 77002** (Address of principal executive offices, including zip code)	**832-204-5400** (Registrant s telephone number, including area code)

KRATON Polymers LLC
(Exact name of registrant as specified in its charter)
Commission file number 333-123747

Delaware (State or other jurisdiction of incorporation or organization)	**94-2805249** (I.R.S. Employer Identification No.)
700 Milam Street, 13th Floor, North Tower **Houston, TX 77002** (Address of principal executive offices, including zip code)	**832-204-5400** (Registrant s telephone number, including area code)

Indicated 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 o NO þ

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act.
YES o NO þ

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FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements, as that term is defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical fact, included or incorporated in this Form 10-Q are forward-looking statements, particularly statements about our plans, strategies and prospects under the headings Consolidated Financial Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations. We may also make written or oral forward-looking statements in our Annual Report on Form 10-K, periodic reports on Form 10-Q and current reports on Form 8-K, in press releases and other written materials and in oral statements made by our officers, directors or employees to third parties. Such forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause the actual results, performance or our achievements, or industry results, to differ materially from historical results, any future results, performance or achievements expressed or implied by such forward-looking statements. Such risks and uncertainties include, but are not limited to, competitive pressures in the specialty chemicals industry, changes in prices of raw materials used in our business, changes in levels of consumer spending or preferences, overall economic conditions, the level of our indebtedness and exposure to interest rate fluctuations, governmental regulations and trade restrictions, acts of war or terrorism in the United States or worldwide, political or financial instability in the countries where our goods are manufactured and other risks and uncertainties described in this report and our other reports and documents. These statements are based on current plans, estimates and projections, and therefore you should not place undue reliance on them. Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update publicly any of them in light of new information or future events.

PRESENTATION OF FINANCIAL STATEMENTS

This Form 10-Q includes financial statements and related notes that present (1) the consolidated financial position, results of operations and cash flows of Polymer Holdings LLC, which we refer to as Polymer Holdings, and its subsidiaries and (2) the consolidated financial position, results of operations and cash flows of KRATON Polymers LLC, which we refer to as KRATON, and its subsidiaries. Polymer Holdings is a holding company whose only material asset is its investment in KRATON, which is its wholly-owned subsidiary. KRATON and its subsidiaries own all of the consolidated operating assets.

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PART I Financial Information

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

Polymer Holdings LLC

Consolidated Balance Sheets

September 30, 2005 and December 31, 2004

(in thousands of U.S. dollars)

	September 30, 2005 (Unaudited)	December 31, 2004 (Restated See note 1(c))
Assets		
Current assets:		
Cash and cash equivalents	$ 71,550	$ 46,357
Receivables, net of allowances of $884 and $750	150,612	120,596
Inventories of products	191,303	211,076
Inventories of materials and supplies	9,412	8,778
Other current assets	17,495	10,381
Total current assets	440,372	397,188
Property, plant, and equipment, less accumulated depreciation of $57,654 and $38,086	395,453	424,333
Identifiable intangible assets, less accumulated amortization of $13,887 and $8,002	103,809	109,694
Investment in joint venture	10,539	10,753
Deferred financing costs	14,999	16,799
Other long-term assets	9,014	8,646
Total assets	$ 974,186	$ 967,413
Liabilities and Member s Equity		
Current liabilities:		
Current portion of long-term debt	$ 2,680	$ 2,680
Accounts payable trade	64,853	79,968
Other payables and accruals	50,269	40,059
Due to related parties	11,937	14,471
Deferred income taxes	1,240	1,240
Insurance bond payable	1,380	
Total current liabilities	132,359	138,418
Long-term debt, net of current portion	562,970	556,335
Deferred income taxes	27,020	24,513
Long-term liabilities	29,317	25,629
Total liabilities	751,666	744,895
Commitments and contingencies (note 5)		
Member s equity:		

Common equity	219,779	200,528
Accumulated other comprehensive income	2,741	21,990
Total member s equity	222,520	222,518
Total liabilities and member s equity	$ 974,186	$ 967,413

See accompanying notes to consolidated financial statements.

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Polymer Holdings LLC
Consolidated Statements of Operations
Three Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Revenues		
Sales	$ 269,017	$ 209,407
Other	7,457	1,840
Total revenues	276,474	211,247
Costs and expense		
Costs of goods sold	225,945	179,186
Gross profit	50,529	32,061
Research and development expenses	6,700	5,530
Selling, general, and administrative expenses	19,130	16,467
Depreciation and amortization of identifiable intangibles	11,548	11,185
Earnings in joint venture	(182)	11
Interest, net	11,746	11,722
Income (loss) before income taxes	1,587	(12,854)
Income tax (provision) benefit	(633)	6,848
Net income (loss)	$ 954	$ (6,006)

See accompanying notes to consolidated financial statements.

Polymer Holdings LLC
Consolidated Statements of Operations
Nine Months Ended September 30, 2005 and 2004
(in thousand of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Revenues		
Sales	$ 732,338	$ 589,886
Other	20,287	8,738
Total revenues	752,625	598,624

Costs and expense		
Costs of goods sold	586,145	514,692
Gross profit	166,480	83,932
Research and development expenses	19,500	17,246
Selling, general, and administrative expenses	54,692	46,503
Depreciation and amortization of identifiable intangibles	33,760	31,849
Earnings in joint venture	(1,050)	(134)
Interest, net	34,578	27,719
Income (loss) before income taxes	25,000	(39,251)
Income tax (provision) benefit	(6,159)	15,332
Net income (loss)	$ 18,841	$ (23,919)

See accompanying notes to consolidated financial statements.

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Polymer Holdings LLC
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 18,841	$ (23,919)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of identifiable intangibles	33,760	31,849
Amortization of deferred financing costs	1,800	2,522
Accretion of discount on senior subordinated notes	8,645	
Change in the fair value of interest rate swaps	(128)	1,669
Loss on disposal of fixed assets	55	637
(Undistributed) distributed earnings in joint venture	(589)	427
Deferred tax provision (benefit)	483	(17,053)
Non-cash compensation	410	
Increase (decrease) in working capital:		
Accounts receivable	(43,567)	(27,426)
Due from related party	351	
Inventories	5,373	49,530
Other assets	(6,274)	(6,330)
Accounts payable, other payables and accruals, and long-term Liabilities	10,004	45,877
Net cash provided by operating activities	29,164	57,783
Cash flows (used in) provided by investing activities:		
Purchase of property, plant and equipment	(8,604)	(28,816)
Proceeds from sale of property, plant and equipment	122	88
Net cash used in investing activities	(8,482)	(28,728)
Cash flows (used in) provided by financing activities:		
Repayment of debt	(2,010)	(17,787)
Net proceeds from insurance bond	1,380	
Net cash used in by financing activities	(630)	(17,787)
Effect of exchange rate differences on cash	5,141	138
Net increase in cash and cash equivalents	25,193	11,406
Cash and cash equivalents, beginning of period	46,357	17,500

Cash and cash equivalents, end of period	$	71,550	$	28,906
Supplemental disclosure cash flow information:				
Cash paid during the period for income taxes, net of refunds received	$	1,058	$	4,547
Cash paid during the period for interest		28,821		20,910

See accompanying notes to consolidated financial statements.

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KRATON Polymers LLC
Consolidated Balance Sheets
September 30, 2005 and December 31, 2004
(in thousands of U.S. dollars)

	September 30, 2005 (Unaudited)	December 31, 2004 (Restated See note 1(c))
Assets		
Current assets:		
Cash and cash equivalents	$ 71,550	$ 46,357
Receivables, net of allowances of $884 and $750	150,612	120,596
Inventories of products	191,303	211,076
Inventories of materials and supplies	9,412	8,778
Other current assets	17,495	10,381
Total current assets	440,372	397,188
Property, plant, and equipment, less accumulated depreciation of $57,654 and $38,086	395,453	424,333
Identifiable intangible assets, less accumulated amortization of $13,887 and $8,002	103,809	109,694
Investment in joint venture	10,539	10,753
Deferred financing costs	13,275	14,973
Other long-term assets	9,014	8,646
Total assets	$ 972,462	$ 965,587
Liabilities and Member s Equity		
Current liabilities:		
Current portion of long-term debt	$ 2,680	$ 2,680
Accounts payable trade	64,853	79,968
Other payables and accruals	50,269	40,059
Due to related parties	11,937	14,471
Deferred income taxes	1,240	1,240
Insurance bond payable	1,380	
Total current liabilities	132,359	138,418
Long-term debt, net of current portion	460,653	462,663
Deferred income taxes	30,723	25,184
Long-term liabilities	29,317	25,629
Total liabilities	653,052	651,894
Commitments and contingencies (note 5)		
Member s equity:		
Common equity	316,669	291,703
Accumulated other comprehensive income	2,741	21,990

Total member s equity		319,410		313,693
Total liabilities and member s equity	$	972,462	$	965,587

See accompanying notes to consolidated financial statements.

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KRATON Polymers LLC
Consolidated Statements of Operations
Three Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Revenues		
Sales	$ 269,017	$ 209,407
Other	7,457	1,840
Total revenues	276,474	211,247
Costs and expense		
Costs of goods sold	225,945	179,186
Gross profit	50,529	32,061
Research and development expenses	6,700	5,530
Selling, general, and administrative expenses	19,130	16,467
Depreciation and amortization of identifiable intangibles	11,548	11,185
Earnings in joint venture	(182)	11
Interest, net	8,683	11,722
Income (loss) before income taxes	4,650	(12,854)
Income tax (provision) benefit	(1,268)	6,848
Net income (loss)	$ 3,382	$ (6,006)

See accompanying notes to consolidated financial statements.

KRATON Polymers LLC
Consolidated Statements of Operations
Nine Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Revenues		
Sales	$ 732,338	$ 589,886
Other	20,287	8,738
Total revenues	752,625	598,624

Costs and expense				
Costs of goods sold		586,145		514,692
Gross profit		166,480		83,932
Research and development expenses		19,500		17,246
Selling, general, and administrative expenses		54,692		46,503
Depreciation and amortization of identifiable intangibles		33,760		31,849
Earnings in joint venture		(1,050)		(134)
Interest, net		25,833		27,719
Income (loss) before income taxes		33,745		(39,251)
Income tax (provision) benefit		(9,189)		15,332
Net income (loss)	$	24,556	$	(23,919)

See accompanying notes to consolidated financial statements.

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KRATON Polymers LLC
Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

	September 30, 2005	September 30, 2004 (Restated See note 1(c))
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 24,556	$ (23,919)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of identifiable intangibles	33,760	31,849
Amortization of deferred financing costs	1,698	2,522
Changes in the fair value of interest rate swaps	(128)	1,669
Loss on disposal of fixed assets	55	637
(Undistributed) distributed earnings in joint venture	(589)	427
Deferred tax provision (benefit)	3,515	(17,053)
Non-cash compensation	410	
Increase (decrease) in working capital:		
Accounts receivable	(43,567)	(27,426)
Due from related party	351	
Inventories	5,373	49,530
Other assets	(6,274)	(6,330)
Accounts payable, other payables and accruals, and long-term liabilities	10,004	45,877
Net cash provided by operating activities	29,164	57,783
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Effect of exchange rate differences on cash	5,141	138
Net increase in cash and cash equivalents	25,193	11,406
Cash and cash equivalents, beginning of period	46,357	17,500

Cash and cash equivalents, end of period	$	71,550	$	28,906
Supplemental disclosure cash flow information:				
Cash paid during the period for income taxes, net of refunds received	$	1,058	$	4,547
Cash paid during the period for interest		28,821		20,910

See accompanying notes to consolidated financial statements.

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Polymer Holdings LLC and KRATON Polymers LLC
Notes to Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(Unaudited)

(1) Summary of Significant Accounting Policies

(a) ***Organization, Acquisition and Description of Business***

Polymer Holdings LLC together with its subsidiaries, unless otherwise indicated, are collectively referred to as Polymer Holdings, we, our, ours, and us. Polymer Holdings is a holding company whose only material asset is i investment in KRATON Polymers LLC, or KRATON. KRATON and its subsidiaries own substantially all of the consolidated operating assets. KRATON is the parent of Elastomers Holdings LLC (parent company of our United States operations), KRATON Polymers Holdings B.V. (parent company of non-U.S. operations) and KRATON Polymers Capital Corporation (a company with no operations). TJ Chemical Holdings LLC, or TJ Chemical, owns 100% of the equity interests of Polymer Holdings. TJ Chemical is indirectly owned by TPG Partners III, L.P., TPG Partners IV, L.P. and certain of their parallel investment entities, entities affiliated with or managed by J.P. Morgan Partners, LLC and its affiliates and KRATON Polymers Management LLC, or Management LLC.

On December 23, 2003, Polymer Acquisition LLC, or Polymer Acquisition, a wholly owned subsidiary of Polymer Holdings, merged into KRATON, in a transaction we refer to as the Acquisition. Under the Merger Agreement dated as of November 5, 2003, as amended and restated on December 23, 2003, or the Merger Agreement, among Ripplewood Chemical, Polymer Holdings and Polymer Acquisition, Polymer Holdings acquired all of KRATON s outstanding equity interests from Ripplewood Chemical Holding LLC, or Ripplewood Chemical, for consideration of $770.0 million for the business and $48.0 million for the excess cash on KRATON s balance sheet immediately prior to closing.

We manufacture styrenic block copolymers, or SBCs, at our manufacturing facilities in six countries: Belpre, Ohio; Wesseling, Germany; Berre, France; Pernis, The Netherlands; Paulinia, Brazil; and our joint venture in Kashima, Japan. SBCs are highly engineered synthetic elastomers, which are used in a wide variety of products to impart flexibility, resilience, strength, durability, and processability. We generally sell our products to customers for use in industrial and consumer applications. Based on our management approach, we believe that all material operations revolve around the manufacturing and sales of SBCs, and we currently report our operations, both internally and externally, as a single business segment.

(b) ***Basis of Presentation***

The consolidated financial statements presented herein are as follows:

a. Polymer Holdings and its wholly-owned subsidiaries, which include both Polymer Holdings and KRATON and its wholly-owned subsidiaries.

b. KRATON and its wholly-owned subsidiaries, which include only KRATON and its wholly-owned subsidiaries.

The consolidated balance sheets, the consolidated statements of operations and the consolidated statements of cash flows for the periods presented are unaudited and reflect all adjustments, consisting of normal recurring items, which management considers necessary for a fair presentation. Operating results for the first nine months of 2005 are not necessarily indicative of results to be expected for the year ending December 31, 2005. All significant intercompany balances and transactions have been eliminated in consolidation. All dollar amounts in the tabulations in the notes to the consolidated financial statements are stated in thousands of dollars unless otherwise indicated. Certain amounts have been reclassified in the prior period to conform to the current period presentation.

Polymer Holdings LLC and KRATON Polymers LLC
Notes to Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(Unaudited)

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires estimates and assumptions that affect the reported amounts as well as certain disclosures. Our financial statements include amounts that are based on management s best estimates and judgments. Actual results could differ from those estimates.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the prospectuses filed with the Securities and Exchange Commission , or the SEC, on September 2, 2005, pursuant to Rule 424(b)(3) under the Securities Act of 1933 for each of Polymer Holdings and KRATON.

Unless specifically noted, these notes to consolidated financial statements apply to both Polymer Holdings and KRATON.

(c) ***Restatement of prior financial statements***

During the preparation of the interim financial statements for the period ended March 31, 2005, we discovered a computational error in the calculation of the additional cost of sales related to the inventory step up associated with the Acquisition. That step up was approximately $38.4 million and was being recorded to cost of sales as the related inventory items were sold. The error caused the reported amount of our cost of sales to be understated by approximately $2.3 million and $3.7 million for the three and nine months ended September 30, 2004, respectively, and $5.0 million for the year ended December 31, 2004, and decreased inventory by those same amounts.

In addition, we have restated the December 31, 2004, balance sheet to record the unrealized gain on interest rate swaps included as a component of accumulated other comprehensive income on an after-tax basis, which has the effect of reducing member s equity by approximately $0.6 million and increasing deferred income taxes by that same amount. This item was discovered in connection with a review of our financial statements undertaken in connection with the above item.

As a result of these adjustments, on May 11, 2005, our audit committee decided to restate our financial statements for the year ended December 31, 2004, and the accompanying financial information reflects that restatement. Our audit committee has discussed these adjustments with our independent registered public accounting firm.

These non-cash adjustments do not impact the calculation of any of the financial ratios in the senior secured credit facility for any period.

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Polymer Holdings LLC and KRATON Polymers LLC
Notes to Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(Unaudited)

The following tables reflect the effects of the adjustments Polymer Holdings and KRATON made to their consolidated statement of operations for the three and nine months ended September 30, 2004, and their consolidated balance sheets as of December 31, 2004 (in thousands).

	Three months ended September 30, 2004 (1)	
	As previously reported	As restated
Cost of goods sold	$ 176,848	$ 179,186
Gross profit	34,399	32,061
Loss before income taxes	(10,516)	(12,854)
Income tax benefit	5,940	6,848
Net loss	(4,576)	(6,006)

	Nine months ended September 30, 2004 (1)	
	As previously reported	As restated
Cost of goods sold	$ 510,984	$ 514,692
Gross profit	87,640	83,932
Loss before income taxes	(35,543)	(39,251)
Income tax benefit	13,943	15,332
Net loss	(21,600)	(23,919)

	KRATON December 31, 2004		Polymer Holdings December 31, 2004	
	As previously reported	As restated	As previously reported	As restated
Inventories of product	$ 216,090	$ 211,076	$ 216,090	$ 211,076
Total current assets	402,202	397,188	402,202	397,188
Total assets	970,601	965,587	972,427	967,413
Deferred income taxes noncurrent	26,509	25,184	25,837	24,513
Total liabilities	653,219	651,894	746,219	744,895
Common equity	294,837	291,703	203,663	200,528
Accumulated other comprehensive income	22,545	21,990	22,545	21,990
Total member s equity	317,382	313,693	226,208	222,518
Total liabilities and member s equity	970,601	965,587	972,427	967,413

(1) The financial information for Polymer Holdings and

KRATON are identical for the items set forth in the table.

Polymer Holdings LLC and KRATON Polymers LLC
Notes to Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(Unaudited)

(d) ***Recently Issued Accounting Standards***

In December 2004, the FASB issued SFAS No. 123(R), Share-Based Payment, which supersedes SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123. SFAS No. 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under APB Opinion No. 25 Accounting for Stock Issued to Employees. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107. Among other things, SAB 107 provides interpretive guidance related to the interaction between SFAS No. 123(R) and certain SEC rules and regulations, as well as provides the SEC staff s views regarding the valuation of share-based payment arrangements for public companies. On April 14, 2005, the SEC issued Release No. 33-8568 which amends the compliance date of SFAS No. 123(R). As a result, SFAS No. 123(R) will be effective for the company as of the beginning of the first annual reporting period that begins after December 15, 2005. The company is currently evaluating the adoption method to be used upon the adoption of SFAS No. 123(R).

FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143* , (FIN 47) clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, *Asset Retirement Obligations* , (Statement No. 143) refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Thus, the timing and (or) method of settlement may be conditional on a future event. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The fair value of a liability for the conditional asset retirement obligation should be recognized when incurred generally upon acquisition, construction, or development and (or) through the normal operation of the asset. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. Statement No. 143 acknowledges that in some cases, sufficient information may not be available to reasonably estimate the fair value of an asset retirement obligation. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. FIN 47 is effective no later than the end of fiscal years ending after December 15, 2005. The adoption of FIN 47 is not expected to have a material impact to the Company.

(2) Detail of Certain Balance Sheet Accounts

	September 30, 2005	December 31, 2004
	(in thousands)	
Inventories:		
Finished products	$ 171,915	$ 185,609
Work in progress	3,413	3,844
Raw materials	15,975	21,623
	$ 191,303	$ 211,076

Polymer Holdings LLC and KRATON Polymers LLC
Notes to Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(Unaudited)

	September 30, 2005	December 31, 2004
	(in thousands)	
Other payables and accruals:		
Employee related	$ 17,357	$ 6,250
Interest	3,845	8,143
Property and other taxes	6,347	5,814
Customer rebates	6,238	6,417
Income taxes payable	2,131	174
Other	14,351	13,261
	$ 50,269	$ 40,059

(3) Comprehensive Income (Loss)

The components of comprehensive income (loss) include the following (in thousands):

	Three months ended September 30, 2005	Three months ended September 30, 2004	Nine months ended September 30, 2005	Nine months ended September 30, 2004
Polymer Holdings				
Net income (loss)	$ 954	$ (6,006)	$ 18,841	$ (23,919)
Foreign currency Adjustments	1,157	4,998	(20,925)	(2,861)
Unrealized gain on interest rate swaps	818		1,676	
Total comprehensive income (loss)	$ 2,929	$ (1,008)	$ (408)	$ (26,780)
KRATON				
Net income (loss)	$ 3,382	$ (6,006)	$ 24,556	$ (23,919)
Foreign currency Adjustments	1,157	4,998	(20,925)	(2,861)
Unrealized gain on interest rate swaps	818		1,676	
Total comprehensive income (loss)	$ 5,357	$ (1,008)	$ 5,307	$ (26,780)

Accumulated the comprehensive income consisted of the following for both Polymer Holdings and KRATON (in thousands):

	September 30, 2005	December 31, 2004
Foreign currency Adjustments	$ 35	$ 20,960
Unrealized gain on interest rate swaps	2,706	1,030

Total accumulated other comprehensive income	$	2,741	$	21,990

(4) Long-Term Debt

Long-term debt consists of the following:

	September 30, 2005	December 31, 2004
	(in thousands)	
KRATON:		
Senior Secured Credit Facility:		
Term loans	$ 263,333	$ 265,343
Revolver		
8.125% Senior Subordinated Notes	200,000	200,000
Total long-term debt	463,333	465,343
Less current portion of long-term debt	2,680	2,680
Total KRATON	460,653	462,663
Polymer Holdings:		
12% Senior Discount Notes	102,317	93,672
Total Polymer Holdings	$ 562,970	$ 556,335

(a) Senior Secured Credit Facility

In connection with the Acquisition, KRATON entered into a senior secured credit facility in the aggregate principal amount of $420 million. The senior secured credit facility consists of a $60 million revolving credit facility, or the Revolving Facility, and a $360 million term loan facility, or the Term Facility, and is subject to the terms and conditions of the credit agreement, dated as of December 23, 2003, or the Credit Agreement, among us, various lenders, Goldman Sachs Credit Partners L.P., UBS Securities LLC, UBS AG, Stamford Branch, Credit Suisse First Boston, Morgan Stanley Senior Funding Inc., and General Electric Capital Corporation. We refer to the loans made under the Revolving Facility as the Revolving Loans, and the loans made under the Term Facility as the Term Loans. Three of KRATON s subsidiaries, KRATON Polymers U.S. LLC, Elastomers Holdings LLC, and KRATON Polymers Capital Corporation, and Polymer Holdings, have guaranteed the senior secured credit facility and we refer to these guarantors, together with KRATON as the Loan Parties. The senior secured credit facility is secured by a perfected first priority security interest in all of each Loan Party s tangible and intangible assets, including intellectual property, real property, all of our capital stock and the capital stock of our domestic subsidiaries and 65% of the capital stock of the direct foreign subsidiaries of each Loan Party. As of September 30, 2005, and December 31, 2004, we had no outstanding borrowings under the Revolving Facility.

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Maturity

The Revolving Loans outstanding are payable in a single maturity on December 23, 2008. The Term Loans are payable in 24 consecutive equal quarterly installments, in an aggregate annual amount equal to 1.0% of the original principal amount of the Term Loans. The remaining balance is payable in four equal quarterly installments commencing on March 31, 2010, and ending on December 23, 2010.

Interest

KRATON s Senior Leverage Ratio was less than 2.50:1.00 for the quarters ended March 31 and June 30, 2005. In accordance with Amendment No. 2, dated October 21, 2004, the Term Loan bear interest at the adjusted Eurodollar rate plus 2.50%, a decrease from 2.75%.

Effective July 1, 2005, the Term Loans bear interest at a rate equal to the adjusted Eurodollar rate plus 2.50% per annum or, at our option, the base rate plus 1.50% per annum. Effective July 1, 2005, the Revolving Loans bear interest at a rate equal to the adjusted Eurodollar rate plus 2.50% per annum or at our option, the base rate plus 1.50% per annum. A commitment fee equal to 0.5% per annum times the daily average undrawn portion of the Revolving Facility accrues and is payable quarterly in arrears.

Mandatory Prepayments

The Term Facility will be subject to mandatory prepayment with, in general: (1) 100% of the net cash proceeds of certain asset sales, subject to certain reinvestment rights; (2) 100% of the net cash proceeds of certain insurance and condemnation payments, subject to certain reinvestment rights; (3) 50% of the net cash proceeds of equity offerings (declining to 25%, if a leverage ratio in met); (4) 100% of the net cash proceeds of debt incurrences (other than debt incurrences permitted under the Credit Agreement); and (5) 50% of our excess cash flow, as defined in the Credit Agreement (declining to 25%, if a leverage ratio is met). Any such prepayment is applied first to the Term Facility and thereafter to the Revolving Facility.

We were not required to make a prepayment related to excess cash flow generated during the year ended December 31, 2004.

Covenants

The Credit Agreement contains certain affirmative covenants including, among others, covenants to furnish the Lenders with financial statements and other financial information and to provide the Lenders notice of material events and information regarding collateral.

The Credit Agreement contains certain negative covenants including limitation on indebtedness, limitation on liens, limitation on fundamental changes, limitation on investments, limitation on asset sales, limitation on sales and leasebacks, limitation on restricted payments, limitation on transactions with affiliates, and certain financial covenants.

As of September 30, 2005, we were in compliance with all covenants under the Credit Agreement.

(b) Senior Subordinated Notes Due January 15, 2014

In connection with the Acquisition, KRATON and KRATON Polymers Capital Corporation issued the 8.125% Notes in an aggregate principal amount of $200.0 million. The 8.125% Notes are subject to the provisions for mandatory and optional prepayment and acceleration and are payable in full on January 15, 2014. Polymer

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Holdings and each of KRATON Polymers U.S. LLC and Elastomers Holdings LLC, which we refer to collectively as the Subsidiary Guarantors, have guaranteed the 8.125% Notes. The amount of 8.125% Notes outstanding at September 30, 2005, and December 31, 2004, is $200.0 million.

Interest

The 8.125% Notes bear interest at a fixed rate of 8.125% per annum. Interest is payable (1) on January 15 and July 15 each year, with the first such payment to be made July 15, 2004, (2) upon any redemption or prepayment as described below, and (3) at maturity.

Optional Redemption

Generally, we cannot elect to redeem the 8.125% Notes until January 15, 2009. After such date, we may elect to redeem the 8.125% Notes at certain predetermined redemption prices, plus accrued, and unpaid interest.

Prior to January 15, 2009, we may redeem up to a maximum of 35% of the 8.125% Notes with the proceeds of certain permitted equity offerings at a redemption price equal to 108.125% of the principal amount of the 8.125% Notes being redeemed, plus accrued and unpaid interest.

Covenants

The 8.125% Notes contain certain affirmative covenants including, among others, covenants to furnish the holders of the 8.125% Notes with financial statements and other financial information and to provide the holders of the 8.125% Notes notice of material events.

The 8.125% Notes contain certain negative covenants including limitation on indebtedness, limitation on restricted payments, limitation on restrictions on distributions from certain subsidiaries, limitation on lines of business, and mergers and consolidations.

As of September 30, 2005, we are in compliance with all covenants under the 8.125% Notes.

Exchange Offer

On October 24, 2005, KRATON completed an offer to exchange all of its outstanding 8.125% Notes issued under an exemption from the registration requirement of the Securities Act for identical notes registered under the Securities Act. In this offer, 100% of the outstanding notes issued under the exemptions from registration were tendered and exchanged for registered notes. The registered notes are identical to the unregistered notes, except that the registered notes do not carry transfer restrictions.

(c) Senior Discount Notes Due July 15, 2014

In connection with an amendment to KRATON s senior secured credit facility, Polymer Holdings and Polymer Holdings Capital Corporation issued $150 million principal amount at maturity (from which $91.9 million of net cash proceeds were realized) of 12% Senior Discount Notes due 2014, or the 12% Discount Notes, on November 2, 2004. Neither KRATON nor any of its subsidiaries guarantee the 12% Discount Notes. The 12% Discount Notes had an initial accreted value of $612.76 per $1,000 in principal amount at maturity. The accreted value of each Note will increase on a daily basis from the date of issuance until January 15, 2009, at a rate of 12.000% per annum, reflecting the accrual of non-cash interest, such that the accreted value on January 15, 2009 will equal the principal amount at maturity. The amount of the 12% Discount Notes outstanding at September 30, 2005, was $150.0 million, with an accreted value of $102.3 million.

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Interest

No cash interest will accrue on the 12% Discount Notes prior to January 15, 2009. Thereafter, cash interest on the 12% Discount Notes will accrue and be payable semi-annually in arrears on January 15 and July 15 of each year, commencing on July 15, 2009, at a rate of 12.000% per annum. Interest is payable (1) on January 15 and July 15 each year, with the first such payment to be made July 15, 2009, (2) upon any redemption or prepayment as described below, and (3) at maturity.

Optional Redemption

At any time prior to January 15, 2007, we may elect to redeem up to 35% of the 12% Discount Notes at a redemption price of 112.000% of the accreted value thereof at the redemption date, with the net cash proceeds of one or more equity offerings by us or KRATON, to the extent the net proceeds are distributed by KRATON to us, or a contribution to the common equity of capital of us from the net proceeds of one or more equity offerings by a direct or indirect payment of us. On or after January 15, 2009, we may elect to redeem the 12% Discount Notes at certain predetermined redemption prices, plus accrued and unpaid interest.

Covenants

The 12% Discount Notes contain certain affirmative covenants including, among others, covenants to furnish the holders of Notes with financial statements and other financial information and to provide the holders of Notes notice of material events.

The 12% Discount Notes contain certain negative covenants including limitation on indebtedness, limitation on restricted payments, limitation on restrictions on distributions from certain subsidiaries, limitation on lines of business, and mergers and consolidations.

As of September 30, 2005, we were in compliance with all covenants under the 12% Discount Notes.

Exchange Offer

On October 20, 2005, Polymer Holdings completed an offer to exchange all of its outstanding 12% Discount Notes issued under an exemption from the registration requirement of the Securities Act, for identical notes registered under the Securities Act. In this offer, 100% of the outstanding notes issued under the exemptions from registration were tendered and exchanged for registered notes. The registered notes are identical to the unregistered notes, except that the registered notes do not carry transfer restrictions.

(5) Income Taxes

Income taxes are recorded utilizing an asset and liability approach. This method gives consideration to the future tax consequences associated with the differences between the financial accounting basis and tax basis of the assets and liabilities, and the ultimate realization of any deferred tax asset resulting from such differences. We consider all foreign earnings as being permanently invested in that country.

(6) Commitments and Contingencies

Legal Proceedings

We, and certain of our subsidiaries, are parties to several legal proceedings that have arisen in the ordinary course of business. While the outcome of these proceedings cannot be predicted with certainty, management does not expect these matters to have a material adverse effect on our financial position, results of operations or cash flows.

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Pernis, The Netherlands Manufacturing Facility Fire

On June 6, 2004, a fire occurred at our Pernis, The Netherlands manufacturing facility, which is operated for us by Shell Nederland Chemie, a subsidiary of Shell Chemicals, under an operating agreement. There were no known injuries or environmental damages and no claims have been made against us arising out of this incident. We currently do not believe we have any liability related to this incident. We currently estimate the damage to property to be approximately $4 million, which we expect will be covered by our property and casualty insurance, subject to a $1 million insurance deductible. The amount of the deductible was included as additional cost of goods sold during the three months ended June 30, 2004. To date, we have received $1.5 million of insurance proceeds and recorded a $0.5 million gain on disposal of assets related to the insurance proceeds in the three months ended March 31, 2005. We continue to negotiate with our insurance carrier to settle the remaining claim.

We have business interruption insurance, which requires a minimum of 45 days of business interruption and satisfaction of a $2.5 million deductible before any benefit may be realized. We have received $0.9 million of insurance proceeds, representing full and final settlement of the business interruption insurance and recorded that amount as a gain in the three months ended June 30, 2005.

(7) Employee Benefits

(a) Investment in KRATON Management LLC

We provided certain key employees who held interests in us prior to the Acquisition the opportunity to roll over their interests into membership units of Management LLC, which owns a corresponding number of membership units in TJ Chemical. Additional employees have also been given the opportunity to purchase membership units in TJ Chemical through Management LLC at the original buy-in price and have been granted restricted and notional restricted membership units. The membership units are subject to customary tag-along and drag-along rights, as well as a call right in the event of termination of employment. On June 15, 2005, TJ Chemical granted Kevin M. Fogarty a notional restricted unit award with a fair value of $300,000. This award will vest 20% on each of the first five anniversaries of his employment commencement date (June 13, 2005), so long as Mr. Fogarty remains employed by us through the applicable vesting date. The actual membership units will not be distributed until the earlier of (1) a change in control or (2) the termination of Mr. Fogarty s employment. In addition, David M. Davis forfeited 350,000 restricted shares in accordance with his separation agreement. As of September 30, 2005, there were 5,655,000 membership units of Management LLC issued and outstanding.

(b) TJ Chemical Holdings LLC 2004 Option Plan

On September 9, 2004, TJ Chemical adopted an option plan, or the Option Plan, which allows for the grant to key employees, consultants, members and service providers of TJ Chemical and its affiliates, including KRATON, of non-qualified options to purchase TJ Chemical membership units in order to provide them with an appropriate incentive to encourage them to continue in the employ of or to perform services for, and to improve the growth and profitability of, TJ Chemical and its affiliates. The aggregate number of membership units with respect to which options may be granted under the Option Plan shall not exceed an amount representing 8% of the outstanding membership units and profits units of TJ Chemical on March 31, 2004, on a fully diluted basis. On June 15, 2005, TJ Chemical granted Mr. Fogarty 1,250,000 options. In addition, Mr. Davis forfeited 1,300,000 options in accordance with his separation agreement. As of September 30, 2005, there were 14,114,375 options granted and outstanding. All options granted in the period ended September 30, 2005, had an exercise price of $1 per membership unit, which is the same as the fair value of the membership unit on the date of grant.

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In general, the options vest and become exercisable in 20% increments annually on each of the first five anniversaries of the grant date, so long as the holder of the option is still an employee on the vesting date. The exercise price per membership unit shall equal the fair market value of a membership unit on the date of grant. Upon a change in control, the options will become 100% vested if the participant s employment is terminated without cause or by the participant for good reason (as each term is defined in the Option Plan) within the 2-year period immediately following such change in control.

A committee, or the Committee, of TJ Chemical s board has been appointed to administer the Option Plan, including, without limitation, the determination of the individuals to whom grants will be made, the number of membership units subject to each grant and the various terms of such grants. The Committee will have the right to terminate all of the outstanding options at any time and pay the participants an amount equal to the excess, if any, of the fair market value of a membership unit as of such date over the exercise price with respect to such option, or the spread. Generally, in the event of a merger (except a merger where membership unit holders receive securities of another corporation), the options will pertain to and apply to the securities that the option holder would have received in the merger; and in the event of a dissolution, liquidation, sale of assets or any other merger, the Committee has the discretion to (1) provide for an exchange of the options for new options on all or some of the property for which the membership units are exchanged (as may be adjusted by the Committee), (2) cancel and cash out the options (whether or not then vested) at the spread or (3) provide for a combination of both. Generally, the Committee may make appropriate adjustments with respect to the number of membership units covered by outstanding options and the exercise price in the event of any increase or decrease in the number of membership units or any other corporate transaction not described in the preceding sentence.

On a termination of a participant s employment (other than without cause or by the participant for good reason within the 2-year period immediately following a change in control), unvested options automatically expire and vested options expire on the earlier of (1) the commencement of business on the date the employment is terminated for cause; (2) 90 days after the date employment is terminated for any reason other than cause, death or disability; (3) 1-year after the date employment is terminated by reason of death or disability; or (4) the 10th anniversary of the grant date for such option.

Generally, pursuant to TJ Chemical s operating agreement, membership units acquired pursuant to the Option Plan are subject to customary tag-along and drag-along rights for the 180-day period following the later of a termination of employment and 6 months and 1-day following the date that units were acquired pursuant to the exercise of the option, TJ Chemical has the right to repurchase each membership unit then owned by the participant at fair value, as determined in good faith by the Board of Directors of TJ Chemical.

(c) Other Equity Awards

We provided certain key employees with a grant of profits units (subject to the 8% pool limitation described above). Profits units are economically equivalent to an option, except that they provide the recipient/employee with an opportunity to recognize capital gains in the appreciation of TJ Chemicals and its affiliates and TJ Chemicals and its affiliates do not receive any deduction at the time of grant or disposition of the profits unit by the employee. Generally, 50% of the profits units granted will vest when the fair value of TJ Chemical s assets equal or exceed two times the Threshold Amount, which is defined as the initial value of TJ Chemical, and 50% of the profits units granted will vest when the fair value of TJ Chemical s assets equal or exceed three times the Threshold Amount, provided, that the participant is employed by KRATON or its subsidiaries on such vesting date, and provided further, that 100% of the profits units shall become vested upon a change in control. Upon the occurrence of any of the foregoing vesting events, TJ Chemicals will pay to the holders of the profits units the amount of the difference between initial value of the profits units and the then current fair value of the profits units as determined by the profits units agreement. Compensation expense will be recorded in our financial statements for this difference at the time it becomes probable the profits units will become vested. On June 15, 2005, TJ Chemical granted Mr. Fogarty 300,000 profit units. In addition, Mr. Davis forfeited 281,250 profits units

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in accordance with his separation agreement. As of September 30, 2005, there were 2,031,250 profits units granted and outstanding.

(d) KRATON Polymers LLC Executive Deferred Compensation Plan

On September 9, 2004, the Board of Directors KRATON adopted the KRATON Deferred Compensation Plan. Under the plan, certain employees will be permitted to elect to defer a portion (generally up to 50%) of their annual incentive bonus with respect to each bonus period. Participating employees will be credited with a notional number of membership units based on the fair value of TJ Chemical membership units as of the date of deferral, although the distribution of membership units in such accounts may be made indirectly through Management LLC. Such membership units will be distributed upon termination of the participant s employment subject to a call right or upon a change in control. We reserved 2 million membership units for issuance pursuant to the KRATON Deferred Compensation Plan and as of September 30, 2005, there were no granted or outstanding membership units.

(e) 2005 Incentive Compensation Plan

On June 9, 2005, the Compensation Committee of the Board of Directors, or the Board, of KRATON approved and adopted the 2005 Incentive Compensation Plan, including the performance-based criteria by which potential payouts to participants will be determined. The 2005 Incentive Compensation Plan is designed to attract, retain, motivate and reward officers, and certain employees that have been deemed eligible to participate. The common bonus pool is determined based on EBITDA and may be increased or decreased up to $1 million based on a series of additional performance criteria as established by the Compensation Committee. For the bonus year which ends December 31, 2005, KRATON believes that the bonus pool will range from approximately $10 million to $14 million. Based on the current forecast for the twelve months ended December 31, 2005, KRATON has adequately accrued for the 2005 Incentive Compensation Plan as of September 30, 2005.

(f) Retirement Plans

The components of net period benefit cost related to pension benefits for the three and nine months ended September 30, 2005 and September 30, 2004 are as follows (in thousands):

	Three Months Ended September 30		Nine months Ended September 30	
	2005	2004	2005	2004
Components of net periodic benefit cost:				
Service cost	$ 886	$ 831	$ 2,658	$ 2,493
Interest cost	779	694	2,337	2,082
Expected return on plan assets	(736)	(683)	(2,208)	(2,048)
Net periodic benefit cost	$ 929	$ 842	$ 2,787	$ 2,527

The components of net periodic benefit cost related to other postretirement benefits for the three and nine months ended September 30, 2005 and September 30, 2004 are as follows (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
Components of net periodic benefit cost:				

Service cost	$ 91	$ 106	$ 275	$ 319
Interest cost	119	134	357	402
Recognized actuarial gain			(3)	
Net periodic benefit cost	$ 210	$ 240	$ 629	$ 721

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(8) Supplemental Guarantor Information Polymer Holdings LLC

Polymer Holdings was not a party to the issuance of the 8.125% Notes. Polymer Holdings separate financial statements are included in the following Supplemental Guarantor Information as of, and for the Nine Months Ended September 30, 2005, for the sole purpose that the following consolidated balances will agree to Polymer Holdings consolidated financial statements.

Balance Sheet

	As of September 30, 2005					
	Polymer Holdings (1)	**KRATON (2)**	**Guarantor Subsidiaries**	**Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**
Assets						
Current assets:						
Cash and cash equivalents	$	$	$ 32,847	$ 38,703	$	$ 71,550
Receivables, net			60,423	97,563	(7,374)	150,612
Inventories of products			118,606	79,935	(7,238)	191,303
Inventories of materials and supplies			5,853	3,559		9,412
Other current assets		5,795	970	10,730		17,495
Total current assets		5,795	218,699	230,490	(14,612)	440,372
Property, plant, and equipment, less accumulated depreciation		130,106	173,176	92,171		395,453
Identifiable intangible assets, less accumulated amortization		54,998		48,811		103,809
Investment in consolidated subsidiaries	329,582				(329,582)	
Investment in joint venture		813		9,726		10,539
Deferred financing costs	1,724	13,275				14,999
Other long-term assets		104,981	272,814	3,964	(372,745)	9,014
Total assets	$ 331,306	$ 309,968	$ 664,689	$ 385,162	$ (716,939)	$ 974,186

Liabilities and Member s Equity

Current liabilities:						
Current portion of long-term debt	$	$ 2,680	$	$	$	$ 2,680
Accounts payable trade		2,900	22,931	39,022		64,853
Other payables and accruals		3,844	19,947	26,478		50,269
Due to (from) related parties			2,127	17,184	(7,374)	11,937
Deferred income taxes			(417)	1,657		1,240
Insurance bond payable		1,380				1,380
Total current liabilities		10,804	44,588	84,341	(7,374)	132,359
Long-term debt, net of current portion	102,317	460,653				562,970
Deferred income taxes	(3,703)	299	30,815	(391)		27,020
Long-term liabilities		279,765	16,583	105,714	(372,745)	29,317
Total liabilities	98,614	751,521	91,986	189,664	(380,119)	751,666
Commitments and contingencies (note 5)						
Member s equity:						
Common equity	232,692	(444,259)	572,703	195,463	(336,820)	219,779
Accumulated other comprehensive income		2,706		35		2,741
Total member s equity	232,692	(441,553)	572,703	195,498	(336,820)	222,520
Total liabilities and member s equity	$ 331,306	$ 309,968	$ 664,689	$ 385,162	$ (716,939)	$ 974,186

(1) Polymer Holdings LLC and Polymer Holdings Capital Corporation are the issuers of the 12% Discount Notes. Polymer Holdings Capital Corporation has minimal assets and income. We do not believe

that separate financial information concerning the issuers would provide information that would be useful. Neither Polymer Holdings nor Polymer Holdings Capital Corporation is a guarantor of the 8.125% Notes.

(2) KRATON Polymers LLC and KRATON Polymers Capital Corporation are the issuers of the 8.125% Notes. KRATON Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be useful.

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Balance Sheet

	As of December 31, 2004					
	Polymer Holdings (1)	**KRATON (2)**	**Guarantor Subsidiaries**	**Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**
Assets						
Current assets:						
Cash and cash equivalents	$	$	$ 15,981	$ 30,376	$	$ 46,357
Receivables, net		454	43,143	84,467	(7,468)	120,596
Inventories of products		1,684	120,264	91,666	(2,538)	211,076
Inventories of materials and supplies			5,673	3,105		8,778
Other current assets		2,288	577	7,516		10,381
Total current assets		4,426	185,638	217,130	(10,006)	397,188
Property, plant, and equipment, less accumulated depreciation		138,133	181,292	104,908		424,333
Identifiable intangible assets, less accumulated amortization		60,883		48,811		109,694
Investment in consolidated subsidiaries	329,582				(329,582)	
Investment in joint venture		813		9,940		10,753
Deferred financing costs	1,826	14,973				16,799
Other long-term assets		118,127	252,066	3,529	(365,076)	8,646
Total assets	$ 331,408	$ 337,355	$ 618,996	$ 384,318	$ (704,664)	$ 967,413
Liabilities and Member s Equity						
Current liabilities:						
Current portion of long-term debt	$	$ 2,680	$	$	$	$ 2,680
Accounts payable trade		2,900	29,977	47,091		79,968

Other payables and accruals		8,143	16,199	15,717		40,059
Due to (from) related parties			456	21,483	(7,468)	14,471
Deferred income taxes			(417)	1,657		1,240
Total current liabilities		13,723	46,215	85,948	(7,468)	138,418
Long-term debt, net of current portion	93,672	462,663				556,335
Deferred income taxes	(671)	12,344	19,053	(6,213)		24,513
Long-term liabilities		261,950	12,865	115,890	(365,076)	25,629
Total liabilities	93,001	750,680	78,133	195,625	(372,544)	744,895
Commitments and contingencies (note 5)						
Member s equity:						
Common equity	238,407	(414,355)	540,863	167,733	(332,120)	200,528
Accumulated other comprehensive income		1,030		20,960		21,990
Total member s equity	238,407	(413,325)	540,863	188,693	(332,120)	222,518
Total liabilities and member s equity	$ 331,408	$ 337,355	$ 618,996	$ 384,318	$ (704,664)	$ 967,413

(1) Polymer Holdings LLC and Polymer Holdings Capital Corporation are the issuers of the 12% Discount Notes. Polymer Holdings Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the issuers would provide information that

would be useful. Neither Polymer Holdings nor Polymer Holdings Capital Corporation is a guarantor of the 8.125% Notes.

(2) KRATON Polymers LLC and KRATON Polymers Capital Corporation are the issuers of the 8.125% Notes. KRATON Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be useful.

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(Unaudited)

Statement of Operations

	Three Months Ended September 30, 2005					
	Polymer Holdings (1)	KRATON (2)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:						
Sales	$	$	$ 143,409	$ 154,784	$ (29,176)	$ 269,017
Other				7,457		7,457
Total revenues			143,409	162,241	(29,176)	276,474
Costs and expenses:						
Cost of goods sold		438	115,689	138,994	(29,176)	225,945
Gross profit		(438)	27,720	23,247		50,529
Research and development expenses			3,437	3,263		6,700
Selling, general, and administrative expenses			10,252	8,878		19,130
Depreciation and amortization		4,953	4,572	2,023		11,548
Earnings in joint venture				(182)		(182)
Interest expense (income)	3,063	9,284	(1,885)	1,284		11,746
Income (loss) before income taxes	(3,063)	(14,675)	11,344	7,981		1,587
Income tax (provision) benefit	635	3,998	(3,091)	(2,175)		(633)
Net income (loss)	$ (2,428)	$ (10,677)	$ 8,253	$ 5,806	$	$ 954

	Three Months Ended September 30, 2004					
	Polymer Holdings (1)	KRATON (2)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:						
Sales	$	$	$ 115,682	$ 124,379	$ (30,654)	$ 209,407
Other				1,840		1,840
Total revenues			115,682	126,219	(30,654)	211,247
Costs and expenses:						

Cost of goods sold		6,011	92,003	111,826	(30,654)	179,186
Gross profit		(6,011)	23,679	14,393		32,061
Research and development expenses			2,681	2,849		5,530
Selling, general, and administrative expenses			11,296	5,171		16,467
Depreciation and amortization		4,692	4,482	2,011		11,185
Earnings in joint venture				11		11
Interest expense (income)		12,107	(1,583)	1,198		11,722
Income (loss) before income taxes		(22,810)	6,803	3,153		(12,854)
Income tax (provision) benefit		9,532	(3,038)	354		6,848
Net income (loss)	$	$ (13,278)	$ 3,765	$ 3,507	$	$ (6,006)

(1) Polymer Holdings LLC and Polymer Holdings Capital Corporation are the issuers of the 12% Discount Notes. Polymer Holdings Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the issuers would provide information that would be useful. Neither Polymer Holdings nor Polymer Holdings Capital Corporation is a

guarantor of the 8.125% Notes.

(2) KRATON Polymers LLC and KRATON Polymers Capital Corporation are the issuers of the 8.125% Notes. KRATON Polymers Capital Corporation has minimal assets and income. We do not believe that separate financial information concerning the Issuers would provide additional information that would be useful.

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Polymer Holdings LLC and KRATON Polymers LLC
Notes to the Consolidated Financial Statements
For the Nine Months Ended September 30, 2005 and 2004
(in thousands of U.S. dollars)
(Unaudited)

Statement of Operations

	Nine Months Ended September 30, 2005					
	Polymer Holdings (1)	KRATON (2)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:						
Sales	$	$	$ 399,119	$ 441,788	$ (108,569)	$ 732,338
Other				20,287		20,287
Total revenues			399,119	462,075	(108,569)	752,625
Costs and expenses:						
Cost of goods sold		6,384	304,790	383,540	(108,569)	586,145
Gross profit		(6,384)	94,329	78,535		166,480
Research and development expenses			9,783	9,717		19,500
Selling, general, and administrative expenses			32,825	21,867		54,692
Depreciation and amortization		13,911	13,814	6,035		33,760
Earnings in joint venture				(1,050)		(1,050)
Interest expense (income)	8,745	27,258	(5,286)	3,861		34,578
Income (loss) before income taxes	(8,745)	(47,553)	43,193	38,105		25,000
Income tax (provision) benefit	3,030	12,949	(11,762)	(10,376)		(6,159)
Net income (loss)	$ (5,715)	$ (34,604)	$ 31,431	$ 27,729	$	$ 18,841

	Nine Months Ended September 30, 2004					
	Polymer Holdings (1)	KRATON (2)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenues:						
Sales	$	$	$ 319,311	$ 347,593	$ (77,018)	$ 589,886
Other				8,738		8,738
Total revenues			319,311	356,331	(77,018)	598,624
Costs and expenses:						

Cost of goods sold	30,940	245,390	315,380	(77,018)	514,692
Gross profit	(30,940)	73,921	40,951		83,932
Research and development expenses		8,174	9,072		17,246
Selling, general, and administrative expenses		28,135	18,368		46,503
Depreciation and amortization	13,297	13,210	5,342		31,849
Earnings in joint venture			(134)		(134

Other

1,011

996

Net cash used in financing activities

(69,948
)

(33,204
)

Net decrease in cash and cash equivalents

(75,371
)

(46,297
)
Cash and cash equivalents at beginning of period

	276,456	225,755
Cash and cash equivalents at end of period	$ 201,085	$ 179,458

See accompanying notes.

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INSPERITY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2015
(Unaudited)

1. Basis of Presentation

Insperity, Inc., a Delaware corporation ("Insperity," "we," "our," and "us"), provides an array of human resources ("HR") and business solutions designed to help improve business performance. Our most comprehensive HR service offerings are provided through our professional employer organization ("PEO") services, known as Workforce Optimization® and Workforce Synchronization solutions (together, our "PEO HR Outsourcing solutions"), which encompass a broad range of HR functions, including payroll and employment administration, employee benefits, workers' compensation, government compliance, performance management, and training and development services.

In addition to our PEO HR Outsourcing solutions, we offer Human Capital Management, Payroll Services, Time and Attendance, Performance Management, Organizational Planning, Recruiting Services, Employment Screening, Financial and Expense Management Services, Retirement Services and Insurance Services (collectively "Strategic Businesses" and formerly known as "Adjacent Businesses"), many of which are offered via desktop applications or cloud-based delivery models. These other products and services are offered separately, in customizable bundles, or along with PEO HR Outsourcing solutions.

The Consolidated Financial Statements include the accounts of Insperity and its subsidiaries, all of which are wholly owned. Intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("GAAP") requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

The accompanying Consolidated Financial Statements should be read in conjunction with our audited Consolidated Financial Statements at and for the year ended December 31, 2014. Our Consolidated Balance Sheet at December 31, 2014 has been derived from the audited financial statements at that date, but does not include all of the information or footnotes required by GAAP for complete financial statements. Our Consolidated Balance Sheet at September 30, 2015 and our Consolidated Statements of Operations and Comprehensive Income for the three and nine month periods ended September 30, 2015 and 2014, our Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2015 and 2014, and our Consolidated Statement of Stockholders' Equity for the nine month period ended September 30, 2015, have been prepared by us without audit. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows, have been made.

The results of operations for the interim periods are not necessarily indicative of the operating results for a full year or of future operations.

2. Accounting Policies

Health Insurance Costs

We provide group health insurance coverage to our worksite employees through a national network of carriers, including UnitedHealthcare ("United"), UnitedHealthcare of California, Kaiser Permanente, Blue Shield of California, HMSA BlueCross BlueShield, Unity Health Plan and Tufts, all of which provide fully insured policies or service contracts.

The policy with United provides the majority of our health insurance coverage. As a result of certain contractual terms, we have accounted for this plan since its inception using a partially self-funded insurance accounting model. Accordingly, we record the costs of the United plan, including an estimate of the incurred claims, taxes and administrative fees (collectively the “Plan Costs”) as benefits expense in our Consolidated Statements of Operations. The estimated incurred claims are based upon: (i) the level of claims processed during the quarter; (ii) estimated completion rates based upon recent claim development patterns under the plan; and (iii) the number of participants in the plan, including both active and COBRA enrollees. Each reporting period, changes in the estimated ultimate costs resulting from claim trends, plan design and migration, participant demographics and other factors are incorporated into the Plan Costs.

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Additionally, since the plan's inception, under the terms of the contract, United establishes cash funding rates 90 days in advance of the beginning of a reporting quarter. If the Plan Costs for a reporting quarter are greater than the premiums paid and owed to United, a deficit in the plan would be incurred and a liability for the excess costs would be accrued in our Consolidated Balance Sheets. On the other hand, if the Plan Costs for the reporting quarter are less than the premiums paid and owed to United, a surplus in the plan would be incurred and we would record an asset for the excess premiums in our Consolidated Balance Sheets. The terms of the arrangement require us to maintain an accumulated cash surplus in the plan of $9.0 million, which is reported as long-term prepaid insurance. In addition, United requires a deposit equal to approximately one day of claims funding activity, which was $3.5 million as of September 30, 2015, and is reported as a long-term asset. As of September 30, 2015, Plan Costs were less than the net premiums paid and owed to United by $17.8 million. As this amount is in excess of the agreed-upon $9.0 million surplus maintenance level, the $8.8 million balance is included in prepaid insurance, a current asset, in our Consolidated Balance Sheets. The premiums owed to United at September 30, 2015 were $8.9 million, which is included in accrued health insurance costs, a current liability in our Consolidated Balance Sheets. Benefits costs include changes in estimated claims run-off related to prior periods and consisted of a reduction of $0.8 million for the first nine of months of 2015 and an increase of $2.4 million for the first nine months of 2014.

Workers' Compensation Costs

Our workers' compensation coverage has been provided through an arrangement with the ACE Group of Companies (the "ACE Program") since 2007. The ACE Program is fully insured in that ACE has the responsibility to pay all claims incurred regardless of whether we satisfy our responsibilities. We bear the economic burden for the first $1 million layer of claims per occurrence, as well as a maximum aggregate amount of $5 million per policy year for those claims that exceed $1 million. The insurance carrier bears responsibility for the claims in excess of such amounts.

Because we bear the economic burden for claims up to the levels noted above, such claims, which are the primary component of our workers' compensation costs, are recorded in the period incurred. Workers' compensation insurance includes ongoing health care and indemnity coverage whereby claims are paid over numerous years following the date of injury. Accordingly, the accrual of related incurred costs in each reporting period includes estimates, which take into account the ongoing development of claims and therefore requires a significant level of judgment.

We employ a third party actuary to estimate our loss development rate, which is primarily based upon the nature of worksite employees' job responsibilities, the location of worksite employees, the historical frequency and severity of workers' compensation claims, and an estimate of future cost trends. Each reporting period, changes in the actuarial assumptions resulting from changes in actual claims experience and other trends are incorporated into our workers' compensation claims cost estimates. During the nine months ended September 30, 2015 and 2014, we reduced our workers' compensation costs by $0.5 million and $3.0 million, respectively, for changes in estimated losses related to prior reporting periods. Workers' compensation cost estimates are discounted to present value at a rate based upon the U.S. Treasury rates that correspond with the weighted average estimated claim payout period (the average discount rate utilized in both the 2015 period and the 2014 period was 1.0%) and are accreted over the estimated claim payment period and included as a component of direct costs in our Consolidated Statements of Operations.

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The following table presents the activity and balances related to incurred but not paid workers' compensation claims:

	Nine Months Ended September 30, 2015	2014
	(in thousands)	
Beginning balance, January 1,	$136,088	$120,833
Accrued claims	49,607	39,130
Present value discount	(1,816)	(1,418)
Paid claims	(28,735)	(28,314)
Ending balance	$155,144	$130,231
Current portion of accrued claims	$43,056	$57,222
Long-term portion of accrued claims	112,088	73,009
	$155,144	$130,231

The current portion of accrued workers' compensation costs on our Consolidated Balance Sheets at September 30, 2015 includes $2.7 million of workers' compensation administrative fees.

As of September 30, 2015 and 2014, the undiscounted accrued workers' compensation costs were $164.7 million and $140.0 million, respectively.

At the beginning of each policy period, the workers' compensation insurance carrier establishes monthly funding requirements comprised of premium costs and funds to be set aside for payment of future claims ("claim funds"). The level of claim funds is primarily based upon anticipated worksite employee payroll levels and expected workers' compensation loss rates, as determined by the insurance carrier. Monies funded into the program for incurred claims expected to be paid within one year are recorded as restricted cash, a short-term asset, while the remainder of claim funds are included in deposits - workers' compensation, a long-term asset in our Consolidated Balance Sheets. During the first nine months of 2015, we received $5.3 million for the return of excess claim funds related to the workers' compensation program, which resulted in a decrease to deposits. During the first nine months of 2014, we paid the insurance carrier $7.2 million in claim funds for prior policy years, which increased deposits. As of September 30, 2015, we had restricted cash of $43.1 million and deposits - workers' compensation of $121.2 million.

Our estimate of incurred claim costs expected to be paid within one year is included in short-term liabilities, while our estimate of incurred claim costs expected to be paid beyond one year is included in long-term liabilities on our Consolidated Balance Sheets.

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3. Cash, Cash Equivalents and Marketable Securities

The following table summarizes our cash and investments in cash equivalents and marketable securities held by investment managers and overnight investments:

	September 30, 2015 (in thousands)	December 31, 2014
Overnight Holdings		
Money market funds (cash equivalents)	$173,586	$271,840
Investment Holdings		
Money market funds (cash equivalents)	21,301	14,125
Marketable securities	9,754	28,631
	204,641	314,596
Cash held in demand accounts	17,748	20,369
Outstanding checks	(11,550)	(29,878)
Total cash, cash equivalents and marketable securities	$210,839	$305,087
Cash and cash equivalents	$201,085	$276,456
Marketable securities	9,754	28,631
Total cash, cash equivalents and marketable securities	$210,839	$305,087

Our cash and overnight holdings fluctuate based on the timing of clients' payroll processing cycles. Included in the cash, cash equivalents and marketable securities at September 30, 2015 and December 31, 2014, are $99.4 million and $152.1 million, respectively, of funds associated with federal and state income tax withholdings, employment taxes and other payroll deductions, as well as $40.5 million and $87.9 million in client prepayments, respectively.

We account for our financial assets in accordance with Accounting Standard Codification 820, Fair Value Measurement. This standard defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The fair value measurement disclosures are grouped into three levels based on valuation factors:

- Level 1 - quoted prices in active markets using identical assets
- Level 2 - significant other observable inputs, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other observable inputs
- Level 3 - significant unobservable inputs

The following table summarizes the levels of fair value measurements of our financial assets:

	Fair Value Measurements (in thousands)			
	September 30, 2015	Level 1	Level 2	Level 3
Money market funds	$194,887	$194,887	$—	$—
Municipal bonds	9,754	—	9,754	—
Total	$204,641	$194,887	$9,754	$—

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	Fair Value Measurements (in thousands) December 31, 2014	Level 1	Level 2	Level 3
Money market funds	$285,965	$285,965	$—	$—
Municipal bonds	28,631	—	28,631	—
Total	$314,596	$285,965	$28,631	$—

The municipal bond securities valued as Level 2 investments are primarily pre-refunded municipal bonds that are secured by escrow funds containing U.S. Government securities. Our valuation techniques used to measure fair value for these securities during the period consisted primarily of third party pricing services that utilized actual market data such as trades of comparable bond issues, broker/dealer quotations for the same or similar investments in active markets and other observable inputs.

The following is a summary of our available-for-sale marketable securities:

	Amortized Cost	Gross Unrealized Gains (in thousands)	Gross Unrealized Losses	Estimated Fair Value
September 30, 2015				
Municipal bonds	$9,746	$10	$(2)	$9,754
December 31, 2014				
Municipal bonds	$28,626	$16	$(11)	$28,631

As of September 30, 2015, the contractual maturities of our marketable securities were as follows:

	Amortized Cost (in thousands)	Estimated Fair Value
Less than one year	$6,294	$6,297
One to five years	3,452	3,457
Total	$9,746	$9,754

4. Impairment Charges and Other

In the first quarter of 2015, we entered into a plan to sell our two aircraft, and as a result, we recorded impairment and other charges of $9.8 million, representing the difference between the carrying value and the estimated fair value of the assets as well as a provision for potential settlement of a Texas sales and use tax assessment. In July 2015, we received proceeds, net of selling costs, of $12.2 million for both aircraft. As a result, we recorded an additional $1.3 million impairment charge in the second quarter of 2015.

During the second quarter of 2014, impairment indicators were identified in our Employment Screening business, which is a discrete reporting unit, due to changes in management, the reporting unit's financial results and the loss of certain customers. As a result, at that time, we performed impairment tests for our Employment Screening business' long-lived assets and goodwill and concluded that the assets were impaired. The impairments resulted primarily from lower projected revenue growth rates and profitability levels. Accordingly, in the second quarter of 2014, we recognized intangible asset impairments of $0.7 million and, upon completion of step two of the goodwill impairment test, we recognized a goodwill impairment charge of $1.8 million. The fair values of the long-lived assets and reporting unit were estimated using discounted cash flow models, which we believed appropriately estimated the fair values of the long-lived assets and reporting unit. The material assumptions used in the models included the weighted average cost of capital and long-term growth rates. We considered these to be Level 3 fair value measures.

5. Revolving Credit Facility

We have a $125 million revolving credit facility (the “Facility”), which may be increased to $150 million based on the terms and subject to the conditions set forth in the agreement relating to the Facility (the “Credit Agreement”). The Facility matures in February 2020. The Facility contains both affirmative and negative covenants, which we believe are customary for arrangements of this nature. At September 30, 2015, we were in compliance with all financial covenants under the Credit Agreement and had not drawn on the Facility. As of September 30, 2015, we had an outstanding $0.6 million letter of credit issued under the Facility.

6. Stockholders' Equity

Our Board of Directors (the “Board”) has authorized a program to repurchase shares of our outstanding common stock (“Repurchase Program”). The purchases are to be made from time to time in the open market or directly from stockholders at prevailing market prices based on market conditions and other factors. In May 2015, the Board increased the authorized number of shares to be repurchased under the Repurchase Program by one million. During the nine months ended September 30, 2015, 1,065,692 shares were repurchased under the Repurchase Program and 114,523 shares not subject to the Repurchase Program were withheld to satisfy tax withholding obligations for the vesting of restricted stock awards. As of September 30, 2015, we were authorized to repurchase an additional 703,073 shares under the Repurchase Program.

The Board declared quarterly dividends as follows:

	2015	2014
	(amounts per share)	
First quarter	$0.19	$0.17
Second quarter	0.22	0.19
Third quarter	0.22	0.19

During the nine months ended September 30, 2015 and 2014, we paid dividends totaling $15.8 million and $14.0 million, respectively.

7. Long-Term Incentive Plan

On March 30, 2015, we adopted the Insperity, Inc. Long-Term Incentive Program (the “LTIP”) under the Insperity, Inc. 2012 Incentive Plan (the “Plan”). The LTIP provides for performance-based long-term compensation awards in the form of performance units to certain employees based on the achievement of pre-established performance goals.

Also on March 30, 2015, we granted performance units under the LTIP to our named executive officers and certain other officers. The total number of performance units granted based on the expected performance target level was 103,450. Each performance unit represents the right to receive one common share at a future date based on our performance against specified targets. Performance units have a vesting schedule of three years. The fair value of each performance unit is the market price of one common share on the date of grant. The compensation expense for such awards is recognized on a straight-line basis over the vesting terms. Over the performance period, the number of shares expected to be issued is adjusted upward or downward based upon the probability of achievement of the performance targets. The ultimate number of shares issued and the related compensation cost recognized is based on a comparison of the final performance metrics to the specified targets. As of September 30, 2015, the unrecognized compensation cost was $8.0 million.

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8. Net Income per Share

We utilize the two-class method to compute net income per share. The two-class method allocates a portion of net income to participating securities, which include unvested awards of share-based payments with non-forfeitable rights to receive dividends. Net income allocated to unvested share-based payments is excluded from net income allocated to common shares. Any undistributed losses resulting from dividends exceeding net income are not allocated to participating securities. Basic net income per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the period, plus the dilutive effect of outstanding stock options.

The following table summarizes the net income allocated to common shares and the basic and diluted shares used in the net income per share computations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(in thousands)			
Net income	$11,950	$8,385	$33,051	$19,840
Less distributed and undistributed earnings allocated to participating securities	(303)	(243)	(822)	(576)
Net income allocated to common shares	$11,647	$8,142	$32,229	$19,264
Weighted average common shares outstanding	24,030	24,650	24,502	24,747
Incremental shares from assumed conversions of common stock options	6	2	7	5
Adjusted weighted average common shares outstanding	24,036	24,652	24,509	24,752
Potentially dilutive securities not included in weighted average share calculation due to anti-dilutive effect	—	16	—	5

9. Commitments and Contingencies

We are a defendant in various lawsuits and claims arising in the normal course of business. Management believes it has valid defenses in these cases and is defending them vigorously. While the results of litigation cannot be predicted with certainty, management believes the final outcome of such litigation will not have a material adverse effect on our financial position or results of operations.

Federal Unemployment Taxes

Employers in certain states are experiencing higher Federal Unemployment Tax Act ("FUTA") tax rates as a result of certain states not repaying their unemployment loans from the federal government in a timely manner. The Benefit Cost Ratio Add-On ("BCR") is an additional tax on the FUTA wage base for employers in states that continue to have outstanding federal unemployment insurance loans beginning with the fifth year in which there is a balance due on the loan. States have the option to apply for a waiver before July 1st of the year in which the BCR is applicable. Four states are at risk for assessment of the BCR in 2015. We expect most states will be notified by the federal government in the fourth quarter of 2015 if a waiver has been granted in response to the state's application. Accordingly, the potential additional FUTA tax associated with worksite employees in these four states was approximately $3.5 million as of September 30, 2015.

Generally, our contractual agreements allow us to incorporate such increases into our service fees upon the effective date of the rate change. However, our ability to fully adjust service fees in our billing systems and collect such increases over the remaining term of the customers' contracts could be limited, resulting in a potential tax increase not being fully recovered. As a result, if these FUTA tax increases are instituted and not collected from our clients, such increases could have a material adverse effect on our financial condition or results of operations.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2014, as well as our Consolidated Financial Statements and notes thereto included in this quarterly report on Form 10-Q.

Results of Operations

Three Months Ended September 30, 2015 Compared to Three Months Ended September 30, 2014.

The following table presents certain information related to our results of operations:

	Three Months Ended September 30,			
	2015	2014	% Change	
	(in thousands, except per share and statistical data)			
Revenues (gross billings of $3.826 billion and $3.362 billion, less worksite employee payroll cost of $3.200 billion and $2.802 billion, respectively)	$626,286	$560,303	11.8	%
Gross profit	106,743	100,817	5.9	%
Operating expenses	86,807	86,357	0.5	%
Operating income	19,936	14,460	37.9	%
Other income	19	43	(55.8	)%
Net income	11,950	8,385	42.5	%
Diluted net income per share of common stock	0.48	0.33	45.5	%
Adjusted net income[(1)]	14,171	9,946	42.5	%
Adjusted diluted net income per share of common stock[(1)]	0.57	0.39	46.2	%
Adjusted EBITDA[(1)]	28,278	22,610	25.1	%
Statistical Data:				
Average number of worksite employees paid per month	149,086	131,545	13.3	%
Revenues per worksite employee per month[(2)]	$1,400	$1,420	(1.4	)%
Gross profit per worksite employee per month	239	255	(6.3	)%
Operating expenses per worksite employee per month	194	218	(11.0	)%
Operating income per worksite employee per month	45	37	21.6	%
Net income per worksite employee per month	27	21	28.6	%

(1) Please read "Non-GAAP Financial Measures" for a reconciliation of the non-GAAP financial measures to their most directly comparable financial measures calculated and presented in accordance with GAAP.

(2) Gross billings of $8,555 and $8,519 per worksite employee per month, less payroll cost of $7,155 and $7,099 per worksite employee per month, respectively.

Revenues

Our revenues for the third quarter of 2015 increased 11.8% over the 2014 period, primarily due to a 13.3% increase in the average number of worksite employees paid per month, partially offset by a 1.4%, or $20, decrease in revenues per worksite employee per month.

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We provide our PEO HR Outsourcing solutions to small and medium-sized businesses in strategically selected markets throughout the United States. By region, our PEO HR Outsourcing solutions revenue change from the third quarter of 2014 and distribution for the quarters ended September 30, 2015 and 2014 were as follows:

	Three Months Ended September 30,			Three Months Ended September 30,	
	2015	2014	% Change	2015	2014
	(in thousands)			(% of total revenue)	
Northeast	$156,700	$142,376	10.1 %	25.5 %	25.9 %
Southeast	64,420	53,615	20.2 %	10.5 %	9.8 %
Central	95,628	79,448	20.4 %	15.6 %	14.5 %
Southwest	155,581	150,404	3.4 %	25.4 %	27.4 %
West	141,353	123,531	14.4 %	23.0 %	22.4 %
	613,682	549,374	11.7 %	100.0 %	100.0 %
Other revenue[1]	12,604	10,929	15.3 %		
Total revenue	$626,286	$560,303	11.8 %		

[1] Comprised primarily of revenues generated by our Strategic Businesses.

The percentage of total PEO HR Outsourcing solutions revenues in our significant markets include the following:

	Three Months Ended September 30,	
	2015	2014
Texas	23.6 %	25.3 %
California	18.3 %	17.8 %
New York	9.4 %	9.6 %
Other	48.7 %	47.3 %
Total	100.0 %	100.0 %

Our growth in the number of worksite employees paid is affected by three primary sources: new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During the third quarter of 2015, we saw improvement in worksite employees paid from each of these sources as compared to the third quarter of 2014.

Gross Profit

Gross profit for the third quarter of 2015 increased 5.9% over the third quarter of 2014 to $106.7 million. The average gross profit per worksite employee decreased 6.3% to $239 per month in the 2015 period from $255 per month in the 2014 period. Included in gross profit in both the 2015 and 2014 periods is an $18 per worksite employee per month contribution from our Strategic Businesses.

Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by maintaining revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses. Our revenues per worksite employee per month during the third quarter of 2015 decreased 1.4% compared to the third quarter of 2014. Our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, decreased 0.3% to $1,161 per worksite employee per month in the third quarter of 2015 compared to $1,165 in the third quarter of 2014. The primary direct cost components changed as follows:

- Benefits costs – The cost of group health insurance and related employee benefits decreased $1 per worksite employee per month, but increased 1.9% on a cost per covered employee basis, compared to the third quarter of 2014. Our benefits costs incurred in the third quarter of 2015 reflect favorable claim trends due to reductions in COBRA participation levels. Included in 2014 benefits costs is a reduction of $6.4 million, or $16 per worksite employee per

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month for changes in estimated claims run-off related to prior periods. The percentage of worksite employees covered under our health insurance plans was 69.7% in the 2015 period compared to 71.2% in the 2014 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Health Insurance Costs,” for a discussion of our accounting for health insurance costs.

- Workers’ compensation costs – Workers’ compensation costs increased 15.5%, or $1 per worksite employee per month, compared to the third quarter of 2014, primarily due to a 13.3% increase in the average number of worksite employees paid per month. As a percentage of non-bonus payroll cost, workers’ compensation costs were 0.70% in the 2015 period compared to 0.68% in the 2014 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Workers’ Compensation Costs,” for a discussion of our accounting for workers’ compensation costs.

- Payroll tax costs – Payroll taxes increased 12.8%, but decreased $2 on a per worksite employee per month basis, compared to the third quarter of 2014, primarily due to a 14.2% increase in payroll costs, partially offset by lower unemployment tax rates. Payroll taxes as a percentage of payroll cost were 6.3% in both the 2015 and the 2014 periods.

Operating Expenses

The following table presents certain information related to our operating expenses:

	Three Months Ended September 30,			Three Months Ended September 30,		
	2015	2014	% Change	2015	2014	% Change
	(in thousands)			(per worksite employee per month)		
Salaries, wages and payroll taxes	$51,329	$49,384	3.9 %	$115	$125	(8.0)%
Stock-based compensation	3,710	2,701	37.4 %	8	7	14.3 %
Commissions	4,516	3,790	19.2 %	10	10	—
Advertising	3,574	4,885	(26.8)%	8	12	(33.3)%
General and administrative expenses	19,191	20,295	(5.4)%	43	51	(15.7)%
Depreciation and amortization	4,487	5,302	(15.4)%	10	13	(23.1)%
Total operating expenses	$86,807	$86,357	0.5 %	$194	$218	(11.0)%

Operating expenses increased 0.5% to $86.8 million compared to $86.4 million in the third quarter of 2014. Operating expenses per worksite employee per month decreased to $194 in the 2015 period from $218 in the 2014 period. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 3.9%, but decreased $10 on a per worksite employee per month basis, compared to the 2014 period. This increase was primarily due to a 4.1% increase in corporate headcount, primarily due to a 16.5% increase in the number of Business Performance Advisors.

- Stock-based compensation increased 37.4%, or $1 per worksite employee per month, compared to the 2014 period. This increase was primarily due to awards issued under the new Insperity, Inc. Long-Term Incentive Program (the “LTIP”). Please read Note 7 to the Consolidated Financial Statements, “Long-Term Incentive Plan,” for additional information.

- Commissions expense increased 19.2%, but remained flat on a per worksite employee per month basis, compared to the 2014 period, primarily due to commissions associated with our PEO HR Outsourcing solutions.

- Advertising costs decreased 26.8%, or $4 per worksite employee per month, compared to the 2014 period, primarily due to reduced spending on radio and television advertising.

- General and administrative expenses decreased 5.4%, or $8 per worksite employee per month, compared to the 2014 period, due in part to lower spending on professional fees and on repair and maintenance costs associated with the two aircraft sold in July 2015. Please read Note 4 to the Consolidated Financial Statements, “Impairment Charges and Other,” for additional information

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- Depreciation and amortization expense decreased 15.4%, or $3 per worksite employee per month compared to the 2014 period, primarily due to the July 2015 sale of our two aircraft, which eliminated the depreciation on those assets. Please read Note 4 to the Consolidated Financial Statements, “Impairment Charges and Other,” for additional information.

Income Tax Expense

Our effective income tax rate was 40.1% in the 2015 period compared to 42.2% in the 2014 period. Our provision for income taxes differed from the U.S. statutory rate of 35% primarily due to state income taxes and non-deductible expenses.

Operating and Net Income

Operating and net income per worksite employee per month was $45 and $27 in the 2015 period, versus $37 and $21 in the 2014 period.

Nine Months Ended September 30, 2015 Compared to Nine Months Ended September 30, 2014.

The following table presents certain information related to our results of operations:

	Nine Months Ended September 30, 2015	2014	% Change
	(in thousands, except per share and statistical data)		
Revenues (gross billings of $11.469 billion and $10.231 billion, less worksite employee payroll cost of $9.515 billion and $8.469 billion, respectively)	$1,953,603	$1,761,923	10.9%
Gross profit	340,822	302,446	12.7%
Operating expenses[1]	285,149	267,981	6.4%
Operating income	55,673	34,465	61.5%
Other income (expense)	(14)	100	(114.0)%
Net income	33,051	19,840	66.6%
Diluted net income per share of common stock	1.32	0.78	69.2%
Adjusted net income[2]	46,578	26,197	77.8%
Adjusted diluted net income per share of common stock[2]	1.86	1.03	80.6%
Adjusted EBITDA[2]	93,211	61,504	51.6%
Statistical Data:			
Average number of worksite employees paid per month	143,392	128,703	11.4%
Revenues per worksite employee per month[3]	$1,514	$1,521	(0.5)%
Gross profit per worksite employee per month	264	261	1.1%
Operating expenses per worksite employee per month	221	231	(4.3)%
Operating income per worksite employee per month	43	30	43.3%
Net income per worksite employee per month	26	17	52.9%

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(1) Includes non-cash impairment and other charges of $11.1 million, or $0.26 per share in the 2015 period and $2.5 million, or $0.06 per share in the 2014 period. Please read Note 4 to the Consolidated Financial Statements,

"Impairment Charges and Other," for additional information.

(2) Please read "Non-GAAP Financial Measures" for a reconciliation of the non-GAAP financial measures to their most directly comparable financial measures calculated and presented in accordance with GAAP.

(3) Gross billings of $8,887 and $8,832 per worksite employee per month, less payroll cost of $7,373 and $7,311 per worksite employee per month, respectively.

Revenues

Our revenues for the nine months ended September 30, 2015 increased 10.9% over the 2014 period, primarily due to an 11.4% increase in the average number of worksite employees paid per month, partially offset by a 0.5%, or $7, decrease in revenues per worksite employee per month.

We provide our PEO HR Outsourcing solutions to small and medium-sized businesses in strategically selected markets throughout the United States. By region, our PEO HR Outsourcing solutions revenue change from the first nine months of 2014 and distribution for the nine months ended September 30, 2015 and 2014 were as follows:

	Nine Months Ended September 30,			Nine Months Ended September 30,	
	2015	2014	% Change	2015	2014
	(in thousands)			(% of total revenue)	
Northeast	$500,899	$451,505	10.9 %	26.1 %	26.1 %
Southeast	193,970	169,472	14.5 %	10.1 %	9.8 %
Central	294,464	249,497	18.0 %	15.4 %	14.4 %
Southwest	489,790	471,218	3.9 %	25.5 %	27.2 %
West	438,758	389,642	12.6 %	22.9 %	22.5 %
	1,917,881	1,731,334	10.8 %	100.0 %	100.0 %
Other revenue[1]	35,722	30,589	16.8 %		
Total revenue	$1,953,603	$1,761,923	10.9 %		

[1] Comprised primarily of revenues generated by our Strategic Businesses.

The percentage of total PEO HR Outsourcing solutions revenues in our significant markets include the following:

	Nine Months Ended September 30,	
	2015	2014
Texas	23.8 %	25.2 %
California	18.2 %	17.8 %
New York	9.7 %	9.8 %
Other	48.3 %	47.2 %
Total	100.0 %	100.0 %

Our growth in the number of worksite employees paid is affected by three primary sources: new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During the first nine months of 2015, we saw improvement in worksite employees paid from each of these sources as compared to the first nine months of 2014.

Gross Profit

Gross profit for the first nine months of 2015 increased 12.7% compared to the first nine months of 2014 to $340.8 million. The average gross profit per worksite employee increased 1.1% to $264 per month in the 2015 period from

$261 per month in the 2014 period. Included in gross profit in 2015 is a $17 per worksite employee per month contribution from our Strategic Businesses compared to $16 per worksite employee per month in the 2014 period.

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Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by maintaining revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses. Our revenues during the first nine months of 2015 decreased 0.5% per worksite employee per month compared to the first nine months of 2014. Our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, decreased 0.8% to $1,250 per worksite employee per month in the first nine months of 2015 compared to $1,260 in the first nine months of 2014. The primary direct cost components changed as follows:

- Benefits costs – The cost of group health insurance and related employee benefits decreased $12 per worksite employee per month, or 0.2% on a cost per covered employee basis, compared to the first nine months of 2014. Our benefits costs incurred in the first nine months of 2015 reflect reductions in COBRA participation levels and includes a reduction in estimated claims run-off related to prior periods of $0.8 million, or $1 per worksite employee per month. Benefits costs incurred in the first nine months of 2014 included an increase in estimated claims run-off related to prior periods of $2.4 million, or $2 per worksite employee per month. The percentage of worksite employees covered under our health insurance plans was 70.5% in the 2015 period compared to 71.7% in the 2014 period. Please read Note 2 to the Consolidated Financial Statements, "Accounting Policies – Health Insurance Costs," for a discussion of our accounting for health insurance costs.

- Workers' compensation costs – Workers' compensation costs increased 20.9%, or $4 per worksite employee per month, compared to the first nine months of 2014, primarily due to higher incurred claim levels and an 11.4% increase in the average number of worksite employees paid per month. As a percentage of non-bonus payroll cost, workers' compensation costs were 0.70% in the 2015 period compared to 0.65% in the 2014 period. Please read Note 2 to the Consolidated Financial Statements, "Accounting Policies – Workers' Compensation Costs," for a discussion of our accounting for workers' compensation costs.

- Payroll tax costs – Payroll taxes increased 11.1%, but decreased $1 per worksite employee per month, compared to the first nine months of 2014, primarily due to a 12.4% increase in payroll costs, partially offset by lower unemployment tax rates. Payroll taxes as a percentage of payroll cost were 7.3% in the 2015 period and 7.4% in the 2014 period.

Operating Expenses

The following table presents certain information related to our operating expenses:

	Nine Months Ended September 30,			Nine Months Ended September 30,		
	2015	2014	% Change	2015	2014	% Change
	(in thousands)			(per worksite employee per month)		
Salaries, wages and payroll taxes	$158,311	$148,245	6.8 %	$123	$128	(3.9)%
Stock-based compensation	10,174	8,346	21.9 %	8	7	14.3 %
Commissions	12,923	10,753	20.2 %	10	9	11.1 %
Advertising	14,681	18,182	(19.3)%	11	16	(31.3)%
General and administrative expenses	63,578	64,143	(0.9)%	49	55	(10.9)%
Impairment charges and other	11,120	2,485	347.5 %	9	2	350.0 %
Depreciation and amortization	14,362	15,827	(9.3)%	11	14	(21.4)%
Total operating expenses	$285,149	$267,981	6.4 %	$221	$231	(4.3)%

Operating expenses increased 6.4% to $285.1 million compared to $268.0 million in the first nine months of 2014. We recorded impairment and other charges of $11.1 million and $2.5 million during first nine months of 2015 and 2014, respectively. Please read Note 4 to the Consolidated Financial Statements, "Impairment Charges and Other," for additional information. Adjusted operating expenses increased 2.6% to $272.5 million from $265.5 million in the first nine months of 2014. Please read “Non-GAAP Financial Measures,” for additional information. Operating expenses per worksite employee per month decreased to $221 in the 2015 period from $231 in the 2014 period. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 6.8%, but decreased $5 on a per worksite employee per month basis, compared to the 2014 period. This increase was primarily due to higher incentive

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compensation accruals as a result of improved operating results and a 2.1% rise in corporate headcount, primarily due to an 11.2% increase in the number of Business Performance Advisors.

- Stock-based compensation increased 21.9%, or $1 per worksite employee per month, compared to the 2014 period. This increase was primarily due to awards issued under the new LTIP. Please read Note 7 to the Consolidated Financial Statements, "Long-Term Incentive Plan," for additional information.

- Commissions expense increased 20.2%, or $1 per worksite employee per month, compared to the 2014 period, primarily due to commissions associated with our PEO HR Outsourcing solutions.

- Advertising costs decreased 19.3%, or $5 per worksite employee per month, compared to the 2014 period, primarily due to reduced spending on radio and television advertising and sponsorships.

- General and administrative expenses, which includes $1.5 million in stockholder advisory expenses in the 2015 period, decreased 0.9%, or $6 per worksite employee per month compared to the 2014 period. This decrease was due in part to lower consulting and professional fees.

- Depreciation and amortization expense decreased 9.3%, or $3 per worksite employee per month compared to the 2014 period, primarily due to the July 2015 sale of our two aircraft, which eliminated the depreciation on those assets. Please read Note 4 to the Consolidated Financial Statements, "Impairment Charges and Other," for additional information.

Income Tax Expense

Our effective income tax rate was 40.6% in the 2015 period compared to 42.6% in the 2014 period. Our provision for income taxes differed from the U.S. statutory rate of 35% primarily due to state income taxes, non-deductible expenses, and the effects of the impairment charges recorded during the period.

Operating and Net Income

Operating and net income per worksite employee per month was $43 and $26 in the 2015 period, versus $30 and $17 in the 2014 period.

Non-GAAP Financial Measures

Non-GAAP financial measures are not prepared in accordance with GAAP and may be different from non-GAAP financial measures used by other companies. Non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP. Investors are encouraged to review the reconciliation of the non-GAAP financial measures used to their most directly comparable GAAP financial measures as provided in the tables below.

Non-bonus payroll cost is a non-GAAP financial measure that excludes the impact of bonus payrolls paid to our worksite employees. Bonus payroll cost varies from period to period, but has no direct impact to our ultimate workers' compensation costs under the current program. As a result, our management refers to non-bonus payroll cost in analyzing, reporting and forecasting our workers' compensation costs. We include these non-GAAP financial measures because we believe they are useful to investors in allowing for greater transparency related to the costs incurred under our current workers' compensation program.

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Following is a GAAP to non-GAAP reconciliation of non-bonus payroll costs:

	Three Months Ended September 30, 2015	Three Months Ended September 30, 2014	% Change		Nine Months Ended September 30, 2015	Nine Months Ended September 30, 2014	% Change	
	(in thousands, except per worksite employee per month data)							
GAAP to non-GAAP reconciliation:								
Payroll cost (GAAP)	$3,199,788	$2,801,722	14.2	%	$9,515,662	$8,468,804	12.4	%
Less: Bonus payroll cost	262,445	204,405	28.4	%	1,038,315	947,751	9.6	%
Non-bonus payroll cost	$2,937,343	$2,597,317	13.1	%	$8,477,347	$7,521,053	12.7	%
Payroll cost per worksite employee per month (GAAP)	$7,155	$7,099	0.8	%	$7,373	$7,311	0.8	%
Less: Bonus payroll cost per worksite employee per month	588	518	13.5	%	805	818	(1.6	)%
Non-bonus payroll cost per worksite employee per month	$6,567	$6,581	(0.2	)%	$6,568	$6,493	1.2	%

Adjusted cash, cash equivalents and marketable securities excludes funds associated with federal and state income tax withholdings, employment taxes and other payroll deductions, as well as client prepayments. Insperity management believes adjusted cash, cash equivalents and marketable securities is a useful measure of the company’s available funds.

Following is a GAAP to non-GAAP reconciliation of cash, cash equivalents and marketable securities:

	September 30, 2015	December 31, 2014
	(in thousands)	
Cash, cash equivalents and marketable securities (GAAP)	$210,839	$305,087
Less: Amounts payable for withheld federal and state income taxes, employment taxes and other payroll deductions	99,382	152,132
Customer prepayments	40,533	87,887
Adjusted cash, cash equivalents and marketable securities	$70,924	$65,068

Adjusted operating expenses represent operating expenses excluding the impact of impairment and other charges related to the sale of two aircraft and stockholder advisory expenses in 2015, and an impairment charge associated with our Employment Screening reporting unit in 2014. Insperity management believes adjusted operating expenses is a useful measure of our operating costs, as it allows for additional analysis of our operating expenses separate from the impact of these items.

Following is a GAAP to non-GAAP reconciliation of operating expenses and adjusted operating expenses:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	% Change		2015	2014	% Change	
	(in thousands)							
Operating expenses (GAAP)	$86,807	$86,357	0.5	%	$285,149	$267,981	6.4	%
Less: Impairment charges and other	—	—	—		11,120	2,485	347.5	%
Stockholder advisory expenses	—	—	—		1,546	—	—	
Adjusted operating expenses	$86,807	$86,357	0.5	%	$272,483	$265,496	2.6	%

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EBITDA represents net income computed in accordance with GAAP, plus interest expense, income tax expense and depreciation and amortization expense. Adjusted EBITDA represents EBITDA plus non-cash impairment and other charges, non-cash stock-based compensation and stockholder advisory expenses. Our management believes EBITDA and Adjusted EBITDA are often useful measures of our operating performance, as they allow for additional analysis of our operating results separate from the impact of these items.

Following is a GAAP to non-GAAP reconciliation of EBITDA and Adjusted EBITDA:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2015	2014	% Change	2015	2014	% Change
	(in thousands)					
Net income (GAAP)	$11,950	$8,385	42.5 %	$33,051	$19,840	66.6 %
Income tax expense	8,005	6,118	30.8 %	22,608	14,725	53.5 %
Interest expense	126	104	21.2 %	350	281	24.6 %
Depreciation and amortization	4,487	5,302	(15.4)%	14,362	15,827	(9.3)%
EBITDA	24,568	19,909	23.4 %	70,371	50,673	38.9 %
Impairment charges and other	—	—	—	11,120	2,485	347.5 %
Stock-based compensation	3,710	2,701	37.4 %	10,174	8,346	21.9 %
Stockholder advisory expenses	—	—	—	1,546	—	—
Adjusted EBITDA	$28,278	$22,610	25.1 %	$93,211	$61,504	51.6 %

Adjusted net income and adjusted diluted net income per share of common stock represent net income and diluted net income per share computed in accordance with GAAP, excluding the impact of non-cash impairment and other charges related to the sale of two aircraft in 2015, and an impairment charge associated with our Employment Screening reporting unit in 2014, stockholder advisory expenses and non-cash stock-based compensation. Our management believes adjusted net income and adjusted diluted net income per share of common stock are useful measures of our operating performance, as they allow for additional analysis of our operating results separate from the impact of these items.

Following is a GAAP to non-GAAP reconciliation of adjusted net income:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2015	2014	% Change	2015	2014	% Change
	(in thousands)					
Net income (GAAP)	$11,950	$8,385	42.5 %	$33,051	$19,840	66.6 %
Impairment charges and other, net of tax	—	—	—	6,572	1,566	319.7 %
Stock-based compensation, net of tax	2,221	1,561	42.3 %	6,041	4,791	26.1 %
Stockholder advisory expenses, net of tax	—	—	—	914	—	—
Adjusted net income	$14,171	$9,946	42.5 %	$46,578	$26,197	77.8 %

Following is a GAAP to non-GAAP reconciliation of adjusted diluted net income per share of common stock:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2015	2014	% Change	2015	2014	% Change
	(in thousands)					
Diluted net income per share of common stock (GAAP)	$0.48	$0.33	45.5 %	$1.32	$0.78	69.2 %
Impairment charges and other, net of tax	—	—	—	0.26	0.06	333.3 %
Stock-based compensation, net of tax	0.09	0.06	50.0 %	0.24	0.19	26.3 %
Stockholder advisory expenses, net of tax	—	—	—	0.04	—	—
Adjusted diluted net income per share of common stock	$0.57	$0.39	46.2 %	$1.86	$1.03	80.6 %

Liquidity and Capital Resources

We periodically evaluate our liquidity requirements, capital needs and availability of resources in view of, among other things, our expansion plans, potential acquisitions and other operating cash needs. To meet short-term liquidity requirements, which are primarily the payment of direct and operating expenses, we rely primarily on cash from operations. Longer-term projects or significant acquisitions may be financed with debt or equity. We have in the past sought, and may in the future seek, to raise additional capital or take other steps to increase or manage our liquidity and capital resources. We had $210.8 million in cash, cash equivalents and marketable securities at September 30, 2015, of which approximately $99.4 million was payable in early October 2015 for withheld federal and state income taxes, employment taxes and other payroll deductions, and approximately $40.5 million were customer prepayments that were payable in October 2015. At September 30, 2015, we had working capital of $76.4 million compared to $73.1 million at December 31, 2014. We currently believe that our cash on hand, marketable securities, cash flows from operations and availability under our credit facility will be adequate to meet our liquidity requirements for the remainder of 2015. We will rely on these same sources, as well as public and private debt or equity financing, to meet our longer-term liquidity and capital needs.

We have a $125 million revolving credit facility (“Facility”) with a syndicate of financial institutions. The Facility is available for working capital and general corporate purposes, including acquisitions. As of September 30, 2015, we had an outstanding $0.6 million letter of credit issued under the Facility. Please read Note 5 to the Consolidated Financial Statements, “Revolving Credit Facility,” for additional information.

Cash Flows from Operating Activities

Net cash used in operating activities in the first nine months of 2015 was $25.7 million. Our primary source of cash from operations is the comprehensive service fee and payroll funding we collect from our clients. Our cash and cash equivalents, and thus our reported cash flows from operating activities are significantly impacted by various external and internal factors, which are reflected in part by the changes in our balance sheet accounts. These include the following:

- Timing of client payments / payroll levels – We typically collect our comprehensive service fee, along with the client’s payroll funding, from clients at least one day prior to the payment of worksite employee payrolls and associated payroll taxes. Therefore, the last business day of a reporting period has a substantial impact on our reporting of operating cash flows. For example, many worksite employees are paid on Fridays; therefore, operating cash flows decrease in the reporting periods that end on a Friday or a Monday. In the period ended September 30, 2015, the last business day of the reporting period was a Wednesday, client prepayments were $40.5 million and accrued worksite employee payroll was $252.0 million. In the period ended September 30, 2014, the last business day of the reporting period was a Tuesday, client prepayments were $18.3 million and accrued worksite employee payroll was $211.0 million.

- Workers' compensation plan funding – Under our workers' compensation insurance arrangements, we make monthly payments to the carriers comprised of premium costs and funds to be set aside for payment of future claims ("claim funds"). These pre-determined amounts are stipulated in our agreements with the carriers, and are based primarily on

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anticipated worksite employee payroll levels and workers' compensation loss rates during the policy year. Changes in payroll levels from those that were anticipated in the arrangements can result in changes in the amount of cash payments, which will impact our reporting of operating cash flows. Our claim funds paid, based upon anticipated worksite employee payroll levels and workers' compensation loss rates, were $40.1 million in the first nine months of 2015 and $40.9 million in the first nine months of 2014. However, our estimate of workers' compensation loss costs was $47.8 million in the 2015 period and $37.7 million in the 2014 period, respectively. During the first nine months of 2015, we received $5.3 million for the return of excess claim funds related to the workers' compensation program. This resulted in an increase to working capital. During the first nine months of 2014, we paid the insurance carrier an additional $7.2 million in claim funds for prior policy years.

- Medical plan funding – Our health care contract with United establishes participant cash funding rates 90 days in advance of the beginning of a reporting quarter. Therefore, changes in the participation level of the United plan have a direct impact on our operating cash flows. In addition, changes to the funding rates, which are solely determined by United based primarily upon recent claim history and anticipated cost trends, also have a significant impact on our operating cash flows. At September 30, 2015, premiums owed and cash funded to United have exceeded Plan Costs, resulting in a $17.8 million surplus, $8.8 million of which is reflected as a current asset, and $9.0 million of which is reflected as a long-term asset on our Consolidated Balance Sheets. The premiums owed to United at September 30, 2015, were $8.9 million, which is included in accrued health insurance costs, a current liability, on our Consolidated Balance Sheets. Funding rates, as determined by United, resulted in an additional quarterly premium of $6.2 million at September 30, 2015 as compared to $20.1 million in additional quarterly premium at September 30, 2014.

- Operating results – Our net income has a significant impact on our operating cash flows. Our net income increased 66.6% to $33.1 million in the nine months ended September 30, 2015, compared to $19.8 million in the nine months ended September 30, 2014, due to higher gross profit. Please read "Results of Operations – Nine Months Ended September 30, 2015 Compared to Nine Months Ended September 30, 2014."

Cash Flows from Investing Activities

Net cash flows provided by investing activities were $20.3 million for the nine months ended September 30, 2015, primarily due to $12.2 million of proceeds from the sale of two aircraft and $18.1 million of marketable securities maturities and dispositions, net of purchases. These inflows were partially offset by property and equipment purchases of $10.0 million.

Cash Flows from Financing Activities

Net cash flows used in financing activities were $69.9 million for the nine months ended September 30, 2015, including $58.6 million in stock repurchases and $15.8 million in dividends paid.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We are primarily exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on the market values of our cash equivalent short-term investments and our available-for-sale marketable securities. In addition, borrowings under our Facility bear interest at a variable market rate. As of September 30, 2015, we had an outstanding $0.6 million letter of credit issued under the Facility. Please read Note 5 to the Consolidated Financial Statements, "Revolving Credit Facility," for additional information. The cash equivalent short-term investments consist primarily of overnight investments, which are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned on these investments. The available-for-sale marketable securities are subject to interest rate risk because these securities generally include a fixed interest rate. As a result, the market values of these securities are affected by changes in prevailing interest rates.

We attempt to limit our exposure to interest rate risk primarily through diversification and low investment turnover. Our investment policy is designed to maximize after-tax interest income while preserving our principal investment. As a result, our marketable securities consist of tax-exempt short and intermediate-term debt securities, which are primarily pre-refunded municipal bonds that are secured by escrow funds containing U.S. Government securities.

ITEM 4. CONTROLS AND PROCEDURES.

In accordance with the Securities Exchange Act of 1934 Rules 13a-15 and 15d-15, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that

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evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2015.

There has been no change in our internal controls over financial reporting that occurred during the three months ended September 30, 2015 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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PART II

ITEM 1. LEGAL PROCEEDINGS.

Please read Note 9 to the Consolidated Financial Statements, “Commitments and Contingencies,” which is incorporated herein by reference.

ITEM 1A. RISK FACTORS.

Forward-Looking Statements

The statements contained herein that are not historical facts are forward-looking statements within the meaning of the federal securities laws (Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934). You can identify such forward-looking statements by the words “expects,” “intends,” “plans,” “projects,” “believes,” “estimates,” “likely,” “possibly,” “probably,” “goal,” “opportunity,” “objective,” “target,” “assume,” “outlook,” “guidance,” “p “indicator” and similar expressions. Forward-looking statements involve a number of risks and uncertainties. In the normal course of business, Insperity, Inc., in an effort to help keep our stockholders and the public informed about our operations, may from time to time issue such forward-looking statements, either orally or in writing. Generally, these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of such plans or strategies, or projections involving anticipated revenues, earnings, unit growth, profit per worksite employee, pricing, operating expenses or other aspects of operating results. We base the forward-looking statements on our expectations, estimates and projections at the time such statements are made. These statements are not guarantees of future performance and involve risks and uncertainties that we cannot predict. In addition, we have based many of these forward-looking statements on assumptions about future events that may prove to be inaccurate. Therefore, the actual results of the future events described in such forward-looking statements could differ materially from those stated in such forward-looking statements. Among the factors that could cause actual results to differ materially are: (i) adverse economic conditions; (ii) regulatory and tax developments and possible adverse application of various federal, state and local regulations; (iii) the ability to secure competitive replacement contracts for health insurance and workers’ compensation insurance at expiration of current contracts; (iv) increases in health insurance costs and workers’ compensation rates and underlying claims trends, health care reform, financial solvency of workers’ compensation carriers, other insurers or financial institutions, state unemployment tax rates, liabilities for employee and client actions or payroll-related claims; (v) failure to manage growth of our operations and the effectiveness of our sales and marketing efforts; (vi) the impact of the competitive environment in the PEO industry on our growth and/or profitability; (vii) our liability for worksite employee payroll, payroll taxes and benefits costs; (viii) our liability for disclosure of sensitive or private information; (ix) our ability to integrate or realize expected returns on our acquisitions; (x) failure of our information technology systems; (xi) an adverse final judgment or settlement of claims against Insperity; and (xii) disruptions to our business resulting from the actions of certain stockholders. These factors are discussed in further detail in our 2014 Annual Report on Form 10-K under “Factors That May Affect Future Results and the Market Price of Common Stock” on page 18, and elsewhere in this report. Any of these factors, or a combination of such factors, could materially affect the results of our operations and whether forward-looking statements we make ultimately prove to be accurate.

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

The following table provides information about purchases by Insperity during the three months ended September 30, 2015, of equity securities that are registered by Insperity pursuant to Section 12 of the Exchange Act:

Period	Total Number of Shares Purchased(1)(2)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Announced Program(1)	Maximum Number of Shares Available for Purchase under Announced Program(1)
07/01/2015 – 07/31/2015	257,769	$50.99	257,605	980,227
08/01/2015 – 08/31/2015	157,069	47.40	157,069	823,158
09/01/2015 – 09/30/2015	120,085	43.61	120,085	703,073
Total	534,923	$48.28	534,759	

(1) Our Board has approved a program to repurchase shares of our outstanding common stock, including an additional one million shares authorized for repurchase in May 2015. During the three months ended September 30, 2015, 534,759 shares were repurchased under the program and 164 shares were withheld to satisfy tax withholding obligations for the vesting of restricted stock awards. As of September 30, 2015, we were authorized to repurchase an additional 703,073 shares under the program. Unless terminated earlier by resolution of the Board, the repurchase program will expire when we have repurchased all shares authorized for repurchase under the repurchase program.

(2) These shares include shares of restricted stock that were withheld to satisfy tax-withholding obligations arising in conjunction with the vesting of restricted stock. The required withholding is calculated using the closing sales price reported by the New York Stock Exchange on the date prior to the applicable vesting date. These shares are not subject to the repurchase program described above.

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ITEM 6. EXHIBITS.

(a) List of Exhibits

10.1(+)	*	Letter Agreement, dated August 28, 2015, by and between Insperity Holdings, Inc. and United HealthCare Insurance Company.
10.2(+)	*	Amendment to the Minimum Premium Financial Agreement, as amended effective January 1, 2013, by and between Insperity Holdings, Inc. and United HealthCare Insurance Company, effective as of January 1, 2015.
10.3(+)	*	Amendment to the Minimum Premium Administrative Services Agreement, as amended effective January 1, 2013, by and between Insperity Holdings, Inc. and United HealthCare Insurance Company, effective as of January 1, 2015.
31.1	*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	*	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.
101.INS	*	XBRL Instance Document.(1)
101.SCH	*	XBRL Taxonomy Extension Schema Document.
101.CAL	*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	*	XBRL Extension Definition Linkbase Document.
101.LAB	*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	*	XBRL Taxonomy Extension Presentation Linkbase Document.

(+) Confidential treatment has been requested for this exhibit and confidential portions have been filed with the Securities and Exchange Commission.

* Filed with this report.

** Furnished with this report.

(1) Attached as exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Operations for the three and nine month periods ended September 30, 2015 and 2014; (ii) the Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2015 and 2014; (iii) the Consolidated Balance Sheets at September 30, 2015 and December 31, 2014; (iv) the Consolidated Statement of Stockholders' Equity for the nine month period ended September 30, 2015; (v) the Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2015 and 2014; and (vi) Notes to the Consolidated Financial Statements.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	Insperity, Inc.
Date: November 2, 2015	By: /s/ Douglas S. Sharp Douglas S. Sharp Senior Vice President of Finance, Chief Financial Officer and Treasurer (Principal Financial Officer)

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