UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended May 31, 2006

Commission file number 0-11330

Paychex, Inc.

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

IRS Employer Identification Number: 16-1124166

Securities registered pursuant to Section 12(b) of the Act:	**None**
Securities registered pursuant to Section 12(g) of the Act:	**Common Stock, $.01 Par Value**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☑ No ☐

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☑

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☑

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐

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

As of November 30, 2005, the last business day of the most recently completed second fiscal quarter, shares held by non-affiliates of the registrant had an aggregate market value of $14,387,643,144 based on the closing price reported for such date on the NASDAQ Stock Market.

As of June 30, 2006, 380,333,725 shares of the registrant's common stock, $.01 par value, were outstanding.

Documents Incorporated by Reference

Portions of the registrant's definitive proxy statement to be issued in connection with its Annual Meeting of Stockholders to be held on October 5, 2006, to the extent not set forth herein, are incorporated herein by reference thereto into Part III, Items 10 through 14, inclusive.

TABLE OF CONTENTS

PART I

"SAFE HARBOR" STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain written and oral statements made by management of Paychex, Inc. and its wholly owned subsidiaries ("our," "we," "us") may constitute "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). Forward-looking statements are identified by such words and phrases as "we expect," "expected to," "estimates," "estimated," "current outlook," "we look forward to," "would equate to," "projects," "projections," "projected to be," "anticipates," "anticipated," "we believe," "could be," and other similar phrases. All statements addressing operating performance, events, or developments that we expect or anticipate will occur in the future, including statements relating to revenue growth, earnings, earnings-per-share growth, or similar projections, are forward-looking statements within the meaning of the Reform Act. Because they are forward-looking, they should be evaluated in light of important risk factors. These risk factors include, but are not limited to, the following and those that are described in "Risk Factors" under Item 1A and elsewhere in this Annual Report on Form 10-K ("Form 10-K"):

- general market and economic conditions, including, among others, changes in United States employment and wage levels, changes in new hiring trends, changes in short- and long-term interest rates, and changes in the market value and the credit rating of securities held by us;
- changes in demand for our products and services, ability to develop and market new products and services effectively, pricing changes and the impact of competition, and the availability of skilled workers;
- changes in the laws regulating collection and payment of payroll taxes, professional employer organizations, and employee benefits, including retirement plans, workers' compensation, state unemployment, and section 125 plans;
- changes in our Professional Employer Organization direct costs, including, but not limited to, workers' compensation rates and underlying claims trends;
- the possibility of failure to keep pace with technological changes and provide timely enhancements to products and services;
- the possibility of failure of our operating facilities, computer systems, and communication systems during a catastrophic event;
- the possibility of third-party service providers failing to perform their functions;
- the possibility of penalties and losses resulting from errors and omissions in performing services;
- the possible inability of our clients to meet their payroll obligations;
- the possible failure of internal controls or our inability to implement business processing improvements; and
- potentially unfavorable outcomes related to pending legal matters.

Any of these factors could cause our actual results to differ materially from our anticipated results. The information provided in this document is based upon the facts and circumstances known at this time. We undertake no obligation to update these forward-looking statements after the date of filing of this Form 10-K with the Securities and Exchange Commission ("SEC" or "Commission") to reflect events or circumstances after such date, or to reflect the occurrence of unanticipated events.

Item 1. *Business*

We are a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses in the United States ("U.S."). At

May 31, 2006, we serviced approximately 543,000 clients and had approximately 10,900 employees. We maintain our corporate headquarters in Rochester, New York, and have more than 100 offices nationwide.

We also have approximately 500 clients in Germany as of May 31, 2006, which are serviced through offices in Hamburg and Berlin. It is anticipated that sales offices in Munich and Dusseldorf will be operational early in the fiscal year ending May 31, 2007 (“fiscal 2007”).

Our company was formed as a Delaware corporation in 1979. We report our results of operations and financial condition as one business segment. Our fiscal year ends May 31.

Company Strategy

We are focused on achieving strong long-term financial performance by:

- Providing high-quality, timely, accurate, and affordable comprehensive payroll and integrated human resource services.
- Delivering these services utilizing a well-trained and responsive work force through a network of local and corporate offices servicing more than 100 of the largest markets in the U.S. and in Germany.
- Growing our client base, primarily through the efforts of our direct sales force.
- Continually improving client service and maximizing client retention.
- Capitalizing on the growth opportunities within our current client base and from new clients, by increasing utilization of our payroll-related and human-resource-related ancillary products and services.
- Capitalizing on and leveraging our highly developed technological and operating infrastructure.
- Supplementing our growth through strategic acquisition or expansion of service offerings when opportunities arise.

Market Opportunities

The outsourcing of business processes is a growing trend within the U.S. Outsourcing of the payroll and human resource functions allows small- to medium-sized businesses to minimize the administrative burden and compliance risks associated with increasingly complex and changing administrative requirements and federal, state, and local tax regulations. By utilizing the expertise of outsourcing service providers, businesses are better able to efficiently meet their compliance requirements and administrative burdens while, at the same time, providing competitive benefits for their employees. The technical capabilities, knowledge, and operational expertise that we have built, along with the broad portfolio of ancillary services we offer our clients, have enabled us to capitalize on the outsourcing trend.

We believe there are approximately 7.6 million employers in the geographic markets that we currently serve within the U.S. Of those employers, 99% have fewer than 100 employees and are our primary customers and target market. Based on publicly available industry data, we estimate that all payroll processors combined serve somewhere between 15% to 20% of the potential businesses in the target market, with much of the unpenetrated market being composed of businesses with ten or fewer employees. We remain focused on servicing small-to medium-sized businesses based upon the growth potential that we believe exists in this market segment.

Substantially all our revenue is generated within the U.S. We also generate revenue within Germany, which was less than 1% of our total revenue for the years ended May 31, 2006 and 2005.

Clients

We serve a diverse base of small- to medium-sized clients operating in a broad range of industries located throughout the continental U.S. At May 31, 2006, we serviced approximately 543,000 clients. We utilize service agreements and arrangements with clients that are generally terminable by the client at any time or upon relatively short notice. For the year ended May 31, 2006 ("fiscal 2006"), client retention was at a record level of slightly less than 80% of our beginning client base. The most significant factor contributing to client losses is companies going out of business. No single client has a material impact on total service revenue or results of operations.

The composition of the market and the client base we serve (in the U.S.) by employee size is as follows:

Business size (Number of employees)	Estimated market distribution (7.6 million businesses in areas served)	Paychex, Inc. percentage of client base
1-4	73%	39%
5-19	20%	42%
20-49	5%	13%
50-99	1%	4%
100+	1%	2%

Products and Services

We offer a comprehensive portfolio of payroll, payroll-related, and human resource products and services to meet the diverse needs of our client base. These include:

- payroll processing;
- payroll tax administration services;
- employee payment services;
- regulatory compliance services (new-hire reporting and garnishment processing);
- comprehensive human resource administrative services;
- retirement services administration;
- workers' compensation insurance administration;
- employee benefits administration;
- time and attendance solutions; and
- other human resource products and services.

By offering ancillary services that leverage the information gathered in the base payroll processing service, we are able to provide comprehensive outsourcing services that allow employers to expand their employee benefits offerings at an affordable cost. We earn our revenue primarily through recurring fees for services performed. Service revenue is primarily driven by the number of clients, utilization of ancillary services, and checks or transactions per client per pay period.

Payroll Processing

Payroll processing is the foundation of our service portfolio. Our payroll service includes the calculation, preparation, and delivery of employee payroll checks; production of internal accounting records and management reports; and the preparation of federal, state, and local payroll tax returns. Payroll processing clients are charged a base fee each period that payroll is processed, plus a fee per employee check processed.

The Core Payroll service is generally targeted at clients with one to forty-nine employees, although many clients with fifty or more employees utilize this service. Our average Core Payroll client employs approximately thirteen people and processes approximately thirty payrolls each year. These figures are impacted year-over-year as larger clients, generally fifty or more employees, convert to our Major Market Services ("MMS").

Core Payroll clients may communicate their payroll information, including hours worked by each employee and any personnel or compensation changes, by telephone, fax, use of the Paychex Paylink®

software, or the Internet. Each client is assigned a payroll specialist who is trained extensively and continuously in all facets of payroll preparation and applicable tax regulations. Clients receive payroll checks and reports from either a delivery service, the U.S. Postal Service, or by picking them up at the local Paychex branch.

We also offer Core Payroll services to our clients and their accountants through Paychex Online. This secure Internet site offers clients a suite of interactive, self-service products and services twenty-four hours a day, seven days a week. These include Paychex Online Payroll℠, Internet Time Sheet, Paychex Online Reports, and General Ledger Reporting Service. Clients can communicate payroll information through the Internet Time Sheet or use the Online Payroll service, and can access current and historical payroll information using Paychex Online Reports. The General Ledger Reporting Service transfers payroll information calculated by us to the clients' general ledger accounting software, eliminating manual entries and improving the accuracy of bookkeeping. Over 180,000 clients are currently utilizing some form of Paychex Online service.

MMS primarily targets companies that have more complex payroll and benefits needs or have outgrown our Core Payroll service, as well as new clients that have fifty or more employees. We currently offer this service in all of our significant markets. Approximately one-third of new MMS clients are conversions from our Core Payroll service.

Most MMS clients communicate their payroll information to us using our Preview® software. Preview provides clients with in-house control of payroll and human resource information because the software and the payroll and human resource database reside on the clients' personal computer or personal computer network. Clients can produce reports and checks at their convenience. We handle the software maintenance and provide the client ancillary products and services as requested.

Ancillary Products and Services

We provide our clients with a portfolio of ancillary products and services that have been developed and refined over many years. Ancillary products and services provide us with additional recurring revenue streams and increased service efficiencies as these products are integrated with payroll processing services. We offer the following ancillary products and services:

Payroll Tax Administration Services: As of May 31, 2006, 92% of our clients utilized our payroll tax administration services (including Taxpay®), which provide accurate preparation and timely filing of quarterly and year-end tax returns, as well as the electronic transfer of funds to the applicable tax or regulatory agencies (federal, state, and local). More than 95% of new clients purchase our payroll tax administration services. We believe that the client utilization percentage of these services is near maturity. In connection with these services, we electronically collect payroll taxes from clients' bank accounts, typically on payday, prepare and file the applicable tax returns, and remit taxes to the applicable tax or regulatory agencies on the respective due dates. These taxes are typically paid between one and thirty days after receipt of collections from clients, with some items extending to ninety days. We handle all regulatory correspondence, amendments, and penalty and interest disputes, and we are subject to cash penalties imposed by tax or regulatory agencies for late filings and late or under payments of taxes. Clients utilizing the payroll tax administration services are charged a base fee and a fee per transaction for each period that payroll is processed. In addition to fees paid by clients, we earn interest on client funds that are collected before due dates and invested until remittance to the applicable tax or regulatory agencies.

Employee Payment Services: As of May 31, 2006, 68% of our clients utilized our employee payment services, which provide the employer the option of paying their employees by direct deposit, Paychex Access Visa® Card, a check drawn on a Paychex account (Readychex®), or a check drawn on the employer's account and electronically signed by us. More than 75% of new clients purchase some form of employee payment services. For the first three methods, we electronically collect net payroll from the clients' bank account, typically one day before payday, and provide payment to the employee on payday. Our flexible payment options provide a cost-effective solution that offers the benefit of convenient, one-step payroll account reconciliation for employers. Clients utilizing employee payment services are charged a base fee for each period that payroll is processed and a fee per transaction or per employee depending on the service provided. In addition to fees paid by clients, we earn interest on client funds that are collected before pay dates and invested until remittance to clients' employees.

The payroll tax administration services and employee payment services are integrated with our payroll processing service. Interest earned on funds held for clients is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services.

Regulatory Compliance Services: We offer new-hire reporting services, which enable clients to comply with federal and state requirements to report information on newly hired employees, to aid the government in enforcing child support orders, and to minimize fraudulent unemployment and workers' compensation insurance claims. Our garnishment processing service provides deductions from employees' pay, forwards payments to third-party agencies, including those that require electronic payments, and tracks the obligation to fulfillment. These services enable employers to comply with legal requirements and reduce the risk of penalties.

Comprehensive Administrative Services: The Paychex Premier^{sm} Human Resource Services ("Paychex Premier") provide businesses a full-service approach to the outsourcing of employer and employee administrative needs. Paychex Premier offers businesses a combined package of services that includes payroll, employer compliance, human resource and employee benefits administration, risk management outsourcing, and the on-site availability of a professionally trained human resource representative. This comprehensive bundle of services is designed to make it easier for businesses to manage their payroll and benefit costs while providing a benefits package equal to that of larger companies. We also operate a Professional Employer Organization ("PEO"), which provides businesses with primarily the same services as Paychex Premier, except we serve as a co-employer of the clients' employees, assume the risks and rewards of workers' compensation insurance, and provide more sophisticated health care offerings to PEO clients. Our PEO service is available primarily for clients domiciled in Florida and Georgia, where the utilization of PEOs is more prevalent than other areas of the U.S. We offer our PEO service through our subsidiary, Paychex Business Solutions, Inc. For these two services, the client pays a fee per employee per processing period. As of May 31, 2006, Paychex Premier serviced over 236,000 client employees and our PEO product serviced approximately 59,000 client employees.

Retirement Services Administration: Our Retirement Services product line offers a variety of options to clients, including 401(k) plans, 401(k) SIMPLE, SIMPLE IRA, 401(k) plans with safe harbor provisions, profit sharing, and money purchase plans. These services provide plan implementation, ongoing compliance with government regulations, employee and employer reporting, participant and employer access online, electronic funds transfer, and other administrative services. Selling efforts for these services are focused primarily on our existing payroll client base, as the processed payroll information allows for data integration necessary to provide these services efficiently. Retirement Services were utilized by over 38,000 clients at May 31, 2006. This demonstrates the continuing interest of small- to medium-sized businesses in providing retirement savings benefits to their employees. We believe that we are now one of the largest 401(k) recordkeepers for small businesses in the U.S. Clients utilizing this service are charged a one-time set up fee, a monthly recurring fee, and a fee per employee. Client employee 401(k) funds externally managed totaled approximately $6.3 billion at May 31, 2006. We earn a fee approximating forty basis points from the external managers based on the total of client employee 401(k) funds.

Workers' Compensation Insurance Administration: Most employers are required to carry workers' compensation insurance, which provides payments to employees who are unable to work because of job-related injuries. We provide workers' compensation insurance administration services by serving, through our licensed insurance agency, as a general agent providing qualified workers' compensation insurance through a variety of insurance carriers who are underwriters. Our Workers' Compensation Payment Service uses rate and job classification information to enable clients to pay workers' compensation premiums in regular monthly amounts rather than with large up-front payments, which stabilizes their cash flow and minimizes year-end adjustments. Our Workers' Compensation Report Service provides our clients with comprehensive information to allow them to better manage workers' compensation insurance costs. As of May 31, 2006, over 52,000 clients utilized the workers' compensation insurance administration services.

Employee Benefits Administration: We offer the outsourcing of plan administration under section 125 of the Internal Revenue Code. The Premium Only Plan allows employees to pay for certain health insurance benefits with pretax dollars, which can result in a reduction in payroll taxes for employers and employees. The Flexible Spending Account Plan allows our clients' employees to pay, with pretax dollars, health and dependent care expenses not covered by insurance. All required implementation, administration, compliance, claims processing and reimbursement, and coverage tests are provided with these services. The Health Savings Account product serves as a tax savings tool for employers and employees, allowing individuals to save money tax-free to pay for qualified medical expenses now and in the future. It also provides the means to manage rising health insurance premiums.

Time and Attendance Solutions: We offer Time In A Box® and other time and attendance solutions, which help employers minimize the time spent compiling time sheet information. These computer-based systems allow the employer flexibility to handle multiple payroll scenarios and result in improved productivity, accuracy, and reliability in the payroll process. Certain clients are charged a monthly fee for use of hardware, software, and support. Clients also have the option to purchase the hardware and software with annual maintenance contracts. Time In A Box is marketed to our small- to medium-sized clients, while other time and attendance solutions are marketed to larger clients.

Other Human Resource Products and Services: Group health benefits are offered in select geographic areas, as are state unemployment insurance services, which provide clients with prompt processing for all claims, appeals, determinations, change statements, and requests for separation documents. Other Human Resource Services products include employee handbooks, management manuals, and personnel and required regulatory forms. These products are designed to simplify clients' office processes and enhance their employee benefits programs.

Sales and Marketing

We market our services primarily through our direct sales force based in the metropolitan markets we serve. Our sales representatives specialize in Core Payroll, MMS payroll, or Human Resource Services product lines. For fiscal 2007, our sales force is expected to total approximately 2,035, with 1,190 for Core Payroll (including international), 225 for MMS payroll, and 620 for various Human Resource Services products. The Human Resource Services sales force includes 285 human resources and Retirement Services sales representatives, 190 Paychex Premier and PEO sales representatives, 110 licensed agents selling workers' compensation insurance and health and benefits services, and 35 time and attendance solution sales representatives. Growth in the direct sales force results from the offering of new products and services, particularly as it relates to licensed agents for health and benefits and the continued expansion within Germany. The direct sales force has grown with the addition of time and attendance solutions. The complexity of the time and attendance solutions requires specialized sales representatives.

In addition to our direct selling and marketing efforts, we utilize relationships with existing clients, certified public accountants ("CPAs"), and banks for new client referrals. Approximately two-thirds of our new clients (excluding acquisitions) come from these referral sources. To further enhance our strong relationship with CPAs, we have partnered with the American Institute of Certified Public Accountants ("AICPA") as the preferred payroll provider for its AICPA Business Solutions Partner Program. During the year ended May 31, 2005, the program was expanded to include our Retirement Services and MMS.

Our website at www.paychex.com, which includes online payroll sales presentations and product and service information, is a cost-efficient tool that serves as a source of leads and new sales while complementing the efforts of our direct sales force. This online tool allows us to market to clients in more geographically remote areas. Our sales representatives are also supported by marketing, advertising, public relations, trade shows, and telemarketing programs. We have grown and expect to continue to grow our direct sales force. In recent years, we have increased our emphasis on the selling of ancillary services to both new clients and our existing client base.

In addition, Advantage Payroll Services, Inc. ("Advantage") has license agreements with fifteen independently owned associate offices ("Associates"), which are responsible for selling and marketing Advantage payroll services and performing certain operational functions, while Paychex, Inc. and Advantage provide all centralized back-office payroll processing and payroll tax administration services. In addition, Advantage has a relationship with New England Business Service, Inc. ("NEBS®") whereby Advantage performs all client functions other than sales and marketing. The marketing and selling by both Associates and NEBS is conducted under their respective logos.

Competition

The market for payroll processing and human resource services is highly competitive and fragmented. We believe our primary national competitor, ADP® ("Automatic Data Processing, Inc."), is the largest U.S. third-party provider of payroll processing and human resource services in terms of revenue. We compete with other national, regional, local, and online service providers, all of which we believe have significantly smaller client bases than us.

In addition to traditional payroll processing and human resource service providers, we compete with in-house payroll and human resource systems and departments. Payroll and human resource systems and software are sold by many vendors. Our Human Resource Services products also compete with a variety of providers of human resource services, such as retirement services companies, insurance companies, and human resources and benefits consulting firms.

Competition in the payroll processing and human resource services industry is primarily based on service responsiveness, product quality and reputation, breadth of product and service offering, and price. We believe we are competitive in each of these areas.

Software Maintenance and Development

The ever-changing mandates of federal, state, and local tax or regulatory agencies require us to regularly update the proprietary software we utilize to provide Payroll and Human Resource Services to our clients. We are continually engaged in developing enhancements to and maintenance of our various software platforms to meet the changing requirements of our clients and the marketplace.

Employees

As of May 31, 2006, we employed approximately 10,900 people. None of our employees were covered by collective bargaining agreements.

Intellectual Property

We own or license and use a number of trademarks, trade names, copyrights, service marks, trade secrets, computer programs and software, and other intellectual property rights. Taken as a whole, our intellectual property rights are material to the conduct of our business. Where it is determined to be appropriate, we take measures to protect our intellectual property rights, including, but not limited to, confidentiality/non-disclosure agreements or policies with employees, vendors, and others; license agreements with licensees and licensors of intellectual property; and registration of certain trademarks. We believe that the "Paychex" name, trademark, and logo are of material importance to us.

Seasonality

There is no significant seasonality to our business. However, during our third fiscal quarter, which ends in February, the number of new Payroll clients, new Retirement Services clients, and new Paychex Premier and PEO worksite employees tends to be higher than during the rest of the fiscal year, primarily because a majority of new clients begin using our services in the beginning of a calendar year. In addition, calendar year-end transaction processing and client funds activity are traditionally higher during the third fiscal quarter due to clients paying year-end bonuses and requesting additional year-end services. Historically, as a result of these factors, our total revenue has been slightly higher in the third fiscal quarter, with greater sales commission expenses also reported in this quarter.

Other

Information about our products and services, stockholder information, press releases, and filings with the SEC can be found on our website at www.paychex.com. Our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and other SEC filings, and any amendments to such reports and filings, are made available, free of charge, on the Investor Relations section of our website as soon as reasonably practical after such material is filed with, or furnished to, the SEC. Also, copies of our Annual Report to Stockholders and Proxy Statement, to be issued in connection with our 2006 Annual Meeting of Stockholders, will be made available, free of charge, upon written request submitted to Paychex, Inc., c/o Corporate Secretary, 911 Panorama Trail South, Rochester, New York 14625-2396.

Item 1A. ***Risk Factors***

Our future results of operations are subject to a number of risks and uncertainties. These risks and uncertainties could cause actual results to differ materially from historical and current results and from our projections. Important factors known to us that could cause such differences include, but are not limited to, those discussed below and those contained in the "Safe Harbor" statement at the beginning of Part I of this Form 10-K.

We may make errors and omissions in providing services, which could result in significant penalties and liabilities for us: Processing, tracking, collecting, and remitting client funds to the applicable tax or regulatory agencies, client employees, and other third parties are complex operations. These tasks could be subject to error and these errors could include, but are not limited to, late filing with applicable tax or regulatory agencies, underpayment of taxes, and failure to comply with applicable banking regulations and laws relating to employee benefits administration, which could result in significant penalties and liabilities that would adversely affect our results of operations. We could also transfer funds in error to an incorrect party or for the wrong amount, and may be unable to correct the error or recover the funds, resulting in a loss to us.

Our business and reputation may be affected by our ability to keep clients' information confidential: Our business involves the use of significant amounts of private and confidential client information including employees identification numbers, bank accounts, and retirement account information. This information is critical to the accurate and timely provision of services to our clients, and certain information may be transmitted via the Internet. There is no guarantee that our systems and processes are adequate to protect against all security breaches. If our systems are disrupted or fail for any reason, or if our systems are infiltrated by unauthorized persons, our clients could experience data loss, financial loss, harm to reputation, or significant business interruption. Such events may expose us to unexpected liability, litigation, regulation investigation and penalties, loss of clients business, unfavorable impact to business reputation, and there could be a material adverse effect on our business and results of operations.

We may be adversely impacted by changes in government regulations and policies: Many of our services, particularly payroll tax administration services and benefit plan administration services, are designed according to government regulations that continue to change. Changes in regulations could affect the extent and type of benefits employers are required, or may choose, to provide employees or the amount and type of taxes employers and employees are required to pay. Such changes could reduce or eliminate the need for some of our services and substantially decrease our revenue. Added requirements could also increase our cost of doing business. Failure by us to modify our services in a timely fashion in response to regulatory changes could have adverse effects on our business and results of operations.

We may be adversely impacted by failure of third-party service providers to perform their functions: As part of providing services to clients, we rely on a number of third-party service providers. These providers include, but are not limited to, couriers used to deliver client payroll checks and banks used to electronically transfer funds from clients to their employees. Failure by these providers, for any reason, to deliver their services in a timely manner could result in material interruptions to our operations, impact client relations, and result in significant penalties or liabilities to us.

In the event of a catastrophe our business continuity plan may fail, which could result in the loss of client data and adversely interrupt operations: Our operations are dependent on our ability to protect our infrastructure against damage from catastrophe or natural disaster, unauthorized security breach, power loss, telecommunications failure, terrorist attack, or other events that could have a significant disruptive effect on our operations. We have a business continuity plan in place in the event of system failure due to any of these events. If the business continuity plan is unsuccessful in a disaster recovery scenario, we could potentially lose client data or experience material adverse interruptions to our operations or delivery of services to our clients.

We may not be able to keep pace with changes in technology: To maintain our growth strategy, we must adapt and respond to technological advances and technological requirements of our clients. Our future success will depend on our ability to enhance capabilities and increase the performance of our internal use systems, particularly our systems that meet our clients' requirements. We continue to make significant investments related to the development of new technology. If our systems become outdated, we may be at a disadvantage when competing in our industry. There can be no assurance that our efforts to update and integrate systems will be successful. If we do not timely integrate and update our systems, or if our investments in technology fail to provide the expected results, there could be an adverse impact to our business and results of operations.

We may not realize the anticipated benefits from acquisitions: The effective integration of acquired companies may be difficult to achieve. It is also possible that we may not realize any or all expected benefits from acquisitions or achieve benefits from acquisitions in a timely manner. In addition, we may incur significant costs and management's time and attention may be diverted in connection with the integration of acquisitions. Failure to effectively integrate future acquisitions could affect our results of operations. We currently have no definitive agreements or current plans with respect to any material prospective acquisitions.

We may have an adverse outcome of legal matters, which could harm our business: We are subject to various claims and legal matters that arise in the normal course of business. These include disputes or potential disputes related to breach of contract, employment-related claims, tax claims, and other matters. As of May 31, 2006, we have a reserve of $15.6 million for pending legal matters. See Item 3 of this Form 10-K for additional disclosure. In light of the legal reserve recorded, our management currently believes that resolution of these matters will not have a material adverse effect on our financial position or results of our operations. However, these matters are subject to inherent uncertainties and there exists the possibility that their ultimate resolution could have a material adverse impact on our financial position and results of operations in the period in which any such effect is recorded.

We may experience a loss as the result of our clients having insufficient funds to cover payments we have made on their behalf to applicable tax or regulatory agencies and employees: As part of the payroll processing service, we are authorized by our clients to transfer money from their bank accounts to fund amounts owed to their employees and applicable tax or regulatory agencies. It is possible that we would be held liable for such amounts in the event the client has insufficient funds to cover them. We have in the past, and may in the future, make payments on our clients' behalf for which we are not reimbursed, resulting in a loss to us.

Our interest earned on funds held for clients may be impacted by changes in government regulations mandating the amount of tax withheld or timing of remittance: We receive interest income from investing client funds collected but not yet remitted to applicable tax or regulatory agencies or to client employees. A change in regulations either decreasing the amount of taxes to be withheld or allowing less time to remit taxes to applicable tax or regulatory agencies would adversely impact this interest income.

We may be exposed to additional risks related to a foreign operation as a result of our business in Germany: We currently have approximately 500 clients in Germany. As a result, our business is subject to political and economic instability unrelated to our operations in the U.S. Additionally, our business in Germany exposes us to currency fluctuations and we must operate under legal and tax regulations that differ from those of the U.S. We do not currently hedge our foreign currency transactions due to the relatively insignificant amounts. Our entry into foreign operations requires a significant investment and management's attention. There can be no assurance that our investment in Germany will produce expected levels of revenue or that other factors noted previously will not harm our business.

Quantitative and qualitative disclosures about market risk: Refer to Item 7A of this Form 10-K for a discussion on Market Risk Factors.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

We owned and leased the following properties at May 31, 2006:

	Square feet
Owned facilities:	
Rochester, New York*	668,000
Other U.S. locations	105,000
Total owned facilities	773,000
Leased facilities:	
Rochester, New York	79,000
Other U.S. locations	2,040,000
Germany	1,000
Total leased facilities	2,120,000

* Includes the 140,000-square-foot building complex of our corporate headquarters located at 911 Panorama Trail South, Rochester, New York 14625.

Our facilities in Rochester, New York house various distribution, processing, and technology functions, certain ancillary functions, a telemarketing unit, and other back-office functions. Facilities outside of Rochester, New York are at various locations throughout the U.S. and Germany and house our regional, branch, and sales offices and data processing centers. These locations are concentrated in metropolitan areas. We believe that adequate, suitable lease space will continue to be available for our needs.

Item 3. ***Legal Proceedings***

We are subject to various claims and legal matters that arise in the normal course of our business. These include disputes or potential disputes related to breach of contract, employment-related claims, tax claims, and other matters.

We and our wholly owned subsidiary, Rapid Payroll, Inc. ("Rapid Payroll"), are currently defendants in three lawsuits pending in the United States Bankruptcy Court, Central District of California, thirteen lawsuits pending in the United States Court of Appeals for the Ninth Circuit, and one lawsuit pending in the California Court of Appeal, Second District, all brought in calendar years 2002 and 2003 by licensees of payroll processing software owned by Rapid Payroll.

In August 2001, Rapid Payroll informed seventy-six licensees that it intended to stop supporting the payroll processing software in August of 2002. Thereafter, lawsuits were commenced by licensees asserting various claims, including breach of contract and related tort and fraud causes of action. These lawsuits sought compensatory damages, punitive damages, and injunctive relief against Rapid Payroll, us, our former Chief Executive Officer, and our Senior Vice President of Sales and Marketing. In accordance with our indemnification agreements with our senior executives, we will defend and, if necessary, indemnify them in connection with these pending matters.

On July 5, 2002, the federal district court entered a preliminary injunction requiring that Rapid Payroll and us continue to support and maintain the subject software pursuant to the license agreements.

In 2005, judgment was entered in *Accuchex, Inc. v. Rapid Payroll, Inc., et al.* following a bench trial before a judge of the Los Angeles County Superior Court. The judgment provided that the limitation of liability clause in the parties' license agreement is valid and enforceable. The court awarded Accuchex damages of $30.5 thousand plus a refund of approximately $35.0 thousand in license fees. The court also ordered Rapid Payroll to support its software being used by Accuchex until such time as Rapid Payroll dissolves, which the court found Rapid Payroll was entitled to do without incurring any further liability to Accuchex. The court rejected all of the other causes of action asserted by the plaintiff. The case is pending on appeal with the California Court of Appeal, Second District.

On February 28 and March 1, 2005, the United States District Court, Central District of California entered judgment in thirteen of the cases pending before it. Those judgments provided that Rapid Payroll's liability is limited by the license fees paid to it by the plaintiff licensees, pursuant to express contractual provisions of the license agreements. Those judgments also extended the court's preliminary injunction, ordering that Rapid Payroll must support the licensed software through April 30, 2006, and, at that time, refund to each of the licensee plaintiffs the license fees paid by that plaintiff. The license fees received by Rapid Payroll under the agreements from these thirteen licensee plaintiffs total approximately $2.5 million. The federal court also ordered the release of the source code pursuant to the escrow terms of the license agreements. The federal court judgments rejected the fraud and other tort claims brought by those plaintiffs against all of the defendants. Plaintiffs have appealed the federal court rulings and we have cross-appealed.

On May 4, 2006, following expiration of the federal district court's injunction, Rapid Payroll filed a petition under Chapter 11 of the U.S. Bankruptcy Code in order to develop a plan that allows Rapid Payroll to discontinue support for the software in a manner that deals fairly with its few remaining licensees. Rapid Payroll is continuing to operate as a debtor-in-possession, paying all of its post-petition debts as they become due.

Based on the application of Statement of Financial Accounting Standard ("SFAS") No. 5, "Accounting for Contingencies," we are required to record a reserve if we believe an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated. Our legal reserve for all litigation totaled $15.6 million at May 31, 2006, and is included in current liabilities on the Consolidated Balance Sheets. The legal reserve has been reduced during fiscal 2006 as actual settlements and incurred professional fees have been charged against it.

In light of the legal reserve recorded, our management currently believes that resolution of these matters will not have a material adverse effect on our financial position or results of operations. However, these matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse impact on our financial position and results of operations in the period in which any such effect is recorded.

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

No matters were submitted to a vote of security holders, through the solicitation of proxies or otherwise, during the three months ended May 31, 2006.

PART II

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

Our common stock trades on The NASDAQ Stock Market® under the symbol "PAYX." Dividends have historically been paid in August, November, February, and May. The level and continuation of future dividends are dependent on our future earnings and cash flows, and are subject to the discretion of the Board of Directors.

On June 30, 2006, there were 18,240 holders of record of our common stock, which includes registered holders and participants in the Paychex, Inc. Dividend Reinvestment and Stock Purchase Plan. There were also 9,284 participants in the Paychex, Inc. Employee Stock Purchase Plan and 6,556 participants in the Paychex, Inc. Employee Stock Ownership Plan.

The high and low sale prices for our common stock as reported on The NASDAQ Stock Market and dividends for each of the years ended May 31, 2006 and 2005, are as follows:

	Fiscal 2006			Fiscal 2005		
	Sales prices		Cash dividends declared per share	Sales prices		Cash dividends declared per share
	High	Low		High	Low	
First quarter	$35.37	$28.60	$ 0.13	$38.88	$28.83	$ 0.12
Second quarter	$43.37	$32.37	$ 0.16	$34.45	$29.25	$ 0.13
Third quarter	$43.20	$35.52	$ 0.16	$34.57	$29.69	$ 0.13
Fourth quarter	$42.37	$36.11	$ 0.16	$34.69	$28.88	$ 0.13

The closing price of our common stock on May 31, 2006, as reported on The NASDAQ Stock Market, was $36.71 per share.

Item 6. *Selected Financial Data*

In thousands, except per share amounts Year ended May 31,	2006	2005	2004	2003	2002
Service revenue	$ 1,573,797	$ 1,384,674	$ 1,240,093	$ 1,046,029	$ 892,189
Interest on funds held for clients	100,799	60,469	54,254	53,050	62,721
Total revenue	$ 1,674,596	$ 1,445,143	$ 1,294,347	$ 1,099,079	$ 954,910
Operating income	$ 649,571	$ 533,775	$ 433,315	$ 401,041	$ 363,694
As a % of total revenue	39%	37%	33%	36%	38%
Net income	$ 464,914	$ 368,849	$ 302,950	$ 293,452	$ 274,531
As a % of total revenue	28%	26%	23%	27%	29%
Diluted earnings per share	$ 1.22	$ 0.97	$ 0.80	$ 0.78	$ 0.73
Cash dividends per common share	$ 0.61	$ 0.51	$ 0.47	$ 0.44	$ 0.42
Purchases of property and equipment	$ 81,143	$ 70,686	$ 50,562	$ 60,212	$ 54,378
Total assets	$ 5,549,302	$ 4,617,418	$ 3,950,203	$ 3,690,783	$ 2,953,075
Total debt	$ —	$ —	$ —	$ —	$ —
Stockholders' equity	$ 1,654,843	$ 1,385,676	$ 1,199,973	$ 1,077,371	$ 923,981
Return on stockholders' equity	30%	28%	28%	29%	32%

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

Management's Discussion and Analysis of Financial Condition and Results of Operations reviews the operating results of Paychex, Inc. ("we," "our," or "us") for each of the three fiscal years ended May 31, 2006 ("fiscal 2006"), May 31, 2005 ("fiscal 2005"), and May 31, 2004 ("fiscal 2004"), and our financial condition at May 31, 2006. This review should be read in conjunction with the accompanying Consolidated Financial Statements and the related Notes to Consolidated Financial Statements contained in Item 8 of this Annual Report on Form 10-K ("Form 10-K") and the "Risk Factors" discussed in Item 1A of this Form 10-K. Forward-looking statements in this review are qualified by the cautionary statement under the heading "Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995 contained at the beginning of Part I of this Form 10-K.

Overview

We are a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses. Our Payroll and Human Resource Services product lines offer a portfolio of products and services that allow our clients to meet their diverse payroll and human resource needs.

Our Payroll services are provided through either our Core Payroll or Major Market Services ("MMS") and include:

- payroll processing;
- payroll tax administration services;
- employee payment services; and
- other payroll-related services including regulatory compliance (new-hire reporting and garnishment processing).

MMS is utilized by clients that have more complex payroll and benefits needs. While MMS is focused on the more than fifty employees market segment, MMS has many clients with less than fifty employees that have more complex payroll requirements.

Our Human Resource Services primarily include:

- comprehensive human resource administrative services, which include Paychex Premier℠ Human Resources ("Paychex Premier") and our Professional Employer Organization ("PEO");
- retirement services administration;
- workers' compensation insurance administration;
- employee benefits administration;
- time and attendance solutions; and
- other human resource products and services.

We earn revenue primarily through recurring fees for services performed related to our products. Service revenue is primarily driven by the number of clients, utilization of ancillary services, and checks or transactions per client per pay period. We also earn interest on funds held for clients between the time of collection from our clients and remittance to the applicable tax or regulatory agencies or client employees. Our strategy is focused on achieving strong long-term financial performance while providing high-quality, timely, accurate, and affordable services, growing our client base, increasing utilization of our ancillary services, and leveraging our technological and operating infrastructure.

Fiscal 2006 was our sixteenth consecutive year of record total revenue, net income, and diluted earnings per share. Our financial results for fiscal 2006 included the following highlights:

- Net income increased 26% to $464.9 million.
- We achieved $1.22 diluted earnings per share in fiscal 2006, an increase of 26%.
- Total revenue increased 16% to $1,674.6 million.
- Payroll service revenue increased 10% to $1,248.9 million.
- Human Resource Services revenue increased 29% to $324.9 million.
- Operating income increased 22% to $649.6 million. Operating income excluding interest on funds held for clients increased 16% to $548.8 million.
- Cash flow from operations increased 22% to $569.2 million.
- Dividends of $231.5 million were paid to stockholders, representing 50% of net income.

Our financial performance in fiscal 2006 was largely due to strong service revenue growth of 14%. This growth in service revenue was attributable to growth in client base, check volume, and utilization of ancillary services.

Our financial performance was also positively impacted by the effects of increases in interest rates earned on our funds held for clients and corporate investment portfolios. The Federal Reserve increased the Federal Funds rate by 200 basis points in fiscal 2005 and by another 200 basis points in fiscal 2006 to a rate of 5.00% at May 31, 2006. Our combined interest on funds held for clients and corporate investment income increased 73% for fiscal 2006. In fiscal 2006, our combined portfolios earned an average rate of return of 3.2%, increased from 2.2% in fiscal 2005 and 1.8% in fiscal 2004. The impact of changing interest rates and related risks is discussed in more detail in the "Market Risk Factors" section in Item 7A of this Form 10-K.

We continue to make investments in our business as part of our growth strategy. Some of these investments include the following:

Growing the client base and increasing utilization of ancillary services: Our client base increased to approximately 543,000 clients at May 31, 2006. This compares with approximately 522,000 clients at May 31, 2005, and approximately 505,000 clients at May 31, 2004. Client growth was approximately 4.0% for fiscal 2006, compared with approximately 3.5% for fiscal 2005.

We have continued to invest in our direct sales force, as we believe there is opportunity for growth within our target market of small- to medium-sized businesses. The approximate composition of our direct sales force is summarized in the following table:

For fiscal year ended May 31,	Expected 2007	Change	2006	Change	2005	Change	2004
Core Payroll (including international)	1,190	7%	1,115	6%	1,050	7%	985
MMS payroll	225	15%	195	15%	170	13%	150
Human Resources/ Retirement Services	285	19%	240	9%	220	10%	200
Paychex Premier and PEO	190	19%	160	14%	140	33%	105
Licensed agents for workers' compensation and health and benefits	110	57%	70	40%	50	25%	40
Time and attendance solutions	35	40%	25	25%	20	100%	—
Total sales representatives	2,035	13%	1,805	9%	1,650	12%	1,480

We believe there are opportunities for growth within our current client base, as well as with new clients, through increased utilization of our payroll-related and human resource ancillary services. Ancillary services effectively leverage payroll processing data and, therefore, are beneficial to our operating margin. Penetration of our payroll tax administration services has continued to increase, and was 92% at May 31, 2006, compared with 90% at May 31, 2005, and 89% at May 31, 2004. Employee payment services penetration has increased to 68% at May 31, 2006, compared with 65% at May 31, 2005, and 63% at May 31, 2004. Our client bases in the Human Resource Services areas have continued to grow, as shown in the following table:

As of May 31,	2006	2005	2004
Retirement Services clients	38,000	33,000	29,000
Workers' compensation insurance clients	52,000	44,000	37,000
Paychex Premier worksite employees	236,000	171,000	106,000
PEO worksite employees	59,000	54,000	51,000

Product and service initiatives: During fiscal 2006, we made investments to broaden our portfolio of products and services and expand into new markets, and:

- Enhanced our 401(k) recordkeeping service, allowing our clients use of our recordkeeping with significantly expanded investment choices.

- Developed an online time and labor management tool to be added to our suite of time and attendance solutions to better serve our MMS clients.
- Continued our expansion within Germany.
- Expanded our health benefits nationwide, simplifying the process for our clients in obtaining coverage through our network of national and regional insurers.
- Released our Health Savings Account product, which serves as a tax savings tool for employers and employees, allowing individuals to save money tax-free to pay for qualified medical expenses now and in the future. This provides a means to manage rising insurance premiums.

Business acquisitions: We will supplement our growth through strategic acquisition when opportunities arise. In the fiscal year ended May 31, 2003, we expanded our client base through the acquisitions of Advantage Payroll Services, Inc. (“Advantage”) and InterPay, Inc. (“InterPay”). In fiscal 2004, the acquisition of substantially all the assets and certain liabilities of Stromberg LLC (“Stromberg”) along with the acquisition of Stromberg’s Time In A Box® product, allowed us to expand our product offering to include time and attendance solutions and thus offer value-added products and services to payroll and non-payroll clients. We currently have no definitive agreements or current plans with respect to any material prospective acquisition.

Focus on customer service: We have always focused on customer service and the maximization of client retention. Fiscal 2006 client retention is at record levels of slightly less than 80% of our beginning client base. The most significant factor contributing to client losses is companies going out of business. In fiscal 2006, we reduced the number of clients per payroll specialist due to our commitment to continuously improve client service.

Financial position: At May 31, 2006, we maintained a strong financial position with total cash and corporate investments of $577.4 million. We also had $384.5 million in long-term corporate investments at May 31, 2006. Our primary source of cash is our ongoing operations. Cash flow from operations was $569.2 million in fiscal 2006 compared to $466.6 million in fiscal 2005. Historically, we have funded our operations, capital purchases, and dividend payments from our operating activities. It is anticipated that current cash and corporate investment balances, along with projected operating cash flows, will support our normal business operations, capital purchases, and dividend payments for the foreseeable future.

For further analysis of our results of operations for fiscal years 2006, 2005, and 2004, and our financial position at May 31, 2006, refer to the tables and analysis in the “Results of Operations” and “Liquidity and Capital Resources” sections of this Item 7 and the discussion in the “Critical Accounting Policies” section of this Item 7.

Outlook

Our current outlook for the full fiscal year ended May 31, 2007 (“fiscal 2007”) is based upon current economic conditions and interest rate levels as of May 31, 2006, and is summarized as follows:

- Payroll service revenue growth is projected to be in the range of 9% to 11%.
- Human Resource Services revenue growth is expected to be in the range of 20% to 23%.
- Total service revenue growth is projected to be in the range of 11% to 13%.
- Interest on funds held for clients is expected to increase approximately 28% to 30%.
- Total revenue growth is estimated to be in the range of 12% to 14%.
- Corporate investment income is anticipated to increase approximately 45% to 50%.
- Stock-based compensation costs will be primarily included in selling, general and administrative expenses and are expected to impact pre-tax and net income in the range of 4% to 5%.

- The effective income tax rate is expected to be approximately 31.0%.
- Net income growth is expected to be in the range of 12% to 14%.

Purchases of property and equipment in fiscal 2007 are expected to be in the range of $85 million to $90 million, in line with our growth rates. Fiscal 2007 depreciation expense is projected to be approximately $55 million, and we project amortization of intangible assets for fiscal 2007 to be approximately $14 million.

Our projections are based on current economic and interest rate conditions continuing with no significant changes. We estimate that the earnings effect of a 25-basis-point change in interest rates (17 basis points for tax-exempt investments) at the beginning of fiscal 2007 would be in the range of $4.5 million to $5.0 million for fiscal 2007. The total investment portfolio (funds held for clients and corporate investments) is expected to average approximately $4.5 billion in fiscal 2007. Given current accounting interpretations, in order to preserve the accounting treatment on available-for-sale securities of recording market value fluctuations through comprehensive income instead of through the income statement, we do not expect to realize any losses in the investment portfolios in fiscal 2007.

Results of Operations

Summary of Results of Operations for the Fiscal Years Ended May 31:

In millions, except per share amounts	2006	Change	2005	Change	2004
Revenue:					
Payroll service revenue	$ 1,248.9	10%	$ 1,133.5	9%	$ 1,040.0
Human Resource Services revenue	324.9	29%	251.2	26%	200.1
Total service revenue	1,573.8	14%	1,384.7	12%	1,240.1
Interest on funds held for clients	100.8	67%	60.4	11%	54.2
Total revenue	**1,674.6**	**16%**	**1,445.1**	**12%**	**1,294.3**
Combined operating and SG&A expenses	1,025.0	12%	911.3	6%	861.0
Operating income	**649.6**	**22%**	**533.8**	**23%**	**433.3**
As a % of total revenue	39%		37%		33%
Investment income, net	25.2	103%	12.4	-25%	16.5
Income before income taxes	**674.8**	**24%**	**546.2**	**21%**	**449.8**
As a % of total revenue	40%		38%		35%
Income taxes	209.9	18%	177.4	21%	146.8
Net income	**$ 464.9**	**26%**	**$ 368.8**	**22%**	**$ 303.0**
As a % of total revenue	28%		26%		23%
Diluted earnings per share	**$ 1.22**	**26%**	**$ 0.97**	**21%**	**$ 0.80**

Details regarding our combined funds held for clients and corporate investment portfolios are as follows:

$ in millions	Year ended May 31, 2006	2005	2004
Average investment balances:			
Funds held for clients	$ 3,080.3	$ 2,759.7	$ 2,515.3
Corporate investments	840.3	599.5	446.9
Total	$ 3,920.6	$ 3,359.2	$ 2,962.2
Average interest rates earned (exclusive of realized gains/losses):			
Funds held for clients	3.2%	2.2%	1.7%
Corporate investments	2.9%	2.1%	2.3%
Combined funds held for clients and corporate investments	3.2%	2.2%	1.8%
Net realized gains/(losses):			
Funds held for clients	$ 0.9	$ 0.3	$ 11.7
Corporate investments	0.1	(0.1)	7.4
Total	$ 1.0	$ 0.2	$ 19.1

As of May 31, $ in millions	2006	2005	2004
Unrealized losses on available-for-sale securities	$ (22.0)	$ (9.9)	$ (4.2)
Federal Funds rate	5.00%	3.00%	1.00%
Three-year “AAA” municipal securities yield	3.65%	2.85%	2.50%
Total market value of available-for-sale securities	$ 3,852.4	$ 3,567.2	$ 3,269.9
Average duration of available-for-sale securities (in years)(A)	2.0	2.1	2.1
Weighted-average yield-to-maturity of available-for-sale securities(A)	3.0%	2.6%	2.3%

(A) These items exclude the impact of auction rate securities and variable rate demand notes (“VRDNs”) as they are tied to short-term interest rates.

Revenue: The increases in Payroll service revenue in fiscal 2006 as compared to fiscal 2005, and in fiscal 2005 as compared to fiscal 2004, were primarily attributable to growth in clients, check volume, and utilization of our ancillary services.

As of May 31, 2006, 92% of all clients utilized our payroll tax administration services, compared with 90% at May 31, 2005, and 89% at May 31, 2004. We believe our client utilization percentage of these services is near maturity. Our employee payment services were utilized by 68% of our clients at May 31, 2006, compared with 65% at May 31, 2005, and 63% at May 31, 2004. More than 95% of new clients purchase our payroll tax administration services and more than 75% of new clients purchase our employee payment services.

MMS revenue increased 27% for both fiscal 2006 and fiscal 2005 to $225.0 million and $176.9 million, respectively. Approximately one-third of our new MMS clients are conversions from our Core Payroll service. We had over 33,000 MMS clients at May 31, 2006.

Human Resource Services revenue increased 29% in fiscal 2006 and 26% in fiscal 2005 as a result of higher revenue from the following services:

- We have continued to see growth in the number of clients utilizing our Retirement Services product. Retirement Services revenue increased 16% for fiscal 2006 and 17% for fiscal 2005 to $106.1 million and $91.4 million, respectively. We serviced over 38,000 and over 33,000 Retirement Services clients at May 31, 2006 and 2005, respectively.

- Sales of our Paychex Premier product, a comprehensive payroll and integrated human resource and employee benefits outsourcing solution for small- to medium-sized businesses, have been strong, as administrative fee revenue from this product increased 57% for fiscal 2006 and 66% for fiscal 2005 to $52.6 million and $33.6 million, respectively. The increases in administrative fee revenue were driven primarily by client growth. Administrative fee revenue in fiscal 2006 also benefited from the implementation of initial enrollment fees, effective May 1, 2005. As of May 31, 2006, our Paychex Premier product serviced over 236,000 client employees, as compared with over 171,000 client employees at May 31, 2005.

- Revenue from the PEO product increased 25% for fiscal 2006 and 14% for fiscal 2005 to $67.1 million and $53.7 million, respectively. This was the result of growth in clients and client employees served, price increases, and favorable fluctuations in workers' compensation claims experience. As of May 31, 2006, our PEO product serviced approximately 59,000 client employees, as compared with over 54,000 client employees at May 31, 2005.

  Our PEO product provides essentially the same services as Paychex Premier, except we serve as a co-employer of the clients' employees, assume the risks and rewards of workers' compensation insurance, and provide more sophisticated health care offerings to PEO clients. The PEO product is available primarily for clients domiciled in Florida and Georgia, where the utilization of PEOs is more prevalent than other areas of the United States ("U.S."). Due to the characteristics of the PEO product, the revenue and profits from this product can fluctuate significantly between quarters. These fluctuations primarily relate to the assumption of the risks and rewards of workers' compensation insurance and, to a lesser extent, the other offerings unique to the PEO product. The risks and rewards of workers' compensation insurance are derived from actuarial changes in estimated losses under workers' compensation policies as the result of actual claims experience under our workers' compensation policies and changes in workers' compensation legislation by the state of Florida.

- Revenue from other Human Resource Services increased 36% for fiscal 2006 and 33% for fiscal 2005 to $99.0 million and $72.5 million, respectively. This was the result of increases in revenue from time and attendance solutions, state unemployment services, and employee handbooks. Other Human Resource Services revenue growth in fiscal 2005 compared to fiscal 2004 also reflected the benefit of revenue from the April 2004 acquisition of Stromberg time and attendance solutions.

The increase in interest on funds held for clients in fiscal 2006 compared to fiscal 2005 is the result of higher average interest rates earned in fiscal 2006 and higher average portfolio balances. The increase in interest on funds held for clients in fiscal 2005 compared to fiscal 2004 is the result of higher average interest rates earned in fiscal 2005 and higher average portfolio balances, offset by lower net realized gains on the sales of available-for-sale securities. The higher average portfolio balances in both fiscal 2006 and fiscal 2005 were driven by client base growth, wage inflation, check volume growth within our current client base, and increased utilization of our payroll tax administration services and employee payment services. See the "Market Risk Factors" section, contained in Item 7A of this Form 10-K, for more information on changing rates.

Combined Operating and SG&A Expenses: The following table summarizes total combined operating and selling, general and administrative ("SG&A") expenses for the fiscal year ended May 31:

In millions	2006	Change	2005	Change	2004
Compensation-related expenses	$ 656.8	15%	$571.4	12%	$510.2
Facilities (excluding depreciation) expenses	48.3	10%	44.1	-3%	45.3
Depreciation of property and equipment	51.6	12%	46.2	18%	39.2
Amortization of intangible assets	14.9	-6%	15.8	-5%	16.6
Other expenses	253.4	8%	233.8	9%	213.9
	1,025.0	12%	911.3	10%	825.2
Expense charge to increase legal reserve	—	0%	—	-100%	35.8
Total operating and SG&A expenses	$1,025.0	12%	$911.3	6%	$861.0
As a % of total service revenue	65.1%		65.8%		69.4%

Combined operating and SG&A expenses increased 12% in fiscal 2006 and 10% in fiscal 2005, excluding the expense charge to increase the legal reserve in fiscal 2004. The increases in both fiscal 2006 and in fiscal 2005 were the result of our continued investment in information technology to create more efficient processes and systems as well as investment in personnel and other costs to support organic growth. During fiscal 2006, total expenses were affected by a strong sales year as our sales force exceeded its targets resulting in higher than normal levels of sales expense, continued investments in new products and services, geographic expansion within Germany, and other expenditures to continually improve client service. Fiscal 2005 growth was impacted by additional expenses as a result of our April 2004 acquisition of Stromberg. At May 31, 2006, we had approximately 10,900 employees compared with approximately 10,000 at May 31, 2005 and 9,400 at May 31, 2004.

Depreciation expense is primarily related to buildings, furniture and fixtures, data processing equipment, and software. Depreciation expense increased in fiscal 2006 compared to fiscal 2005 due to the purchase in May 2005 of a 127,000-square foot building in Rochester, New York and higher levels of capital expenditures. Amortization of intangible assets is primarily related to client lists obtained from previous acquisitions, which are amortized using accelerated methods. Other expenses include items such as delivery, forms and supplies, communications, travel and entertainment, professional services, and other costs incurred to support our business.

Operating Income: Operating income year-over-year growth was 22% for fiscal 2006 and 23% for fiscal 2005. The increases in operating income in fiscal 2006 and fiscal 2005 are attributable to the factors previously discussed.

Investment Income, Net: Investment income, net primarily represents earnings from our cash and cash equivalents and investments in available-for-sale securities. Investment income does not include interest on funds held for clients, which is included in total revenue. The increase in investment income in fiscal 2006 compared with fiscal 2005 is mainly due to higher average interest rates earned in fiscal 2006 and higher average portfolio balances resulting from investment of cash generated from ongoing operations. The decrease in investment income in fiscal 2005 compared with fiscal 2004 is mainly due to lower net realized gains on sales of available-for-sale securities and lower average interest rates earned on longer-term investments, offset by an increase in average daily balances.

Income Taxes: Our effective income tax rate was 31.1% in fiscal 2006, compared with 32.5% in fiscal 2005, and 32.6% in fiscal 2004. The decrease in our effective income tax rate in fiscal 2006 was primarily the result of higher levels of tax-exempt income, which is derived primarily from municipal debt securities in the funds held for clients and corporate investment portfolios and a lower effective state income tax rate. See Note H of the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for additional disclosures on income taxes.

Net Income: Net income growth was 26% for fiscal 2006 and 22% for fiscal 2005. The increases in net income for fiscal 2006 and fiscal 2005 are attributable to the factors previously discussed.

Liquidity and Capital Resources

At May 31, 2006, our principal source of liquidity was $577.4 million of cash and corporate investments. We also had $384.5 million in long-term corporate investments at May 31, 2006. Current cash and corporate investments and projected operating cash flows are expected to support our normal business operations, capital purchases, and dividend payments for the foreseeable future.

Commitments and Contractual Obligations

We have unused borrowing capacity available under four uncommitted, secured, short-term lines of credit with financial institutions at market rates of interest as follows:

Financial institution	Amount available	Expiration date
JP Morgan Chase Bank, N.A.	$ 350 million	February 2007
Fleet National Bank, a Bank of America company	$ 250 million	February 2007
PNC Bank, National Association	$ 150 million	February 2007
Wells Fargo Bank, National Association	$ 150 million	February 2007

Our credit facilities are evidenced by Promissory Notes and are secured by separate Pledge Security Agreements by and between Paychex, Inc. and each of the financial institutions (the "Lenders"), pursuant to which we have granted each of the Lenders a security interest in certain of our investment securities accounts. The collateral is maintained in a pooled custody account pursuant to the terms of a Control Agreement and is to be administered under an Intercreditor Agreement among the Lenders. Under certain circumstances, individual Lenders may require that collateral be transferred from the pooled account into segregated accounts for the benefit of such individual Lenders.

The primary uses of the lines of credit would be to meet short-term funding requirements related to deposit account overdrafts and client fund deposit obligations arising from electronic payment transactions on behalf of our clients in the ordinary course of business, if necessary. No amounts were outstanding against these lines of credit during fiscal 2006 or at May 31, 2006.

We had standby letters of credit outstanding totaling $53.4 million at May 31, 2006, required to secure commitments for certain of our insurance policies. These letters of credit expire at various dates between July 2006 and December 2008 and are secured by securities held in our corporate investment portfolios, including a $44.2 million letter of credit for which funds have been segregated into a separate account. Effective June 28, 2006, this $44.2 million letter of credit was increased to $50.9 million, bringing the total letters of credit outstanding to $60.2 million. No amounts were outstanding on these letters of credit during fiscal 2006 or at May 31, 2006.

We have entered into various operating leases and purchase obligations that, under U.S. generally accepted accounting principles, are not reflected on the Consolidated Balance Sheets at May 31, 2006. The table below summarizes our estimated annual payment obligations under these commitments, as well as other contractual obligations shown as other liabilities on the Consolidated Balance Sheets at May 31, 2006:

	Payments due by period				
In millions	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Operating leases(1)	$134.2	$ 37.6	$ 60.1	$ 31.6	$ 4.9
Other purchase obligations(2)	77.0	40.4	18.0	14.5	4.1
Other liabilities(3)	1.5	0.3	0.6	0.4	0.2
Total	$212.7	$ 78.3	$ 78.7	$ 46.5	$ 9.2

(1) Operating leases are primarily for office space and equipment used in our branch operations. These amounts do not include future payments under redundant leases related to the acquisitions of Advantage and InterPay, which are included in the table above with other liabilities.

(2) Purchase obligations include our estimate of the minimum outstanding commitments under purchase orders to buy goods and services and legally binding contractual arrangements with future payment obligations. Included in the total purchase obligations is $8.2 million of commitments to purchase capital assets. Amounts actually paid under certain of these arrangements may be higher due to variable components of these agreements.

(3) The obligations shown as other liabilities represent business acquisition reserves and are reflected in the Consolidated Balance Sheets at May 31, 2006, with $0.3 million in other current liabilities and $1.2 million in other long-term liabilities. Certain deferred compensation plan obligations and other long-term liabilities amounting to $39.4 million are excluded because the timing of actual payments cannot be specifically or reasonably determined due to the variability in assumptions required to project the timing of future payments.

Advantage has license agreements with fifteen independently owned associate offices ("Associates"), which are responsible for selling and marketing Advantage payroll services and performing certain operational functions, while Paychex, Inc. and Advantage provide all centralized back-office payroll processing and payroll tax administration services. In addition, Advantage has a relationship with New England Business Services, Inc. ("NEBS®") whereby Advantage performs all client functions other than sales and marketing. Under these arrangements, Advantage pays the Associates and NEBS commissions based on processing activity for the related clients. Since the actual amounts of future payments are uncertain, obligations under these arrangements are not included in the table above. Commission expense for the Associates and NEBS in fiscal 2006 and fiscal 2005 was $19.0 million and $16.7 million, respectively.

We guarantee performance of service on annual maintenance contracts for clients who financed their service contracts through a third party. In the normal course of business, we make representations and warranties that guarantee the performance of services under service arrangements with clients. In addition, we have entered into indemnification agreements with our officers and directors, which require us to defend and, if necessary, indemnify these individuals for certain pending or future legal claims as they relate to their services to Paychex and our subsidiaries. Historically, there have been no material losses related to such guarantees and indemnifications.

We currently self-insure the deductible portion of various insured exposures under certain of our employee benefit plans. Our estimated loss exposure under these insurance arrangements is recorded in other current liabilities. Historically, the amounts accrued have not been material. We have insurance coverage in addition to our purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, and acts of terrorism, and capacity for deductibles and self-insured retentions through our captive insurance company.

Off-Balance Sheet Arrangements

As part of our ongoing business, we do not participate in transactions with unconsolidated entities such as special purpose entities or structured finance entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other limited purposes. We do maintain investments as a limited partner in low-income housing projects that are not considered part of our ongoing operations. These investments are accounted for under the equity method of accounting.

Operating Cash Flow Activities

In millions	2006	2005	2004
	Year ended May 31,		
Net income	$ 464.9	$ 368.8	$ 303.0
Non-cash adjustments to net income	99.5	106.7	105.6
Cash provided by/(used in) changes in operating assets and liabilities	4.8	(8.9)	(19.6)
Net cash provided by operating activities	$ 569.2	$ 466.6	$ 389.0

The increase in our operating cash flows in fiscal 2006 and fiscal 2005 was driven by higher net income, impacted by changes in operating assets and liabilities. The fluctuations in our operating assets and liabilities between periods were primarily related to the timing of accounts receivable billing and collection, and timing of payments for compensation, PEO payroll, income tax, and other liabilities.

Investing Cash Flow Activities

In millions	2006	2005	2004
	Year ended May 31,		
Net change in funds held for clients and corporate investment activities	$ (224.0)	$ (177.3)	$ (151.8)
Purchases of property and equipment, net of proceeds from the sale of property and equipment	(81.1)	(67.2)	(50.6)
Acquisitions of businesses, net of cash acquired	(0.7)	(0.4)	(13.2)
Purchases of other assets	(4.2)	(2.7)	(2.4)
Net cash used in investing activities	$ (310.0)	$ (247.6)	$ (218.0)

Funds held for clients and corporate investments: Funds held for clients are primarily comprised of short-term funds and available-for-sale securities. Corporate investments are primarily comprised of available-for-sale securities. The portfolio of funds held for clients and corporate investments is detailed in Note D of the Notes to Consolidated Financial Statements, included in Item 8 of this Form 10-K.

The amount of funds held for clients will vary based upon the timing of collecting client funds, and the related remittance of funds to applicable tax or regulatory agencies for payroll tax administration services and to employees of clients utilizing employee payment services. Fluctuations in net funds held for clients and corporate investment activities primarily relate to timing of purchases, sales, or maturities of corporate investments. Additional discussion of interest rates and related risks is included in the “Market Risk Factors” section, contained in Item 7A of this Form 10-K.

Acquisitions of businesses, net of cash acquired: In fiscal 2004, we paid approximately $12.6 million in cash for the acquisition of Stromberg and $0.6 million of additional purchase price related to the InterPay acquisition.

Purchases of property and equipment: To support our continued client and ancillary product growth, purchases of property and equipment were made for data processing equipment and software, and for the expansion and upgrade of various operating facilities. In fiscal 2006, we made purchases of property and equipment of $81.1 million, compared with $70.7 million of purchases in fiscal 2005 and $50.6 million of purchases in fiscal 2004. In May 2005, we purchased a 127,000-square-foot facility in Rochester, New York for $10.5 million. Construction in progress totaled $36.3 million and $29.5 million at May 31, 2006 and 2005, respectively. Of these costs, $29.4 million and $18.9 million represent software being developed for internal use at May 31, 2006 and 2005, respectively. Capitalization of costs ceases when the software is ready for its intended use, at which time we will begin amortization of the costs.

During fiscal 2006, fiscal 2005, and fiscal 2004, we purchased approximately $4.6 million, $2.5 million, and $1.2 million, respectively, of data processing equipment and software from EMC Corporation, whose Chairman, President, and Chief Executive Officer is a member of our Board of Directors.

Financing Cash Flow Activities

In millions, except per share amounts	Year ended May 31, 2006	2005	2004
Dividends paid	$ (231.5)	$ (193.0)	$ (177.4)
Proceeds from exercise of stock options	32.1	9.0	18.3
Net cash used in financing activities	$ (199.4)	$ (184.0)	$ (159.1)
Cash dividends per common share	$ 0.61	$ 0.51	$ 0.47

Dividends paid: In October 2005, our Board of Directors approved an increase in the quarterly dividend payment to $0.16 per share from $0.13 per share. In October 2004, our Board of Directors approved an increase in the quarterly dividend payment to $0.13 per share from $0.12 per share. The dividends paid as a percentage of net income totaled 50%, 52%, and 59% in fiscal 2006, fiscal 2005, and fiscal 2004, respectively. Future dividends are dependent on our future earnings and cash flow and are subject to the discretion of our Board of Directors.

Proceeds from exercise of stock options: The increase in proceeds from the exercise of stock options in fiscal 2006 compared with fiscal 2005 is primarily due to an increase in the number of stock options exercised and an increase in the average exercise price per share. The decrease in proceeds from the exercise of stock options in fiscal 2005 compared with fiscal 2004 is primarily due to a decrease in the number of stock options exercised. Common shares acquired through exercise of stock options in fiscal 2006 were 1.7 million shares compared with 0.7 million shares in fiscal 2005 and 1.3 million shares in fiscal 2004. We have recognized a tax benefit from the exercise of stock options of $11.6 million, $4.5 million, and $10.2 million for fiscal 2006, fiscal 2005, and fiscal 2004, respectively. This tax benefit reduces the accrued income tax liability and increases additional paid-in capital, with no impact on the expense amount for income taxes. See Note G to the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for additional disclosures on our stock option plans.

Other

New accounting pronouncements: In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 123(R), "Share-Based Payment," which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." This statement requires that all stock-based payments to employees, including grants of employee stock options, be recognized as compensation costs in the financial statements based on their fair values measured at the date of grant.

Prior to June 1, 2006, we had accounted for grants of employee stock options under the intrinsic value method allowed under APB 25 and related interpretations, and therefore had not recognized any compensation costs for stock-based awards. As permitted by SFAS No. 123, we presented pro forma financial results including the effects of share-based compensation costs in the footnotes to the financial statements. Refer to Note A to the Consolidated Financial Statements, included in Item 8 of this Form 10-K, under the heading "Stock-based compensation costs," for the pro forma results for fiscal 2006, 2005, and 2004.

SFAS No. 123(R) is effective for fiscal years beginning after December 15, 2005 and permits adoption using one of the following two methods:

- *Modified prospective method*, in which compensation costs will be recognized in our Consolidated Financial Statements for all awards granted after the date of adoption as well as for the unvested portion of existing awards as of the date of adoption (the "Existing Awards"), and requires that prior periods not be restated.
- *Modified retrospective method*, which includes the requirements of the modified prospective method described above for new awards and Existing Awards, but also permits entities to restate prior periods based on amounts previously determined under SFAS No. 123 for pro forma disclosures.

We will adopt this standard beginning June 1, 2006, using the modified prospective method. Accordingly, the results of operations for future periods will not be comparable to our historical results of operations. We anticipate the adoption of SFAS No. 123(R) will negatively impact net income in the range of 4% to 5% in fiscal 2007, increasing our operating expenses and selling, general and administrative expenses.

Unrecognized stock-based compensation costs related to Existing Awards as of May 31, 2006 were approximately $38.3 million and are expected to be recognized over a weighted-average period of 2.4 years. We cannot yet estimate what the compensation cost impact will be on our Consolidated Financial Statements for the awards that we issue after June 1, 2006, as it will depend on the terms of any future grants approved by the Board of Directors and the underlying assumptions used in calculating the fair value at the time of any such future grants. The calculation of fair value is very sensitive to changes in the underlying assumptions, especially volatility and expected option term life.

In addition, SFAS No. 123(R) will impact how income taxes are recorded to our Consolidated Financial Statements, as tax deductions for certain tax-qualified option grants ("incentive stock options") are allowed only at the time a taxable disposition occurs. This may result in an increase in our effective tax rate in the early periods after adoption and it could cause variability in our effective tax rate throughout a fiscal year as these events occur.

SFAS No. 123(R) also amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash inflow rather than a reduction of taxes paid in operating cash flows. We cannot estimate what the amount of excess tax deductions will be in future periods. However, the amounts of operating cash flows recognized in prior periods for excess tax deductions were $11.6 million, $4.5 million, and $10.2 million for fiscal 2006, 2005, and 2004, respectively.

Our pro-forma disclosures under SFAS No. 123 utilized a Black-Scholes option pricing model for valuing employee stock options and allocated the expense using an accelerated method. Upon adoption of SFAS No. 123(R), we will continue to use a Black-Scholes option pricing model, but will begin to allocate the expense on a straight-line basis over the requisite service period as we believe this better aligns the cost with the employee services provided.

Upon adoption of SFAS No. 123(R), we will be required to estimate forfeitures and only record compensation costs for those awards that are expected to vest. In our pro forma disclosures under SFAS No. 123, we have accounted for forfeitures as they occurred. Our assumptions for forfeitures will be determined based on factors including type of award and historical experience, and will be reevaluated regularly as an award vests.

We currently offer an Employee Stock Purchase Plan to all employees, under which stock can be purchased through a payroll deduction with no discount to the market price and no look-back provision. We have determined that this plan is non-compensatory and is not subject to the provisions of SFAS No. 123(R). Therefore, no compensation costs will be recognized related to this plan.

The following FASB Staff Positions ("FSP") issued during our fiscal year ended May 31, 2006 and related to SFAS No. 123(R) will be applied upon adoption of SFAS No. 123(R) for our fiscal year beginning June 1, 2006:

- FAS 123(R)-1, "Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R);"
- FAS 123(R)-2, "Practical Accommodation to the Application of Grant Date as Defined in FASB Statement 123(R);"
- FAS 123(R)-3, "Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards;" and
- FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event."

In October 2005, the FASB issued FSP FAS13-1, "Accounting for Rental Costs Incurred During a Construction Period." This FSP provides that rental costs associated with operating leases that are incurred during a construction period should be recognized as rental expense and included in income from continuing operations. The guidance in this FSP was effective in the first reporting period beginning after December 15, 2005. We have historically expensed rental costs incurred during a construction period, and therefore, the adoption of this FSP did not have an impact on our results of operations or financial position.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This FSP provides guidance on determining if an investment is considered to be impaired, if the impairment is other-than-temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and was effective for reporting periods beginning after December 15, 2005. We account for investments in accordance with this guidance, and therefore, the adoption of this FSP did not have an impact on our results of operations or financial position.

In February and March 2006, the FASB issued the following statements amending SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a Replacement of FASB Statement No. 125:"

- SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments — an Amendment of FASB Statements No. 133 and 140;" and
- SFAS No. 156, "Accounting for Servicing of Financial Assets — an Amendment of FASB Statement No. 140."

The guidance in these statements is effective in the first fiscal year beginning after September 15, 2006. We do not utilize derivative financial instruments and currently do not have any servicing assets or servicing liabilities that would fall under the guidance of either statement, and therefore, the adoption of these statements will not have a material impact on our results of operations or financial position.

Critical Accounting Policies

Note A to the Consolidated Financial Statements, included in Item 8 of this Form10-K, discusses the significant accounting policies of Paychex, Inc. Our discussion and analysis of our financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates, judgments, and assumptions that affect reported amounts of assets, liabilities, revenue, and expenses. On an ongoing basis, we evaluate the accounting policies and estimates used to prepare the Consolidated Financial Statements. We base our estimates on historical experience, future expectations, and assumptions believed to be reasonable under current facts and circumstances. Actual amounts and results could differ from these estimates. Certain accounting policies that are deemed critical to our results of operations or financial position are discussed below.

Revenue recognition: Service revenue is recognized in the period services are rendered and earned under service arrangements with clients where service fees are fixed or determinable and collectibility is reasonably assured. Certain processing services are provided under annual service arrangements with revenue recognized ratably over the annual service period. Our service revenue is largely attributable to payroll-related processing services where the fee is based on a fixed amount per processing period or a fixed amount per processing period plus a fee per employee or transaction processed. The revenue earned on delivery service for the distribution of certain client payroll checks and reports is included in service revenue, and the costs for delivery are included in operating expenses on the Consolidated Statements of Income.

PEO revenue is included in service revenue and is reported net of direct costs billed and incurred, which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred for PEO worksite employees were $2,414.5 million, $2,230.8 million, and $1,846.1 million for fiscal 2006, 2005, and 2004, respectively.

Revenue from certain time and attendance solutions is recognized using the residual method when all of the following are present: persuasive evidence of an arrangement exists, typically a non-cancelable sales order; delivery is complete for the software and hardware; the fee is fixed or determinable and free of contingencies; and collectibility is reasonably assured. Maintenance contracts are generally purchased by our clients in conjunction with their purchase of certain time and attendance solutions. Revenue from these maintenance contracts is recognized ratably over the term of the contract.

Interest on funds held for clients is earned primarily on funds that are collected from clients before due dates for payroll tax administration services and for employee payment services, and invested until remittance to the applicable tax or regulatory agencies or client employees. These collections from clients are typically remitted between one and thirty days after receipt, with some items extending to ninety days. The interest earned on these funds is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services. Interest on funds held for clients also includes net realized gains and losses from the sales of available-for-sale securities.

PEO workers' compensation insurance: Workers' compensation insurance reserves are established to provide for the estimated costs of paying claims underwritten by us. These reserves include estimates for reported losses, plus amounts for those claims incurred but not reported and estimates of certain expenses associated with processing and settling the claims. In establishing the workers' compensation insurance reserves, we utilize an independent actuarial estimate of undiscounted future cash payments that would be made to settle the claims.

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and actuarial loss projections, and is subject to change due to multiple factors, including social and economic trends, changes in legal liability law, and damage awards, all of which could materially impact the reserves as reported in the Consolidated Financial Statements. Accordingly, final claim settlements may vary from our present estimates, particularly when those payments may not occur until well into the future.

We regularly review the adequacy of our estimated workers' compensation insurance reserves. Adjustments to previously established reserves are reflected in the operating results of the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

In fiscal 2006 and fiscal 2005, workers' compensation insurance for PEO worksite employees was provided based on claims paid as incurred. Our maximum individual claims liability was $750,000 under the fiscal 2006 policy and $500,000 under the fiscal 2005 policy.

We had recorded the following amounts on our Consolidated Balance Sheets for workers' compensation claims as of May 31:

In thousands	Prepaid expense	Current liability	Long-term liability
2006	$ 3,150	$ 7,061	$ 18,374
2005	$ 3,702	$ 7,164	$ 13,963

Valuation of investments: Our investments in available-for-sale securities are reported at market value. Unrealized gains related to increases in the market value of investments and unrealized losses related to decreases in the market value are included in comprehensive income, net of tax, as reported on our Consolidated Statements of Stockholders' Equity. However, changes in the market value of investments impact our net income only when such investments are sold or impairment is recognized. Realized gains and losses on the sale of securities are determined by specific identification of the security's cost basis. On our Consolidated Statements of Income, realized gains and losses from funds held for clients are included in interest on funds held for clients, whereas realized gains and losses from corporate investments are included in investment income, net.

We are exposed to credit risk in connection with our available-for-sale securities from the possible inability of borrowers to meet the terms of their bonds. We attempt to mitigate this risk by investing primarily in high credit quality securities, AAA- and AA-rated securities, and A-1-rated short-term securities. We periodically review our investment portfolio to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns, which would require us to record an impairment charge in the period any such determination is made. In making this judgment, we evaluate, among other things, the duration and extent to which the market value of an investment is less than its cost, the credit rating and any changes in credit rating for the investment, and our ability and intent to hold the investment until the earlier of market price recovery or maturity. Our assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in our strategies or assumption related to any particular investment.

Goodwill and intangible assets: For business combinations, we assign estimated fair values to all assets and liabilities acquired, including intangible assets, such as customer lists, certain license agreements, trade names, and non-compete agreements. The assignment of fair values to acquired assets and liabilities and the determination of useful lives for depreciable and amortizable assets requires significant estimates, judgments, and assumptions. For certain fixed assets, including software and intangible assets, we utilize the assistance of independent valuation consultants. The remaining purchase price of the acquired business not assigned to identifiable assets and liabilities is recorded as goodwill.

We have $405.8 million of goodwill recorded on our Consolidated Balance Sheet at May 31, 2006, resulting from acquisitions in fiscal 2003 and fiscal 2004. SFAS No. 142, "Goodwill and Other Intangible Assets," requires that goodwill not be amortized, but instead tested for impairment on an annual basis and between annual tests if an event occurs or circumstances change in a way to indicate that there has been a potential decline in the fair value of the reporting unit. Impairment is determined by comparing the estimated fair value of the reporting unit to its carrying amount, including goodwill. We perform our annual review at the beginning of the fourth fiscal quarter. Our business is largely homogeneous and, as a result, substantially all of the goodwill is associated with one reporting unit. Based on the results of our goodwill impairment review, no impairment loss was recognized in the results of operations for fiscal 2006 or fiscal 2005. Subsequent to this review, there have been no events or circumstances that indicate any potential impairment of our goodwill balance.

We also test intangible assets for potential impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Accrual for client fund losses: We maintain an accrual for estimated losses associated with our clients' inability to meet their payroll obligations. As part of providing payroll, payroll tax administration services, and employee payment services, we are authorized by the client to initiate money transfers from the client's account for the amount of tax obligations and employees' direct deposits. Electronic money fund transfers from client bank accounts are subject to potential risk of loss resulting from clients' insufficient funds to cover such transfers. We evaluate certain uncollected amounts on a specific basis and analyze historical experience for amounts not specifically reviewed to determine the likelihood of recovery from the clients.

Contingent liabilities: We are subject to various claims and legal matters that arise in the normal course of business. At May 31, 2006, we had approximately $15.6 million of reserves for pending legal matters. Based on the application of SFAS No. 5, "Accounting for Contingencies," which requires us to record a reserve if we believe an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated, we deem this amount adequate. The determination of whether any particular matter involves a probable loss or if the amount of a probable loss can be reasonably estimated requires considerable judgment. This reserve may change in the future due to new developments or changes in our strategies or assumptions related to any particular matter. In light of the legal reserve recorded, we currently believe that resolution of these matters will not have a material adverse effect on our financial position or results of operations. However, these matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse impact on our financial position and our results of operations in the period in which any such effect is recorded. For additional information regarding pending legal matters, refer to Note L in the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K.

Income taxes: We account for deferred taxes by recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in our financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. We account for the tax benefit from the exercise of non-qualified stock options by reducing our accrued income tax liability and increasing additional paid-in capital.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

Market Risk Factors

Changes in interest rates and interest rate risk: Funds held for clients are primarily comprised of short-term funds and available-for-sale securities and corporate investments are primarily comprised of available-for-sale securities. As a result of our operating and investing activities, we are exposed to changes in interest rates that may materially affect our results of operations and financial position. Changes in interest rates will impact the earnings potential of future investments and will cause fluctuations in the market value of our longer-term available-for-sale securities. In seeking to minimize the risks and/or costs associated with such activities, we generally direct investments towards high credit quality, fixed-rate municipal and government securities and manage the available-for-sale securities to a benchmark duration of two and one-half to three years. We do not utilize derivative financial instruments to manage our interest rate risk.

Our investment portfolios and the earnings from these portfolios have been impacted by the fluctuations in interest rates. The Federal Funds rate has increased to 5.00% as of May 31, 2006. During fiscal 2006, the average interest rate earned on our combined funds held for clients and corporate investment portfolios was 3.2% compared with 2.2% for fiscal 2005 and 1.8% for fiscal 2004. Short-term rates rose steadily throughout fiscal 2005 and fiscal 2006. In fiscal 2005, longer-term rates, on average, were basically unchanged from fiscal 2004, but have risen steadily in fiscal 2006. While short-term and long-term interest rates generally move in the same direction, there are certain economic and liquidity conditions that will affect this relationship. While interest rates are rising, the full benefit of higher interest rates will not immediately be reflected in net income due to the interaction of long- and short-term interest rate changes as discussed below. The Federal Funds rate decreased from 6.50% at May 31, 2000 to 1.00% at May 31, 2004. The decreasing interest rate environment experienced through fiscal 2004 negatively affected net income growth. During fiscal 2004, the decreasing rate environment generated significant unrealized gains for our longer-term available-for-sale securities and we were able to mitigate some of the impact of lower interest rates on earnings by realizing gains from sales of our investments.

Increases in interest rates increase earnings from our short-term investments, and over time will increase earnings from our longer-term available-for-sale securities. Earnings from the available-for-sale securities, which currently have an average duration of 2.0 years excluding the impact of auction rate securities and VRDNs that are tied to short-term interest rates, will not reflect increases in interest rates until the investments are sold or mature and the proceeds are reinvested at higher rates. An increasing interest rate environment will generally result in a decrease in the market value of our investment portfolio.

The cost and market value of available-for-sale securities that have stated maturities at May 31, 2006 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

	May 31, 2006	
In thousands	**Cost**	**Market value**
Maturity date:		
Due in one year or less	$ 545,046	$ 542,178
Due after one year through three years	688,411	678,728
Due after three years through five years	282,107	276,241
Due after five years	2,356,196	2,352,513
Total available-for-sale securities	$ 3,871,760	$ 3,849,660

VRDNs and auction rate securities are primarily categorized as due after five years in the table above as the contractual maturities on these securities is typically twenty to thirty years. Although these securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature.

The following table summarizes the changes in the Federal Funds rate over the past three fiscal years:

	2006	2005	2004
Federal Funds rate — beginning of fiscal year	3.00%	1.00%	1.25%
Rate increase/(decrease):			
First quarter	0.50	0.50	(0.25)
Second quarter	0.50	0.50	—
Third quarter	0.50	0.50	—
Fourth quarter	0.50	0.50	—
Federal Funds rate — end of fiscal year	5.00%	3.00%	1.00%
Three-year “AAA” municipal securities yields — end of fiscal year	3.65%	2.85%	2.50%

The Federal Funds rate was increased to 5.25% on June 29, 2006.

Calculating the future effects of changing interest rates involves many factors. These factors include, but are not limited to, daily interest rate changes, seasonal variations in investment balances, actual duration of short-term and available-for-sale securities, the proportional mix of taxable and tax-exempt investments, and changes in tax-exempt municipal rates versus taxable investment rates, which are not synchronized or simultaneous. Subject to these factors, a 25-basis-point change in taxable interest rates generally affects our tax-exempt interest rates by approximately 17 basis points.

Our total investment portfolio (funds held for clients and corporate investments) averaged approximately $3.9 billion for the full year ended May 31, 2006. Our normal and anticipated allocation is approximately 60% invested in short-term securities and available-for-sale securities that are priced and traded as short-term securities (auction rate securities and VRDNs) with an average duration of thirty-five days, and 40% invested in other available-for-sale securities with an average duration of two and one-half to three years. Based on these current assumptions, we estimate that the earnings effect of a 25-basis-point change in interest rates

(17 basis points for tax-exempt investments) at the beginning of fiscal 2007 would be approximately $4.5 million to $5.0 million for fiscal 2007.

The combined funds held for clients and corporate available-for-sale securities reflected a net unrealized loss of $22.0 million at May 31, 2006, compared with a net unrealized loss of $9.9 million at May 31, 2005, and a net unrealized loss of $4.2 million at May 31, 2004. During fiscal 2006, the net unrealized gain or loss position ranged from a net unrealized loss of $25.2 million to $6.1 million. During fiscal 2005, the net unrealized gain or loss position ranged from approximately $14.4 million net unrealized loss to $10.6 million net unrealized gain. The net unrealized loss position of our investment portfolios was approximately $23.9 million at July 20, 2006.

As of May 31, 2006 and May 31, 2005, we had $3.9 billion and $3.6 billion, respectively, invested in available-for-sale securities at market value. Excluding auction rate securities and VRDNs classified as available-for-sale securities which are tied to short-term interest rates, the weighted average yields to maturity were 3.0% and 2.6%, as of May 31, 2006 and May 31, 2005, respectively. Assuming a hypothetical increase in both short-term and longer-term interest rates of 25 basis points, the resulting potential decrease in market value for our portfolio of securities at May 31, 2006, would be approximately $8.5 million. Conversely, a corresponding decrease in interest rates would result in a comparable increase in market value. This hypothetical decrease or increase in the market value of the portfolio would be recorded as an adjustment to the portfolio's recorded value, with an offsetting amount recorded in stockholders' equity and with no related or immediate impact on the results of operations.

Credit risk: We are exposed to credit risk in connection with these investments through the possible inability of the borrowers to meet the terms of the bonds. We attempt to limit credit risk by investing primarily in AAA-and AA-rated securities and A-1- rated short-term securities, and by limiting amounts that can be invested in any single issuer.

Item 8. ***Financial Statements and Supplementary Data***

TABLE OF CONTENTS

REPORT ON MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Paychex, Inc. (the "Company") is responsible for establishing and maintaining an adequate system of internal control over financial reporting as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Consolidated Financial Statements. Our internal control over financial reporting is supported by a program of internal audits and appropriate reviews by management, written policies and guidelines, careful selection and training of qualified personnel, and a written Code of Business Conduct adopted by our Company's Board of Directors, applicable to all Company Directors and all officers and employees of our Company.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Audit Committee of our Company's Board of Directors meets with the independent public accountants, management, and internal auditors periodically to discuss internal control over financial reporting and auditing and financial reporting matters. The Audit Committee reviews with the independent public accountants the scope and results of the audit effort. The Audit Committee also meets periodically with the independent public accountants and the chief internal auditor without management present to ensure that the independent public accountants and the chief internal auditor have free access to the Audit Committee. The Audit Committee's Report can be found in the Definitive Proxy Statement to be issued in connection with the Company's 2006 Annual Meeting of Stockholders.

Management assessed the effectiveness of the Company's internal control over financial reporting as of May 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control — Integrated Framework*. Based on our assessment, management believes that the Company maintained effective internal control over financial reporting as of May 31, 2006.

The Company's independent public accountants, Ernst & Young LLP, a registered public accounting firm, are appointed by its Audit Committee. Ernst & Young LLP has audited and reported on the Consolidated Financial Statements of Paychex, Inc., management's assessment of the effectiveness of the Company's internal control over financial reporting and the effectiveness of the Company's internal control over financial reporting. The reports of the independent public accountants are contained in this Annual Report on Form 10-K.

/s/ Jonathan J. Judge	/s/ John M. Morphy
Jonathan J. Judge President and Chief Executive Officer	John M. Morphy Senior Vice President, Chief Financial Officer, and Secretary

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Audit Committee of the Board of Directors
and the Stockholders of Paychex, Inc.

We have audited the accompanying consolidated balance sheets of Paychex, Inc. as of May 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006. Our audits also included the financial statement schedule listed in the index at Item 15(a). These financial statements and schedule are the responsibility of Paychex, Inc.'s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Paychex, Inc. at May 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended May 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Paychex, Inc.'s internal control over financial reporting as of May 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated July 13, 2006 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Cleveland, Ohio
July 13, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Audit Committee of the Board of Directors
and the Stockholders of Paychex, Inc.

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control over Financial Reporting, that Paychex, Inc. (the Company) maintained effective internal control over financial reporting as of May 31, 2006, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Paychex Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Paychex, Inc. maintained effective internal control over financial reporting as of May 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Paychex, Inc. maintained, in all material respects, effective internal control over financial reporting as of May 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Paychex, Inc. as of May 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended May 31, 2006, and our report dated July 13, 2006, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Cleveland, Ohio
July 13, 2006

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF INCOME
In thousands, except per share amounts

Year ended May 31,	2006	2005	2004
Revenue:			
Service revenue	$ 1,573,797	$ 1,384,674	$ 1,240,093
Interest on funds held for clients	100,799	60,469	54,254
Total revenue	**1,674,596**	**1,445,143**	**1,294,347**
Expenses:			
Operating expenses	560,255	499,025	463,465
Selling, general and administrative expenses	464,770	412,343	397,567
Total expenses	**1,025,025**	**911,368**	**861,032**
Operating income	**649,571**	**533,775**	**433,315**
Investment income, net	25,195	12,391	16,469
Income before income taxes	**674,766**	**546,166**	**449,784**
Income taxes	209,852	177,317	146,834
Net income	**$ 464,914**	**$ 368,849**	**$ 302,950**
Basic earnings per share	**$ 1.23**	**$ 0.97**	**$ 0.80**
Diluted earnings per share	**$ 1.22**	**$ 0.97**	**$ 0.80**
Weighted-average common shares outstanding	**379,465**	**378,337**	**377,371**
Weighted-average common shares outstanding, assuming dilution	**381,351**	**379,763**	**379,524**
Cash dividends per common share	**$ 0.61**	**$ 0.51**	**$ 0.47**

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

CONSOLIDATED BALANCE SHEETS
In thousands, except per share amount

At May 31,	2006	2005
Assets		
Cash and cash equivalents	$ 137,423	$ 77,669
Corporate investments	440,007	225,719
Interest receivable	38,139	31,108
Accounts receivable, net of allowance for doubtful accounts	189,835	161,849
Deferred income taxes	18,314	19,946
Prepaid income taxes	7,574	5,781
Prepaid expenses and other current assets	21,398	20,587
Current assets before funds held for clients	**852,690**	**542,659**
Funds held for clients	3,591,611	2,979,348
Total current assets	**4,444,301**	**3,522,007**
Long-term corporate investments	384,481	404,152
Property and equipment, net of accumulated depreciation	234,664	205,319
Intangible assets, net of accumulated amortization	60,704	71,458
Goodwill	405,842	405,992
Deferred income taxes	12,783	1,213
Other long-term assets	6,527	7,277
Total assets	**$ 5,549,302**	**$ 4,617,418**
Liabilities		
Accounts payable	$ 46,668	$ 30,385
Accrued compensation and related items	130,069	106,635
Deferred revenue	5,809	4,271
Legal reserve	15,625	25,271
Other current liabilities	34,008	28,391
Current liabilities before client fund deposits	**232,179**	**194,953**
Client fund deposits	3,606,193	2,985,386
Total current liabilities	**3,838,372**	**3,180,339**
Deferred income taxes	15,481	17,545
Other long-term liabilities	40,606	33,858
Total liabilities	**3,894,459**	**3,231,742**
Commitments and contingencies — Note L		
Stockholders' equity		
Common stock, $0.01 par value; Authorized: 600,000 shares; Issued and outstanding: 380,303 shares at May 31, 2006, and 378,629 shares at May 31, 2005, respectively	3,803	3,786
Additional paid-in capital	284,395	240,700
Retained earnings	1,380,971	1,147,611
Accumulated other comprehensive loss	(14,326)	(6,421)
Total stockholders' equity	**1,654,843**	**1,385,676**
Total liabilities and stockholders' equity	**$ 5,549,302**	**$ 4,617,418**

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
In thousands

	Common stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income/(loss)	Total
	Shares	Amount				
Balance at May 31, 2003	**376,698**	**$ 3,767**	**$ 198,713**	**$ 846,196**	**$ 28,695**	**$ 1,077,371**
Net income				302,950		302,950
Unrealized losses on securities, net of tax					(31,404)	(31,404)
Total comprehensive income						271,546
Cash dividends declared				(177,408)		(177,408)
Exercise of stock options	1,270	13	18,257			18,270
Tax benefit from exercise of stock options			10,194			10,194
Balance at May 31, 2004	**377,968**	**3,780**	**227,164**	**971,738**	**(2,709)**	**1,199,973**
Net income				368,849		368,849
Unrealized losses on securities, net of tax					(3,712)	(3,712)
Total comprehensive income						365,137
Cash dividends declared				(192,976)		(192,976)
Exercise of stock options	661	6	9,020			9,026
Tax benefit from exercise of stock options			4,516			4,516
Balance at May 31, 2005	**378,629**	**3,786**	**240,700**	**1,147,611**	**(6,421)**	**1,385,676**
Net income				464,914		464,914
Unrealized losses on securities, net of tax					(7,905)	(7,905)
Total comprehensive income						457,009
Cash dividends declared				(231,554)		(231,554)
Exercise of stock options	1,674	17	32,108			32,125
Tax benefit from exercise of stock options			11,587			11,587
Balance at May 31, 2006	**380,303**	**$ 3,803**	**$ 284,395**	**$ 1,380,971**	**$ (14,326)**	**$ 1,654,843**

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
In thousands

Year ended May 31,	2006	2005	2004
Operating activities			
Net income	$ 464,914	$ 368,849	$ 302,950
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization on property and equipment and intangible assets	66,517	62,004	55,837
Amortization of premiums and discounts on available-for-sale securities	27,897	28,618	26,079
(Benefit)/provision for deferred income taxes	(7,716)	9,590	(8,004)
Tax benefit related to exercise of stock options	11,587	4,516	10,194
Provision for allowance for doubtful accounts	2,173	2,179	2,941
Provision for legal reserves	—	—	35,800
Other non-cash adjustments	—	—	1,947
Net realized gains on sales of available-for-sale securities	(975)	(223)	(19,133)
Changes in operating assets and liabilities:			
Interest receivable	(7,031)	(8,544)	223
Accounts receivable	(30,057)	(28,264)	(19,622)
Prepaid expenses and other current assets	(2,604)	(3,620)	(5,288)
Accounts payable and other current liabilities	37,740	20,371	9,798
Net change in other assets and liabilities	6,788	11,148	(4,720)
Net cash provided by operating activities	**569,233**	**466,624**	**389,002**
Investing activities			
Purchases of available-for-sale securities	(90,551,938)	(84,226,693)	(80,325,156)
Proceeds from sales and maturities of available-for-sale securities	90,227,659	83,895,320	79,963,867
Net change in funds held for clients' money market securities and other cash equivalents	(520,504)	(37,494)	119,555
Net change in client fund deposits	620,807	191,647	89,874
Purchases of property and equipment	(81,143)	(70,686)	(50,562)
Proceeds from sale of property and equipment	42	3,506	7
Acquisition of businesses, net of cash acquired	(726)	(444)	(13,213)
Purchases of other assets	(4,247)	(2,742)	(2,395)
Net cash used in investing activities	**(310,050)**	**(247,586)**	**(218,023)**
Financing activities			
Dividends paid	(231,554)	(192,976)	(177,408)
Proceeds from exercise of stock options	32,125	9,026	18,270
Net cash used in financing activities	**(199,429)**	**(183,950)**	**(159,138)**
Increase in cash and cash equivalents	**59,754**	**35,088**	**11,841**
Cash and cash equivalents, beginning of fiscal year	77,669	42,581	30,740
Cash and cash equivalents, end of fiscal year	**$ 137,423**	**$ 77,669**	**$ 42,581**

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note A — Description of Business and Significant Accounting Policies

Description of Business: Paychex, Inc. and its wholly owned subsidiaries (the "Company" or "Paychex") is a leading provider of comprehensive payroll and integrated human resource and employee benefits outsourcing solutions for small- to medium-sized businesses in the United States ("U.S."). The Company also has approximately 500 clients in Germany. The Company, a Delaware corporation, reports one segment based upon the provision of Statement of Financial Accounting Standard ("SFAS") No. 131, "Disclosures about Segments of an Enterprise and Related Information."

Total revenue is comprised of service revenue and interest on funds held for clients. Service revenue is comprised of the Payroll and Human Resource Services product and service lines. Payroll service revenue is earned primarily from payroll processing, payroll tax administration services, employee payment services, and other ancillary services.

Payroll processing services include the calculation, preparation, and delivery of employee payroll checks; production of internal accounting records and management reports; the preparation of federal, state, and local payroll tax returns; and collection and remittance of payroll obligations for small- to medium-sized businesses.

In connection with the automated payroll tax administration services, the Company collects payroll taxes electronically from clients' bank accounts, typically on payday, prepares and files the applicable tax returns, and remits taxes to the applicable tax or regulatory agencies on their due dates. These collections from clients are typically paid between one and thirty days after receipt, with some items extending to ninety days. The Company handles all regulatory correspondence, amendments, and penalty and interest disputes, and is subject to cash penalties imposed by tax or regulatory agencies for late filings and late or under payment of taxes. With employee payment services, employers are offered the option of paying their employees by direct deposit, Paychex Access Visa® Card, a check drawn on a Paychex account (Readychex®), or a check drawn on the employer's account and electronically signed by Paychex. For the first three methods, net payroll is collected electronically from the clients' bank account, typically one day before payday, and provides payment to the employee on payday. In connection with both the payroll tax administration and employee payment services, authorized electronic money transfers from client bank accounts are subject to potential risk of loss resulting from insufficient funds to cover such transfers.

In addition to service fees paid by clients, the Company earns interest on funds held for clients that are collected before due dates and invested until remittance to the applicable tax or regulatory agencies or client employees. The funds held for clients and related client deposit liability are included in the Consolidated Balance Sheets as current assets and current liabilities. The amount of funds held for clients and related client deposit liability varies significantly during the year.

The Human Resource Services product and service line provides small- to medium-sized businesses with retirement services administration, workers' compensation insurance administration, employee benefits administration, group health benefits, and state unemployment insurance. The Company's Paychex Premier℠ Human Resource Services ("Paychex Premier") product provides a combined package of services that include payroll, employer compliance, human resource and employee benefits administration, risk management outsourcing, and the on-site availability of a professionally trained human resource representative. This comprehensive bundle of services is designed to make it easier for businesses to manage their payroll and related benefits costs while providing a benefits package equal to that of larger companies. The Company also operates a Professional Employer Organization ("PEO"), which provides primarily the same package of services as the Paychex Premier product, except Paychex serves as a co-employer of the clients' employees, assumes the risks and rewards of workers' compensation insurance, and provides more sophisticated health care offerings to PEO clients. The Company makes available time and attendance solutions to larger companies, and offers solutions to small- to medium-sized businesses through Time In A Box®.

Principles of consolidation: The Consolidated Financial Statements include the accounts of Paychex, Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Cash and cash equivalents: Cash and cash equivalents consist of available cash, money market securities, and other investments with a maturity of three months or less at the Balance Sheet date. Amounts reported in the Consolidated Balance Sheets approximate fair value.

Accounts receivable, net of allowance for doubtful accounts: Accounts receivable balances are shown on the Consolidated Balance Sheets net of the allowance for doubtful accounts of $2.5 million at both May 31, 2006 and 2005, respectively. Amounts reported in the Consolidated Balance Sheets approximate fair values. No single client has a material impact on total accounts receivable, service revenue, or results of operations.

Funds held for clients and corporate investments: Marketable securities included in funds held for clients and corporate investments consist primarily of securities classified as available-for-sale and are recorded at market value obtained from an independent pricing service. Funds held for clients also include cash, money market securities, and short-term investments. Unrealized gains and losses, net of applicable income taxes, are reported as comprehensive income in the Consolidated Statements of Stockholders' Equity. Realized gains and losses on the sales of securities are determined by specific identification of the cost basis of each security. On the Consolidated Statements of Income, realized gains and losses from funds held for clients are included in interest on funds held for clients and realized gains and losses from corporate investments are included in investment income, net.

Concentrations: Substantially all of the Company's deposited cash is maintained at two large credit-worthy financial institutions. These deposits may exceed the amount of any insurance provided. All of the Company's deliverable securities are held in custody with one of the two aforementioned financial institutions, for which that institution bears the risk of custodial loss. Non-deliverable securities, primarily time deposits and money market securities, are restricted to credit-worthy broker-dealers and financial institutions.

Property and equipment, net of accumulated depreciation: Property and equipment is stated at cost, less accumulated depreciation and amortization. Depreciation is based on the estimated useful lives of property and equipment using the straight-line method. The estimated useful lives of depreciable assets are generally ten to thirty-five years, or the remaining life, whichever is shorter, for buildings and improvements, two to seven years for data processing equipment, three to five years for software, seven years for furniture and fixtures, and ten years or the life of the lease, whichever is shorter, for leasehold improvements. Normal and recurring repair and maintenance costs are charged to expense as incurred. The Company reviews the carrying value of property and equipment, including capitalized software, for impairment when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable.

Software development and enhancements: Expenditures for software purchases and software developed for internal use are capitalized and depreciated on a straight-line basis over the estimated useful lives, which are generally three to five years, except for substantial changes in the functionality of processing applications, for which the estimated useful life may be longer. For software developed for internal use, costs are capitalized in accordance with Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Capitalized internal use software costs include external direct costs of materials and services associated with developing or obtaining the software, and payroll and payroll-related costs for employees who are directly associated with internal-use software projects. Capitalization of these costs ceases no later than the point at which the project is substantially complete and ready for its intended use. Costs associated with preliminary project stage activities, training, maintenance, and other post-implementation stage activities are expensed as incurred. The carrying value of software and development costs, along with other long-lived assets, is reviewed for impairment when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable.

Goodwill and other intangible assets, net of accumulated amortization: The Company has recorded goodwill in connection with the acquisitions of businesses during the years ended May 31, 2003 ("fiscal 2003") and May 31, 2004 ("fiscal 2004"). See Note B of the Notes to Consolidated Financial Statements, included in Item 8 of this Form 10-K, for further discussion on the fiscal 2004 acquisition. Under the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is tested for impairment on an annual basis and between annual tests if an event occurs or circumstances change in a way to indicate a potential decline in the fair value of the reporting unit. Impairment is determined by comparing the estimated fair value of the reporting unit to its carrying amount, including goodwill. The Company's business is largely homogeneous, and as a result, substantially all the goodwill is associated with one reporting unit. The Company performs its annual impairment testing in the fourth fiscal quarter. Based on the Company's review, no impairment loss was recognized in the results of operations for the year ended May 31, 2006 ("fiscal 2006") or the year ended May 31, 2005 ("fiscal 2005").

Intangible assets are primarily comprised of client list acquisitions and license agreements with independently owned associate offices and are reported net of accumulated amortization on the Consolidated Balance Sheets. Intangible assets are amortized over periods generally ranging from five to twelve years using either straight-line or accelerated methods. The Company tests intangible assets for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Other long-term assets: Other long-term assets are primarily related to the Company's investment as a limited partner in various low-income housing partnerships. These partnerships were determined to be variable interest entities as defined by Financial Accounting Standards Board ("FASB") Interpretation No. 46, "Consolidation of Variable Interest Entities." The Company is not the primary beneficiary of these variable interest entities and, therefore, does not consolidate them in its results of operations and financial position. The investments in these partnerships are accounted for under the equity method, with the Company's share of partnership losses recorded in investment income, net on the Consolidated Statements of Income. The net investment in these entities recorded on the Consolidated Balance Sheets was $4.5 million at May 31, 2006 and $5.2 million at May 31, 2005.

Revenue recognition: Service revenue is recognized in the period services are rendered and earned under service arrangements with clients where service fees are fixed or determinable and collectibility is reasonably assured. Certain processing services are provided under annual service arrangements with revenue recognized ratably over the annual service period. The Company's service revenue is largely attributable to payroll-related processing services where the fee is based on a fixed amount per processing period or a fixed amount per processing period plus a fee per employee or transaction processed. The revenue earned from delivery service for the distribution of certain client payroll checks and reports is included in service revenue, and the costs for the delivery are included in operating expenses on the Consolidated Statements of Income.

PEO revenue is included in service revenue and is reported net of direct costs billed and incurred, which include wages, taxes, benefit premiums, and claims of PEO worksite employees. Direct costs billed and incurred were $2,414.5 million, $2,230.8 million, and $1,846.1 million for fiscal 2006, 2005, and 2004, respectively.

Revenue from certain time and attendance solutions is recognized using the residual method when all of the following are present: persuasive evidence of an arrangement exists, typically a non-cancelable sales order; delivery is complete for the software and hardware; the fee is fixed or determinable and free of contingencies; and collectibility is reasonably assured. Maintenance contracts are generally purchased by the Company's clients in conjunction with their purchase of the related time and attendance solutions. Revenue from these maintenance contracts is recognized ratably over the term of the contract.

Interest on funds held for clients is earned primarily on funds that are collected from clients before due dates for payroll tax administration services and employee payment services, and invested until remittance to the applicable tax or regulatory agencies or client employees. These collections from clients are typically remitted between one and thirty days after receipt, with some items extending to ninety days. The interest earned on these funds is included in total revenue on the Consolidated Statements of Income because the collection, holding, and remittance of these funds are critical components of providing these services. Interest on funds held for clients also includes net realized gains and losses from the sales of available-for-sale securities.

Advantage Payroll Services, Inc. (“Advantage”), a subsidiary of the Company, has license agreements with fifteen independently owned associate offices (“Associates”). The Associates are responsible for selling and marketing Advantage payroll services and performing certain operational functions. Paychex and Advantage provide all centralized back-office payroll processing and payroll tax administration services for the Associates, including the billing and collection of processing fees and the collection and remittance of payroll and payroll tax funds pursuant to Advantage’s service arrangement with Associate customers. The marketing and selling by the Associates is conducted under their respective logos. Commissions earned by the Associates are based on the processing activity for the related clients. Revenue generated from customers as a result of these relationships and commissions paid to Associates are included in the Consolidated Statements of Income as service revenue and selling, general and administrative expense, respectively.

PEO workers’ compensation insurance: Workers’ compensation insurance reserves are established to provide for the estimated costs of paying claims underwritten by the Company. These reserves include estimates for reported losses, plus amounts for those claims incurred but not reported and estimates of certain expenses associated with processing and settling the claims. In establishing the workers’ compensation insurance reserves, the Company utilizes an independent actuarial estimate of undiscounted future cash payments that would be made to settle the claims.

Estimating the ultimate cost of future claims is an uncertain and complex process based upon historical loss experience and independent actuarial loss projections, and is subject to change due to multiple factors, including social and economic trends, changes in legal liability law, and damage awards, all of which could materially impact the reserves as reported in the Consolidated Financial Statements. Accordingly, final claim settlements may vary from the present estimates, particularly when those payments may not occur until well into the future.

The Company regularly reviews the adequacy of its estimated workers’ compensation insurance reserves. Adjustments to previously established reserves are reflected in the operating results of the period in which the adjustment is identified. Such adjustments could possibly be significant, reflecting any variety of new and adverse or favorable trends.

In fiscal 2006 and fiscal 2005, workers’ compensation insurance for PEO worksite employees was provided based on claims paid as incurred. The Company’s maximum individual claims liability was $750,000 under its fiscal 2006 policy and $500,000 under the fiscal 2005 policy.

The Company had recorded the following amounts on its Consolidated Balance Sheets for workers’ compensation claims as of May 31:

In thousands	Prepaid expense	Current liability	Long-term liability
2006	$ 3,150	$ 7,061	$ 18,374
2005	$ 3,702	$ 7,164	$ 13,963

The amount included in prepaid expense on the Consolidated Balance Sheets relates to the fiscal 2004 policy, which was a pre-funded policy.

Other insurance: The Company’s captive insurance company provides insurance coverage to Paychex in addition to primary insurance policies purchased by Paychex. The coverage provided includes gap coverage for employment practices liability, errors and omissions, warranty liability, acts of terrorism, capacity for deductibles, and self-insured retentions.

Income taxes: The Company accounts for deferred taxes by recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company accounts for the tax benefit from the exercise of non-qualified stock options by reducing its accrued income tax liability and increasing additional paid-in capital.

Stock-based compensation costs: SFAS No. 123, "Accounting for Stock-Based Compensation," establishes accounting and reporting standards for stock-based employee compensation plans. As permitted by SFAS No. 123, the Company accounts for such arrangements under Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, no compensation expense is recognized for stock option grants because the exercise price of the stock options equals the market price of the underlying stock on the date of the grant.

The following table illustrates the pro forma effect on net income and earnings per share as if the Company had applied the fair value recognition provision of SFAS No. 123 to stock-based compensation:

In thousands, except per share amounts	Year ended May 31, 2006	2005	2004
Net income, as reported	$ 464,914	$ 368,849	$ 302,950
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	18,821	15,525	9,703
Pro forma net income	$ 446,093	$ 353,324	$ 293,247
Earnings per share:			
Basic — as reported	$ 1.23	$ 0.97	$ 0.80
Basic — pro forma	$ 1.18	$ 0.93	$ 0.78
Diluted — as reported	$ 1.22	$ 0.97	$ 0.80
Diluted — pro forma	$ 1.17	$ 0.93	$ 0.77

For purposes of pro forma disclosures, the estimated fair value of the stock option is amortized to expense over the option's vesting period. The weighted-average fair value of stock options granted for fiscal 2006, 2005, and 2004 was $11.10, $9.02, and $9.61 per share, respectively. The fair value of these stock options was estimated at the date of the grant using a Black-Scholes option pricing model with the following weighted-average assumptions:

	Year ended May 31, 2006	2005	2004
Risk-free interest rate	4.0%	3.6%	2.8%
Dividend yield	1.6%	1.6%	1.4%
Volatility factor	.31	.31	.33
Expected option term life in years	6.4	5.0	4.7

Additional information related to the Company's stock option plans is detailed in Note G of the Notes to Consolidated Financial Statements.

Use of estimates: The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, judgments, and assumptions that affect reported amounts of assets, liabilities, revenue, and expenses during the reporting period. Actual amounts and results could differ from these estimates.

New accounting pronouncements: In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment," which replaces SFAS No. 123, "Accounting for Stock-Based Compensation" and supersedes APB 25, "Accounting for Stock Issued to Employees." This statement requires that all stock-based payments to employees, including grants of employee stock options, be recognized as compensation costs in the financial statements based on their fair values measured at the date of grant.

Prior to June 1, 2006, the Company had accounted for grants of employee stock options under the intrinsic value method allowed under APB 25 and related interpretations, and therefore had not recognized any compensation costs for stock-based awards. As permitted by SFAS No. 123, the Company presented pro forma financial results including the effects of share-based compensation costs in this Note A to the Consolidated Financial Statements.

SFAS No. 123(R) is effective for fiscal years beginning after December 15, 2005 and permits adoption using one of the following two methods:

- *Modified prospective method*, in which compensation costs will be recognized in the Company's Consolidated Financial Statements for all awards granted after the date of adoption as well as for the unvested portion of existing awards as of the date of adoption (the "Existing Awards"), and requires that prior periods not be restated.

- *Modified retrospective method*, which includes the requirements of the modified prospective method described above for new awards and Existing Awards, but also permits entities to restate prior periods based on amounts previously determined under SFAS No. 123 for pro forma disclosures.

The Company will adopt this standard beginning June 1, 2006, using the modified prospective method. Accordingly, the results of operations for future periods will not be comparable to the Company's historical results of operations. Paychex anticipates the adoption of SFAS No. 123(R) will negatively impact net income in the range of 4% to 5% for the fiscal year ending May 31, 2007, increasing the Company's operating expenses and selling, general and administrative expenses.

Unrecognized stock-based compensation costs related to Existing Awards as of May 31, 2006 were approximately $38.3 million and are expected to be recognized over a weighted-average period of 2.4 years. The Company cannot yet estimate what the compensation cost impact will be on the financial statements for the awards that the Company issues after June 1, 2006, as it will depend on the terms of any future grants approved by the Board of Directors and the underlying assumptions used in calculating the fair value at the time of any such future grants. The calculation of fair value is very sensitive to changes in the underlying assumptions, especially volatility and expected option term life.

In addition, SFAS No. 123(R) will impact how income taxes are recorded to the Company's Consolidated Financial Statements, as tax deductions for certain tax-qualified option grants ("incentive stock options") are allowed only at the time a taxable disposition occurs. This may result in an increase in the Company's effective tax rate in the early periods after adoption and it could cause variability in the Company's effective tax rate throughout a fiscal year as these events occur.

SFAS No. 123(R) also amends SFAS No. 95, "Statement of Cash Flows," to require that excess tax benefits be reported as a financing cash inflow rather than a reduction of taxes paid in operating cash flows. The Company cannot estimate what the amount of excess tax deductions will be in future periods. However, the amounts of operating cash flows recognized in prior periods for excess tax deductions were $11.6 million, $4.5 million, and $10.2 million for fiscal 2006, 2005, and 2004, respectively.

The Company’s pro-forma disclosures under SFAS No. 123 utilized a Black-Scholes option pricing model for valuing employee stock options and allocated the expense using an accelerated method. Upon adoption of SFAS No. 123(R), Paychex will continue to use a Black-Scholes option pricing model, but will begin to allocate the expense on a straight-line basis over the requisite service period to better reflect the cost of employee services provided.

Upon adoption of SFAS No. 123(R), Paychex will be required to estimate forfeitures and only record compensation costs for those awards that are expected to vest. In the Company’s pro forma disclosures under SFAS No. 123, it has accounted for forfeitures as they occurred. Assumptions for forfeitures will be determined based on factors including type of award and historical experience, and will be reevaluated regularly as an award vests.

Paychex currently offers an Employee Stock Purchase Plan to all employees, under which stock can be purchased through a payroll deduction with no discount to the market price and no look-back provision. The Company has determined that this plan is non-compensatory and is not subject to the provisions of SFAS No. 123(R). Therefore, no compensation cost will be recognized related to this plan.

The following FASB Staff Positions (“FSP”) issued during the Company’s fiscal year ended May 31, 2006 and related to SFAS No. 123(R) will be applied upon adoption of SFAS No. 123(R) for the Company’s fiscal year beginning June 1, 2006:

- FAS 123(R)-1, “Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R);”
- FAS 123(R)-2, “Practical Accommodation to the Application of Grant Date as Defined in FASB Statement 123(R);”
- FAS 123(R)-3, “Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards;” and
- FAS 123(R)-4, “Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event.”

In October 2005, the FASB issued FSP FAS13-1, “Accounting for Rental Costs Incurred During a Construction Period.” This FSP provides that rental costs associated with operating leases that are incurred during a construction period should be recognized as rental expense and included in income from continuing operations. The guidance in this FSP was effective in the first reporting period beginning after December 15, 2005. The Company has historically expensed rental costs incurred during a construction period, and therefore, the adoption of this FSP did not have an impact on the Company’s results of operations or financial position.

In November 2005, the FASB issued FSP FAS 115-1 and FAS 124-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” This FSP provides guidance on determining if an investment is considered to be impaired, if the impairment is other-than-temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in this FSP amends SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” and was effective for reporting periods beginning after December 15, 2005. The Company accounts for investments in accordance with this guidance, and therefore, the adoption of this FSP did not have an impact on the Company’s results of operations or financial position.

In February and March 2006, the FASB issued the following statements amending SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities” and SFAS No. 140, “Accounting for

Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a Replacement of FASB Statement No. 125:"

- SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments — an Amendment of FASB Statements No. 133 and 140;" and
- SFAS No. 156, "Accounting for Servicing of Financial Assets — an Amendment of FASB Statement No. 140."

The guidance in these statements is effective in the first fiscal year beginning after September 15, 2006. The Company does not utilize derivative financial instruments and currently does not have any servicing assets or servicing liabilities that would fall under the guidance of either statement, and therefore, the adoption of these statements will not have a material impact on the Company's results of operations or financial position.

Reclassifications: Certain prior periods presented reflect the change in classification of variable rate demand notes ("VRDNs") and auction rate securities from cash equivalents to available-for-sale securities. This reclassification had no impact on reported consolidated earnings.

VRDNs are variable rate securities where the interest rate is periodically reset, as established at the time of the notes issuance, and is often tied to short-term interest rates. However, the contractual maturity on these notes is typically twenty to thirty years. The Company invests in these securities to provide near-term liquidity as it can tender the notes at par to a remarketing agent either daily or within five business days. Auction rate securities are also variable rate and tied to short-term interest rates with maturities in excess of ninety days. Interest rates on these securities reset through a Dutch auction, at predetermined short-term intervals, usually every seven, twenty-eight, thirty-five, or forty-nine days. Interest paid during a given period is based upon the interest rate determined during the prior auction. Although VRDNs and auction rate securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature. The Company has historically classified these securities as cash equivalents if the period between interest rate resets was ninety days or less.

Based on the Company's review of the maturity dates associated with the underlying securities and as liquidity is provided by a party other than the original issuer, the Company has reclassified VRDNs and auction rate securities to available-for-sale securities, within corporate investments and funds held for clients, for each of the periods presented in the accompanying Consolidated Balance Sheets. This reclassification was $1.7 billion and $1.6 billion from cash equivalents to available-for-sale securities within funds held for clients as of May 31, 2006 and May 31, 2005, respectively, and $263.5 million and $203.3 million from cash and cash equivalents to corporate investments as of May 31, 2006 and May 31, 2005, respectively. In addition, "Purchases of available-for-sale securities," "Proceeds from sales and maturities of available-for-sale securities," "Net change in funds held for clients' money market securities and other cash equivalents," and "Net realized gains on sales of available-for-sale securities" included in the accompanying Consolidated Statements of Cash Flows, have been revised to reflect the purchase and sale of VRDNs and auction rate securities during the periods presented.

Certain prior period amounts have been reclassified to conform to the current period presentation. These reclassifications had no effect on reported consolidated earnings. Expenses have been reclassified between operating expenses and selling, general and administrative expenses to more appropriately reflect the Company's current way of conducting business. The role of the branch and its relationship to corporate support and information technology functions has evolved to the point where the classification of branch-related expenses needed to be revised. The new classification provides better year-over-year comparisons for operating expenses and selling, general and administrative expenses.

Note B — Business Combinations

As a result of acquisitions in fiscal 2003, the Company recorded reserves for severance and redundant lease costs in the allocation of purchase price under Emerging Issues Task Force 95-3, "Recognition of Liabilities in Connection With a Purchase Combination." The purchase price allocation for the acquisitions included reserves of $10.0 million for severance and $5.9 million for redundant lease costs. Activity for fiscal 2006 for these reserves is summarized as follows:

In thousands	Balance at May 31, 2005	Utilization of reserve	Other reserve adjustments	Balance at May 31, 2006
Severance costs	$ 618	$ 427	$ —	$ 191
Redundant lease costs	$ 2,490	$ 996	$ 45	$ 1,539

The remaining severance payments will be complete by the end of the fiscal year ending May 31, 2008. The majority of redundant lease payments are expected to be complete in the fiscal year ending May 31, 2007, with the remaining payments extending until 2015. Payments of $1.4 million extend beyond one year and are included in other long-term liabilities on the Consolidated Balance Sheets at May 31, 2006.

Fiscal 2004 acquisition: During fiscal 2004, the Company expanded its product offerings to include time and attendance solutions. Effective April 12, 2004, Paychex acquired substantially all the assets and certain liabilities of Stromberg LLC ("Stromberg"), a provider of time and attendance solutions for medium- to large-sized businesses, for approximately $13.5 million. Paychex had purchased Stromberg's Time In A Box product, a time and attendance solution for small- to medium-sized businesses, in October 2003. The purchase price was allocated to the assets and liabilities of Stromberg based on their fair values as follows:

In thousands	Stromberg
Current assets and other long-term assets	$ 723
Property and equipment	2,097
Intangible assets	950
Goodwill	11,757
Accounts payable and accrued expenses	(2,053)
Total purchase price	$ 13,474

The amount assigned to property and equipment primarily represents the fair value of software and is based upon an independent appraisal. The goodwill balance is deductible for tax purposes.

Note C — Basic and Diluted Earnings Per Share

Basic and diluted earnings per share were calculated as follows:

In thousands, except per share amounts	Year ended May 31, 2006	2005	2004
Basic earnings per share:			
Net income	$ 464,914	$ 368,849	$ 302,950
Weighted-average common shares outstanding	379,465	378,337	377,371
Basic earnings per share	**$ 1.23**	**$ 0.97**	**$ 0.80**
Diluted earnings per share:			
Net income	$ 464,914	$ 368,849	$ 302,950
Weighted-average common shares outstanding	379,465	378,337	377,371
Effect of dilutive stock options at average market price	1,886	1,426	2,153
Weighted-average common shares outstanding, assuming dilution	381,351	379,763	379,524
Diluted earnings per share	**$ 1.22**	**$ 0.97**	**$ 0.80**
Weighted-average anti-dilutive stock options	**2,711**	**4,918**	**1,907**

Weighted-average anti-dilutive stock options to purchase shares of common stock were excluded from the computation of diluted earnings per share. These options had an exercise price that was greater than the average market price of the common shares for the period; therefore, the effect would have been anti-dilutive.

Note D — Funds Held for Clients and Corporate Investments

Funds held for clients and corporate investments at May 31, 2006 and 2005 are as follows:

	May 31, 2006			
In thousands	Cost	Gross unrealized gains	Gross unrealized losses	Market value
Type of issue:				
Money market securities and other cash equivalents	$ 557,074	$ —	$ —	$ 557,074
Available-for-sale securities:				
General obligation municipal bonds	796,543	229	(12,201)	784,571
Pre-refunded municipal bonds	215,491	153	(3,015)	212,629
Revenue municipal bonds	423,922	12	(6,099)	417,835
Auction rate securities and variable rate demand notes	2,136,906	94	—	2,137,000
U.S. government securities	301,573	—	(1,272)	300,301
Other equity securities	20	57	—	77
Total available-for-sale securities	3,874,455	545	(22,587)	3,852,413
Other	6,148	515	(51)	6,612
Total funds held for clients and corporate investments	**$ 4,437,677**	**$ 1,060**	**$ (22,638)**	**$ 4,416,099**

Table of Contents

	May 31, 2005			
In thousands	Cost	Gross unrealized gains	Gross unrealized losses	Market value
Type of issue:				
Money market securities and other cash equivalents	$ 36,571	$ —	$ —	$ 36,571
Available-for-sale securities:				
General obligation municipal bonds	730,571	1,497	(7,042)	725,026
Pre-refunded municipal bonds	196,321	612	(1,112)	195,821
Revenue municipal bonds	414,358	697	(3,806)	411,249
Auction rate securities and variable rate demand notes	2,060,037	2	—	2,060,039
U.S. government securities	175,792	14	(762)	175,044
Other equity securities	20	48	—	68
Total available-for-sale securities	3,577,099	2,870	(12,722)	3,567,247
Other	5,169	254	(22)	5,401
Total funds held for clients and corporate investments	**$ 3,618,839**	**$ 3,124**	**$ (12,744)**	**$ 3,609,219**

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

In thousands	May 31, 2006	May 31, 2005
Funds held for clients	$ 3,591,611	$ 2,979,348
Corporate investments	440,007	225,719
Long-term corporate investments	384,481	404,152
Total funds held for clients and corporate investments	**$ 4,416,099**	**$ 3,609,219**

The Company is exposed to credit risk in connection with these investments through the possible inability of the borrowers to meet the terms of the bonds. In addition, the Company is exposed to interest rate risk, as rate volatility will cause fluctuations in the market value of held investments and in the earnings potential of future investments. The Company attempts to limit these risks by investing primarily in AAA- and AA-rated securities and A-1- rated short-term securities, limiting amounts that can be invested in any single issuer, and by investing in short- to intermediate-term instruments whose market value is less sensitive to interest rate changes.

The Company's available-for-sale securities reflected a net unrealized loss position of $22.0 million at May 31, 2006 compared with $9.9 million at May 31, 2005. The change in the net unrealized loss position of the Company's available-for-sale securities from May 31, 2005 to May 31, 2006 resulted from increases in long-term market interest rates. The gross unrealized losses at May 31, 2006 were comprised of 441 available-for-sale securities, which had a total market value of $1,625.7 million. The gross unrealized losses at May 31, 2005 were comprised of 327 available-for-sale securities with a total market value of $1,211.5 million. The securities in an unrealized loss position were in a loss position as follows as of May 31, 2006 and 2005:

	Less than 12 Months		More than 12 Months	
In thousands	Gross unrealized loss	Market value	Gross unrealized loss	Market value
2006	$ (7,724)	$ 735,610	$ (14,863)	$ 890,076
2005	$ (6,474)	$ 818,782	$ (6,248)	$ 392,748

The Company periodically reviews its investment portfolios to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns. At May 31, 2006, the Company believed that the investments it held were not other-than-temporarily impaired. While certain available-for-sale securities had market values that were below cost, the Company believed that it was probable that the principal and interest would be collected in accordance with contractual terms, and that the decline in the market value was due to changes in interest rates and was not due to increased credit risk. At May 31, 2006 and May 31, 2005, substantially all of the securities in an unrealized loss position held an AA rating or better. The Company currently believes that it has the ability and intent to hold these investments until the earlier of market price recovery or maturity. The Company's assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in the Company's strategies or assumptions related to any particular investment. As of May 31, 2006, the Company had separately reported its long-term corporate investments on its Consolidated Balance Sheets as the Company has the ability to hold these investments for a period in excess of one year. To conform to the current period presentation, the Company has also reclassified its investments at May 31, 2005.

Realized gains and losses are as follows:

	Year ended May 31,		
In thousands	**2006**	**2005**	**2004**
Gross realized gains	$ 1,036	$ 1,114	$ 19,808
Gross realized losses	(61)	(891)	(675)
Net realized gains	**$ 975**	**$ 223**	**$ 19,133**

The cost and market value of available-for-sale securities that have stated maturities at May 31, 2006 are shown below by contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties.

	May 31, 2006	
In thousands	**Cost**	**Market value**
Maturity date:		
Due in one year or less	$ 545,046	$ 542,178
Due after one year through three years	688,411	678,728
Due after three years through five years	282,107	276,241
Due after five years	2,356,196	2,352,513
Total available-for-sale securities	**$ 3,871,760**	**$ 3,849,660**

VRDNs and auction rate securities are primarily categorized as due after five years in the table above as the contractual maturities on these securities is typically twenty to thirty years. Although these securities are issued as long-term securities, both are priced and traded as short-term instruments because of the liquidity provided through the auction or tender feature.

Note E — Property and Equipment, Net of Accumulated Depreciation

The components of property and equipment, at cost, consisted of the following:

In thousands	May 31, 2006	May 31, 2005
Land and improvements	$ 3,552	$ 3,402
Buildings and improvements	79,875	66,019
Data processing equipment	134,636	116,465
Software	66,945	58,463
Furniture, fixtures, and equipment	112,733	98,312
Leasehold improvements	47,627	35,958
Construction in progress	36,350	29,470
Total property and equipment, gross	481,718	408,089
Less: Accumulated depreciation and amortization	247,054	202,770
Property and equipment, net of accumulated depreciation	**$ 234,664**	**$ 205,319**

Depreciation expense was $51.6 million, $46.2 million, and $39.2 million for fiscal years 2006, 2005, and 2004, respectively.

Within construction in progress, there are costs for software being developed for internal use of $29.4 million and $18.9 million at May 31, 2006 and May 31, 2005, respectively. Capitalization of costs ceases when the software is ready for its intended use, at which time the Company begins amortization of the costs.

Note F — Intangible Assets, Net of Accumulated Amortization

The Company accounts for certain intangible assets with finite lives in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." The components of intangible assets, at cost, consisted of the following:

In thousands	May 31, 2006	May 31, 2005
Client lists and associate offices license agreements	$ 122,909	$ 118,749
Other intangible assets	4,165	4,166
Total intangible assets, gross	127,074	122,915
Less: Accumulated amortization	66,370	51,457
Intangible assets, net of accumulated amortization	**$ 60,704**	**$ 71,458**

Amortization expense for intangible assets was $14.9 million, $15.8 million, and $16.6 million for fiscal years 2006, 2005, and 2004, respectively.

The estimated amortization expense for the next five fiscal years relating to intangible asset balances as of May 31, 2006, is as follows:

In thousands Fiscal year ended May 31,	Estimated amortization expense
2007	$13,475
2008	$11,736
2009	$ 9,995
2010	$ 8,367
2011	$ 6,592

Note G — Stock Option Plans

The Paychex, Inc. 2002 Stock Incentive Plan, as amended and restated (the “2002 Plan”), became effective on October 12, 2005 upon its approval by the Company’s stockholders. The 2002 Plan authorizes the granting of options to purchase up to 29.1 million shares of the Company’s common stock. At May 31, 2006, there were 20.5 million shares available for future grants under the 2002 Plan.

No future grants will be made pursuant to the Paychex, Inc. 1998 or 1995 Stock Incentive Plans, which expired in August 2002 and 1998, respectively. However, options to purchase an aggregate of 4.5 million shares under these two plans remain outstanding at May 31, 2006.

The exercise price for the shares subject to options of the Company’s common stock is equal to the fair market value on the date of the grant. All stock option grants have a contractual life of ten years from the date of the grant. Non-qualified stock option grants since July 2005 vest 20% per annum, with previously granted stock options vesting at 33.3% after two years of service from the date of the grant, with annual vesting at 33.3% thereafter.

The Company has granted stock options to employees in the following broad-based incentive stock option grants:

Date of broad-based grant	Shares granted	Exercise price	Shares outstanding at May 31, 2006	Vesting schedule
November 1996	3,157,000	$11.53	180,000	50% on May 3, 1999, 50% on May 1, 2001
July 1999	1,381,000	$21.46	328,000	25% each July in 2000 through 2003
October 2001	1,295,000	$33.17	579,000	25% each October in 2002 through 2005
April 2004	1,655,000	$37.72	1,173,000	25% each April in 2005 through 2008

Historically, each April and October, the Company has granted options to newly hired employees who met certain criteria. Beginning with grants issued in July 2005, such grants of options vest 20% per annum.

The following table summarizes stock option activity for the three years ended May 31, 2006:

In thousands, except per share amounts	Shares subject to options	Weighted-average exercise price
Outstanding at May 31, 2003	**8,871**	**$23.77**
Granted	3,429	$34.29
Exercised	(1,270)	$14.38
Cancelled	(424)	$32.89
Outstanding at May 31, 2004	**10,606**	**$27.93**
Granted	2,729	$31.54
Exercised	(661)	$13.65
Cancelled	(745)	$34.19
Outstanding at May 31, 2005	**11,929**	**$29.15**
Granted	3,860	$34.32
Exercised	(1,674)	$19.19
Cancelled	(605)	$34.72
Outstanding at May 31, 2006	**13,510**	**$31.61**
Exercisable at May 31, 2004	**5,000**	**$21.31**
Exercisable at May 31, 2005	**5,622**	**$25.50**
Exercisable at May 31, 2006	**5,482**	**$29.49**

Stock options granted during fiscal 2005 include a grant of 650,000 options, at an exercise price of $30.68 per share, to the Company's current President and Chief Executive Officer on October 1, 2004. Of these stock options, 100,000 were granted under the 2002 Plan and the remaining 550,000 were granted under a non-qualified stock option agreement.

Historically, the Company has granted options to purchase common stock in an annual aggregate amount that is less than one percent of the outstanding common shares. With the July 2005 grant of options to purchase common stock, the Company has increased the annual amount to approximately one percent of outstanding common shares.

The following table summarizes information about stock options outstanding and exercisable at May 31, 2006:

	Options outstanding			Options exercisable	
Range of exercise prices per share	Shares subject to options (in thousands)	Weighted-average exercise price per share	Weighted-average remaining contractual life in years	Shares subject to options (in thousands)	Weighted-average exercise price per share
$ 8.71 — $17.24	719	$11.59	1.0	719	$11.59
$17.25 — $25.78	1,191	$20.85	2.8	1,191	$20.85
$25.79 — $34.32	8,465	$31.85	8.0	1,622	$30.56
$34.33 — $42.86	3,006	$39.14	6.8	1,821	$39.76
$42.87 — $51.38	129	$50.53	4.3	129	$50.53
$ 8.71 — $51.38	13,510	$31.61	6.8	5,482	$29.49

Table of Contents

Note H — Income Taxes

The components of deferred tax assets and liabilities are as follows:

In thousands	May 31, 2006	May 31, 2005
Deferred tax assets:		
Legal reserve	$ 4,481	$ 8,973
Captive loss reserve	2,364	1,826
Compensation and employee benefit liabilities	9,522	7,471
PEO workers' compensation claims reserve	3,589	6,400
Unrealized losses on available-for-sale securities	7,717	3,431
Other current liabilities	5,667	3,501
Tax credit carry forward	11,242	—
Depreciation	3,120	658
Other	2,265	2,301
Gross deferred tax assets	**49,967**	**34,561**
Deferred tax liabilities:		
Capitalized software	11,609	8,684
Intangible assets	12,704	10,316
Revenue not subject to current taxes	8,973	7,985
Depreciation	711	3,549
Other	354	413
Gross deferred tax liabilities	**34,351**	**30,947**
Net deferred tax asset	**$ 15,616**	**$ 3,614**

The components of the provision for income taxes are as follows:

In thousands	Year ended May 31, 2006	2005	2004
Current:			
Federal	$ 209,659	$ 159,007	$ 140,130
State	7,909	8,720	14,708
Total current	**217,568**	**167,727**	**154,838**
Deferred:			
Federal	(7,872)	9,155	(7,657)
State	156	435	(347)
Total deferred	**(7,716)**	**9,590**	**(8,004)**
Provision for income taxes	**$ 209,852**	**$ 177,317**	**$ 146,834**

A reconciliation of the U.S. federal statutory tax rate to the effective rates reported for income before taxes for the three years ending May 31, 2006, is as follows:

	Year ended May 31, 2006	2005	2004
Federal statutory tax rate	35.0%	35.0%	35.0%
Increase/(decrease) resulting from:			
State income taxes, net of federal benefit	0.8	1.1	2.1
Tax-exempt municipal bond interest	(4.5)	(3.9)	(3.8)
Other items	(0.2)	0.3	(0.7)
Effective income tax rate	**31.1%**	**32.5%**	**32.6%**

Note I — Other Comprehensive Loss

The following table sets forth the related tax effects allocated to unrealized gains and losses on available-for-sale securities, which is the only component of other comprehensive loss:

In thousands	Year ended May 31, 2006	2005	2004
Unrealized holding losses	$ (11,216)	$ (5,445)	$ (30,011)
Income tax benefit related to unrealized holding losses	3,941	1,878	10,768
Reclassification adjustment for the net gain on sale of available-for-sale securities realized in net income	(975)	(223)	(19,133)
Income tax expense on reclassification adjustment for net gain on sale of available-for-sale securities	345	78	6,972
Other comprehensive loss	**$ (7,905)**	**$ (3,712)**	**$ (31,404)**

At May 31, 2006, accumulated other comprehensive loss was $14.3 million, net of tax of $7.8 million. At May 31, 2005, accumulated other comprehensive loss was $6.4 million, net of tax of $3.4 million.

Note J — Supplemental Cash Flow Information

Supplemental disclosure of non-cash financing activities and cash flow information is as follows:

In thousands	Year ended May 31, 2006	2005	2004
Income taxes paid	$ 207,632	$ 166,903	$ 145,710
Tax benefit from the exercise of stock options	$ 11,587	$ 4,516	$ 10,194

Note K — Employee Benefit Plans

401(k) Plans: The Company maintains a contributory savings plan that qualifies under section 401(k) of the Internal Revenue Code. The Paychex, Inc. 401(k) Incentive Retirement Plan (the "Plan") allows all employees to immediately participate in the salary deferral portion of the Plan, contributing up to a maximum of 50% of their salary. Employees who have completed one year of service are eligible to receive a company matching contribution. The Company currently matches 50% of an employee's voluntary contribution up to 6% of a participant's gross wages.

This Plan is 100% participant-directed. Plan participants can fully diversify their portfolios by choosing from any or all investment fund choices in the Plan. Transfers in and out of investment funds, including the Paychex, Inc. Employee Stock Ownership Plan ("ESOP") Stock Fund, are not restricted in any manner. The Company match contribution follows the same fund elections as the employee compensation deferrals.

Company contributions to the 401(k) plan for fiscal 2006, 2005, and 2004 were $9.1 million, $7.9 million, and $7.1 million, respectively.

Deferred Compensation Plans: The Company offers a non-qualified and unfunded Deferred Compensation Plan to a select group of key employees, executive officers, and Directors. Eligible employees are provided with the opportunity to defer up to 50% of their annual base salary and bonus and non-employee directors to defer 100% of their Board compensation. Gains and losses are credited based on the participant's election of a variety of investment choices. The Company does not match any participant deferral or guarantee its return. The amounts accrued under this Plan were $6.6 million and $5.4 million at May 31, 2006 and 2005, respectively, and are reflected in other long-term liabilities in the accompanying Consolidated Balance Sheets.

Prior to the April 1, 2003 acquisition, InterPay, Inc. ("InterPay") entered into various salary continuation agreements with certain former employees. These agreements provide for benefits to these retired employees, and in certain cases to their beneficiaries, for life or other designated periods through 2015. The amounts accrued under these agreements were $1.6 million and $1.8 million at May 31, 2006 and 2005, respectively, and represent the estimated present value of the benefits earned under these agreements.

Employee Stock Purchase Plan: The Company offers an Employee Stock Purchase Plan under which eligible employees may purchase common stock of the Company at current market prices with no look-back provision. All transactions occur directly through the Company's transfer agent and no brokerage fees are charged to employees, except for when stock is sold.

Note L — Commitments and Contingencies

Lines of credit: The Company has unused borrowing capacity available under four uncommitted, secured, short-term lines of credit with financial institutions at market rates of interest as follows:

Financial institution	Amount available	Expiration date
JP Morgan Chase Bank, N.A.	$350 million	February 2007
Fleet National Bank, a Bank of America company	$250 million	February 2007
PNC Bank, National Association	$150 million	February 2007
Wells Fargo Bank, National Association	$150 million	February 2007

The credit facilities are evidenced by Promissory Notes and are secured by separate Pledge Security Agreements by and between Paychex, Inc. and each of the financial institutions (the "Lenders"), pursuant to which the Company has granted each of the Lenders a security interest in certain investment securities accounts. The collateral is maintained in a pooled custody account pursuant to the terms of a Control Agreement and is to be administered under an Intercreditor Agreement among the Lenders. Under certain circumstances, individual Lenders may require that collateral be transferred from the pooled account into segregated accounts for the benefit of such individual Lenders.

The primary uses of the lines of credit would be to meet short-term funding requirements related to deposit account overdrafts and client fund deposit obligations arising from electronic payment transactions on behalf of clients in the ordinary course of business, if necessary. No amounts were outstanding against these lines of credit during fiscal 2006 or at May 31, 2006.

Letters of credit: The Company had standby letters of credit outstanding totaling $53.4 million and $53.1 million at May 31, 2006 and 2005, respectively, required to secure commitments for certain insurance policies. These letters of credit at May 31, 2006, expire at various dates between July 2006 and December 2008 and are secured by securities held in the Company's corporate investment portfolios, including a $44.2 million letter of credit for which funds have been segregated into a separate account. Effective June 28, 2006, this $44.2 million letter of credit was increased to $50.9 million, bringing the total letters of credit outstanding to $60.2 million. No amounts were outstanding on these letters of credit during fiscal 2006 or at May 31, 2006.

Contingencies: The Company is subject to various claims and legal matters that arise in the normal course of its business. These include disputes or potential disputes related to breach of contract, employment-related claims, tax claims, and other matters.

The Company and its wholly owned subsidiary, Rapid Payroll, Inc. ("Rapid Payroll"), are currently defendants in three lawsuits pending in the United States Bankruptcy Court, Central District of California, thirteen lawsuits pending in the United States Court of Appeals for the Ninth Circuit, and one lawsuit pending in the California Court of Appeal, Second District, all brought in calendar years 2002 and 2003 by licensees of payroll processing software owned by Rapid Payroll.

In August 2001, Rapid Payroll informed seventy-six licensees that it intended to stop supporting the payroll processing software in August of 2002. Thereafter, lawsuits were commenced by licensees asserting various claims, including breach of contract and related tort and fraud causes of action. These lawsuits sought compensatory damages, punitive damages, and injunctive relief against Rapid Payroll, the Company, the Company's former Chief Executive Officer, and its Senior Vice President of Sales and Marketing. In accordance with the Company's indemnification agreements with its senior executives, the Company will defend and, if necessary, indemnify them in connection with these pending matters.

On July 5, 2002, the federal district court entered a preliminary injunction requiring that Rapid Payroll and the Company continue to support and maintain the subject software pursuant to the license agreements.

In 2005, judgment was entered in *Accuchex, Inc. v. Rapid Payroll, Inc., et al.* following a bench trial before a judge of the Los Angeles County Superior Court. The judgment provided that the limitation of liability clause in the parties' license agreement is valid and enforceable. The court awarded Accuchex damages of $30.5 thousand plus a refund of approximately $35.0 thousand in license fees. The court also ordered Rapid Payroll to support its software being used by Accuchex until such time as Rapid Payroll dissolves, which the court found Rapid Payroll was entitled to do without incurring any further liability to Accuchex. The court rejected all of the other causes of action asserted by the plaintiff. The case is pending on appeal with the California Court of Appeal, Second District.

On February 28 and March 1, 2005, the United States District Court, Central District of California entered judgment in thirteen of the cases pending before it. Those judgments provided that Rapid Payroll's liability is limited by the license fees paid to it by the plaintiff licensees, pursuant to express contractual provisions of the license agreements. Those judgments also extended the court's preliminary injunction, ordering that Rapid Payroll must support the licensed software through April 30, 2006, and, at that time, refund to each of the licensee plaintiffs the license fees paid by that plaintiff. The license fees received by

'Rapid Payroll under the agreements from these thirteen licensee plaintiffs total approximately $2.5 million. The federal court also ordered the release of the source code pursuant to the escrow terms of the license agreements. The federal court judgments rejected the fraud and other tort claims brought by those plaintiffs against all of the defendants. Plaintiffs have appealed the federal court rulings and the Company has cross-appealed.

On May 4, 2006, following expiration of the federal district court's injunction, Rapid Payroll filed a petition under Chapter 11 of the U.S. Bankruptcy Code in order to develop a plan that allows Rapid Payroll to discontinue support for the software in a manner that deals fairly with its few remaining licensees. Rapid Payroll is continuing to operate as a debtor-in-possession, paying all of its post-petition debts as they become due.

Based on the application of SFAS No. 5, "Accounting for Contingencies," the Company is required to record a reserve if it believes an unfavorable outcome is probable and the amount of the probable loss can be reasonably estimated. The Company's legal reserve for all litigation totaled $15.6 million at May 31, 2006, and is included in current liabilities on the Consolidated Balance Sheets. The legal reserve has been reduced in fiscal 2006 as actual settlements and incurred professional fees have been charged against it.

In light of the legal reserve recorded, the Company's management currently believes that resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations. However, these matters are subject to inherent uncertainties and there exists the possibility that the ultimate resolution of these matters could have a material adverse impact on the Company's financial position and the results of operations in the period in which any such effect is recorded.

Lease commitments: The Company leases office space and data processing equipment under terms of various operating leases, with most data processing equipment leases containing a purchase option at prices representing the fair value of the equipment at expiration of the lease term. Rent expense for fiscal 2006, 2005, and 2004 was $37.6 million, $35.9 million, and $37.7 million, respectively. At May 31, 2006, future minimum lease payments under various non-cancelable operating leases with terms of more than one year are as follows:

In thousands **Fiscal year ended May 31,**	**Minimum lease payments**
2007	$37,902
2008	$33,687
2009	$27,019
2010	$19,859
2011	$12,100
Thereafter	$ 5,104

The amounts shown above for operating leases include obligations under redundant leases related to Advantage and InterPay.

Other commitments: At May 31, 2006, the Company had outstanding commitments under purchase orders and legally binding contractual arrangements with minimum future payment obligations of approximately $77.0 million, including $8.2 million of commitments to purchase capital assets.

The Company guarantees performance of service on annual maintenance contracts for clients who financed their service contracts through a third party. In the normal course of business, the Company makes representations and warranties that guarantee the performance of services under service arrangements with clients. The Company has entered into indemnification agreements with its officers and directors, which require the Company to defend and, if necessary, indemnify these individuals for certain pending or future legal claims as they relate to their services to Paychex and its subsidiaries. Historically, there have been no material losses related to such guarantees and indemnifications.

Paychex currently self-insures the deductible portion of various insured exposures under certain employee benefit plans. The Company's estimated loss exposure under these insurance arrangements is recorded in other current liabilities. Historically, the amounts accrued have not been material. The Company maintains insurance coverage in addition to its purchased primary insurance policies for gap coverage for employment practices liability, errors and omissions, warranty liability, and acts of terrorism, and capacity for deductibles and self-insured retentions through its captive insurance company.

Note M — Related Parties

During fiscal years 2006, 2005, and 2004, the Company purchased approximately $4.6 million, $2.5 million, and $1.2 million, respectively, of data processing equipment and software from EMC Corporation, whose Chairman, President, and Chief Executive Officer is a member of the Board of Directors of Paychex.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note N — Quarterly Financial Data (Unaudited)
In thousands, except per share amounts

	Three Months Ended				
Fiscal 2006	**August 31**	**November 30**	**February 28**	**May 31**	**Full Year**
Service revenue	$ 384,415	$ 379,028	$ 401,883	$ 408,471	$ 1,573,797
Interest on funds held for clients	19,300	20,787	28,703	32,009	100,799
Total revenue	403,715	399,815	430,586	440,480	1,674,596
Operating income	162,820	158,605	160,600	167,546	649,571
Investment income, net	4,859	5,552	6,358	8,426	25,195
Income before income taxes	167,679	164,157	166,958	175,972	674,766
Income taxes	52,651	51,545	52,424	53,232	209,852
Net income	$ 115,028	$ 112,612	$ 114,534	$ 122,740	$ 464,914
Basic earnings per share(A)	$ 0.30	$ 0.30	$ 0.30	$ 0.32	$ 1.23
Diluted earnings per share(A)	$ 0.30	$ 0.30	$ 0.30	$ 0.32	$ 1.22
Weighted-average common shares outstanding	378,810	379,268	379,680	380,092	379,465
Weighted-average common shares outstanding, assuming dilution	380,180	381,256	381,751	382,207	381,351
Cash dividends per common share	$ 0.13	$ 0.16	$ 0.16	$ 0.16	$ 0.61
Total net realized gains(B)	$ 112	$ 14	$ 498	$ 351	$ 975

	Three Months Ended				
Fiscal 2005	**August 31**	**November 30**	**February 28**	**May 31**	**Full Year**
Service revenue	$ 334,203	$ 334,876	$ 357,094	$ 358,501	$ 1,384,674
Interest on funds held for clients	10,772	12,409	16,767	20,521	60,469
Total revenue	344,975	347,285	373,861	379,022	1,445,143
Operating income	128,668	126,898	135,382	142,827	533,775
Investment income, net	2,259	2,751	3,099	4,282	12,391
Income before income taxes	130,927	129,649	138,481	147,109	546,166
Income taxes	43,206	42,784	45,699	45,628	177,317
Net income	$ 87,721	$ 86,865	$ 92,782	$ 101,481	$ 368,849
Basic earnings per share(A)	$ 0.23	$ 0.23	$ 0.25	$ 0.27	$ 0.97
Diluted earnings per share(A)	$ 0.23	$ 0.23	$ 0.24	$ 0.27	$ 0.97
Weighted-average common shares outstanding	378,107	378,265	378,403	378,569	378,337
Weighted-average common shares outstanding, assuming dilution	379,706	379,696	379,814	379,831	379,763
Cash dividends per common share	$ 0.12	$ 0.13	$ 0.13	$ 0.13	$ 0.51
Total net realized gains/(losses)(B)	$ 177	$ 92	$ (170)	$ 124	$ 223

(A) Each quarter is a discrete period and the sum of the four quarters' basic and diluted earnings per share amounts may not equal the full year amount.

(B) Total net realized gains/(losses) on the combined funds held for clients and corporate investment portfolios, net of immaterial adjustments related to the reclassification of auction rate securities as described in Note A of the Notes to Consolidated Financial Statements.

Table of Contents

Schedule II — Valuation and Qualifying Accounts

PAYCHEX, INC.

CONSOLIDATED FINANCIAL STATEMENT SCHEDULE
FOR THE YEAR ENDED MAY 31,
In thousands

Description	Balance at beginning of year	Additions charged to expenses	Additions/ (deductions) to other accounts (A)	Costs and deductions (B)	Balance at end of year
2006					
Allowance for doubtful accounts	$ 2,472	$ 2,173	$ —	$ 2,115	$ 2,530
Reserve for client fund losses	$ 1,582	$ 3,444	$ —	$ 2,505	$ 2,521
2005					
Allowance for doubtful accounts	$ 3,262	$ 2,179	$ —	$ 2,969	$ 2,472
Reserve for client fund losses	$ 1,427	$ 2,481	$ —	$ 2,326	$ 1,582
2004					
Allowance for doubtful accounts	$ 2,208	$ 2,941	$ 702	$ 2,589	$ 3,262
Reserve for client fund losses	$ 2,168	$ 2,943	$ (207)	$ 3,477	$ 1,427

(A) Reflects amounts acquired in purchase transactions or adjustments to purchase price allocations.

(B) Uncollectible amounts written off, net of recoveries.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Item 9A. ***Controls and Procedures***

Disclosure Controls and Procedures and Internal Control Over Financial Reporting: Disclosure controls and procedures are designed with the objective of ensuring that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), such as this report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures are also designed with the objective of ensuring that such information is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Evaluation of Disclosure Controls and Procedures: As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective at meeting their objectives.

Changes in Internal Controls: There were no changes in the Company's internal controls over financial reporting that occurred during the Company's most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The Report on Management's Assessment of Internal Control Over Financial Reporting and the Report of Independent Registered Public Accounting Firm on Effectiveness of Internal Control Over Financial Reporting are incorporated herein by reference from Part II, Item 8 of this Form 10-K.

Item 9B. ***Other Information***

None.

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

The following table shows the executive officers of the Company as of May 31, 2006, and information regarding their positions and business experience. Such executive officers maintain principal policy-making powers at the Company.

Name	Age	Position and business experience
Jonathan J. Judge	52	Mr. Judge became President and Chief Executive Officer of the Company in October 2004. Prior to joining the Company, from October 2002 through December 2003, he served as President and Chief Executive Officer of Crystal Decisions, Inc., an information management software company. From 2001 to 2002, Mr. Judge was General Manager of IBM's Personal Computing Division. From 1998 to 2001, he headed up the worldwide sales, service, and support functions of IBM's Personal Computing Division and was a member of the worldwide management committee of IBM. Mr. Judge also serves as a director of the Company and is also a director of PMC-Sierra, Inc.

Name	Age	Position and business experience
John M. Morphy	58	Mr. Morphy joined the Company in October 1995 and was named Senior Vice President in October 2002. He was named Chief Financial Officer and Secretary in October 1996. He was Vice President, Director of Finance from July 1996 to October 2002. Prior to joining the Company, he served as Chief Financial Officer and in other senior management capacities for over ten years at Goulds Pumps, Incorporated, a pump manufacturer.
Martin Mucci	46	Mr. Mucci joined the Company in March 2002 as a consultant on operational issues of the Company, including responsibility for implementation of the Advantage Payroll Services, Inc. acquisition, and was appointed Senior Vice President, Operations in October 2002. Prior to joining the Company, he served as President of Telephone Operations for Frontier Communications, a telecommunications services provider, and Chief Executive Officer of Frontier Communications of Rochester, N.Y., a telecommunications services provider.
Walter Turek	53	Mr. Turek has served as Senior Vice President, Sales and Marketing, since October 2002. From 1989 to October 2002, he was Vice President, Sales. He has been with the Company since 1981 and has served in various sales and management capacities.
Melinda A. Janik	49	Ms. Janik joined the Company in March 2005 as Vice President and Controller. Prior to joining the Company, she was Senior Vice President and Chief Financial Officer for Glimcher Realty Trust, a publicly traded national mall Real Estate Investment Trust, for a number of years beginning in July 2002. Prior to July 2002, she was Vice President and Treasurer for NCR Corporation, a technology company.
William G. Kuchta, Ed. D	59	Mr. Kuchta joined the Company in February 1995 and was named Vice President, Organizational Development in April 1996. From 1993 to 1995, he was principal of his own consulting firm, and from 1989 to 1993, he served as Vice President of Human Resources of Fisons Corporation.

The additional information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders in the sections titled "PROPOSAL 1 — ELECTION OF DIRECTORS FOR A ONE-YEAR TERM," "CORPORATE GOVERNANCE," "CODE OF ETHICS," and "SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE," and is incorporated herein by reference thereto.

Item 11. *Executive Compensation*

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders in the section titled "EXECUTIVE OFFICER COMPENSATION," and is incorporated herein by reference thereto.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

The information required by this item is set forth below and in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT," and is incorporated herein by reference thereto.

The Company maintains equity compensation plans in the form of stock option incentive plans. Currently, stock options are granted to employees in the form of non-qualified or incentive stock options (broad-based grants only) from the Paychex, Inc. 2002 Stock Incentive Plan, as amended and restated (the "2002 Plan"). The 2002 Plan was adopted on July 7, 2005, by the Board of Directors of the Company and became effective upon stockholder approval at the Company's Annual Meeting of Stockholders held on October 12, 2005. There are previously granted options to purchase shares under the Paychex, Inc. 1998 and 1995 Stock Incentive Plans that remain outstanding at May 31, 2006. There will not be any new grants under these expired plans. Refer to Note G in the Notes to Consolidated Financial Statements, contained in Item 8 of this Form 10-K, for more information on the Company's stock option plans.

The following table details information on securities authorized for issuance under the Company's stock incentive plans as of May 31, 2006:

In thousands	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders	12,960	$ 31.64	20,509
Equity compensation plans not approved by security holders	550	$ 30.68	—
Total	13,510	$ 31.61	20,509

Item 13. ***Certain Relationships and Related Transactions***

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "OTHER MATTERS AND INFORMATION," under the sub-heading "Certain Relationships and Related Transactions," and is incorporated herein by reference thereto.

Item 14. ***Principal Accountant Fees and Services***

The information required by this item is set forth in the Company's Definitive Proxy Statement for its 2006 Annual Meeting of Stockholders under the heading "INDEPENDENT REGISTERED PUBLIC ACCOUNTANTS," and is incorporated herein by reference thereto.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules***

1. Financial Statements and Supplementary Data
   See Financial Statements and Supplementary Data Table of Contents at page 31.
2. Financial statement schedules required to be filed by Item 8 of this Form 10-K include Schedule II — Valuation and Qualifying Accounts. See Financial Statements and Supplementary Data Table of Contents at page 31.
   All other schedules are omitted as the required matter is not present, the amounts are not significant, or the information is shown in the financial statements or the notes thereto.
3. Exhibits

	(3)(a)	Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3(a) to the Company's Form 10-K filed with the Commission on July 20, 2004.
*	(3)(b)	Bylaws, as amended.
#	(10)(a)	Paychex, Inc. 1995 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 33-64389.

#	(10)(b)	Paychex, Inc. 1998 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-65191.
#	(10)(c)	Paychex, Inc. 2002 Stock Incentive Plan, incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-101074.
#	(10)(d)	Paychex, Inc. 2002 Stock Incentive Plan (as amended and restated), incorporated herein by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-129572.
#	(10)(e)	Paychex, Inc. 2002 Stock Incentive Plan (as amended and restated effective October 12, 2005) Award Agreement for Non-Qualified Stock Options, incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed with the Commission on October 17, 2005.
#	(10)(f)	Paychex, Inc. Non-Qualified Stock Option Agreement, incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-8, No. 333-129571.
#	(10)(g)	Form of Indemnification Agreement for Directors and Officers, incorporated herein by reference to Exhibit 10.1 to the Company's Form 10-Q filed with the Commission on March 21, 2003.
#	(10)(h)	Paychex, Inc. Indemnification Agreement with B. Thomas Golisano, incorporated herein by reference to Exhibit 10(g) to the Company's Form 10-K filed with the Commission on July 20, 2004.
#	(10)(i)	Paychex, Inc. Indemnification Agreement with Walter Turek, incorporated herein by reference to Exhibit 10(h) to the Company's Form 10-K filed with the Commission on July 20, 2004.
#	(10)(j)	Paychex, Inc. Deferred Compensation Plan, incorporated herein by reference to Exhibit 10(i) to the Company's Form 10-K filed with the Commission on July 20, 2004.
#	(10)(k)	Paychex, Inc. Employment Agreement with Jonathan J. Judge dated October 1, 2004, incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed with the Commission on October 4, 2004.
#	(10)(l)	Compensation arrangement with B. Thomas Golisano, effective October 1, 2004, for service as Chairman of the Board of Directors, incorporated by reference to Exhibit 10(j) to the Company's Form 10-K filed with the Commission on July 22, 2005.
#	(10)(m)	Paychex, Inc. Indemnification Agreement with Jonathan J. Judge, incorporated by reference to Exhibit 10(k) to the Company's Form 10-K filed with the Commission on July 22, 2005.
#	(10)(n)	Certain compensation information for Jonathan J. Judge, President and Chief Executive Officer of the Company, is incorporated herein by reference from the Company's Form 8-K filed with the Commission on February 10, 2006.
*#	(10)(o)	Paychex, Inc. Officer Performance Incentive Program for the year ended May 31, 2007.
*	(21.1)	Subsidiaries of the Registrant.
*	(23.1)	Consent of Independent Registered Public Accounting Firm.
*	(24.1)	Power of Attorney.
*	(31.1)	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*	(31.2)	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
*	(32.1)	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
*	(32.2)	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Exhibit filed with this report

\# Management contract or compensatory plan

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on July 21, 2006.

PAYCHEX, INC.

By: /s/ Jonathan J. Judge

Jonathan J. Judge
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on July 21, 2006.

/s/ Jonathan J. Judge

Jonathan J. Judge, President and
Chief Executive Officer, and Director
(Principal Executive Officer)

/s/ John M. Morphy

John M. Morphy, Senior Vice President,
Chief Financial Officer, and Secretary
(Principal Financial and Accounting Officer)

B. Thomas Golisano*, Chairman of the Board

David J. S. Flaschen*, Director

Phillip Horsley*, Director

Grant M. Inman*, Director

Pamela A. Joseph*, Director

J. Robert Sebo*, Director

Joseph M. Tucci*, Director

*By: /s/ Jonathan J. Judge

Jonathan J. Judge, as Attorney-in-Fact

EXHIBIT 3(b)

BY-LAWS

OF

PAYCHEX, INC.

ARTICLE I

OFFICES

SECTION 1. The registered office of Paychex, Inc., a Delaware corporation (hereinafter referred to as the "Corporation"), shall be located within the State of Delaware.

SECTION 2. The Corporation may also have offices at such places, either within or without the State of Delaware and either within or without the United States of America, as the board of directors may from time to time designate or the business of the Corporation may require.

ARTICLE II

MEETINGS OF STOCKHOLDERS

SECTION 1. All meetings of the stockholders for the election of directors or for any other purpose shall be held at such time and place, either within or without the State of Delaware and either within or without the United States of America, as shall be stated in the notice of meeting or in a duly executed waiver thereof.

SECTION 2. The annual meeting of stockholders shall be held on such date and at such hour as shall be designated each year by the board of directors. At such annual meeting, the stockholders shall elect a board of directors and transact such other business as may be properly brought before the meeting.

SECTION 3. Special meetings of stockholders for any purpose or purposes, unless otherwise prescribed by statute or by the Corporation's certificate of incorporation, may be called by the Chairman of the Board or the President and shall be called by the Chairman of the Board, the President or the Secretary at the request in writing of a majority of the board of directors, or at the request in writing of stockholders owning a majority in amount of the entire capital stock of the Corporation issued and outstanding and entitled to vote. Such request shall state the purpose or purposes of the proposed meeting.

SECTION 4. Except as otherwise expressly required by statute, written notice of each annual and special meeting of stockholders, stating the place, date and hour of the meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called, shall be given to each stockholder of record entitled to vote

thereat not less than ten (10) nor more than sixty (60) days before the date of the meeting. Notice shall be given personally or by mail and, if by mail, shall be sent in a postage prepaid envelope, addressed to the stockholder at his address as it appears on the records of the Corporation. Notice by mail shall be deemed given at the time when the same shall be deposited in the United States mail, postage prepaid. Attendance of a person at a meeting shall constitute a waiver of notice of such meeting, except when such person attends the meeting in person or by proxy for the express purpose of objecting, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. A written waiver of notice signed by the person entitled to notice, whether before or after the time stated therein, shall be deemed equivalent to notice. Neither the business to be transacted at, nor the purpose of, an annual or special meeting of stockholders need be specified in any written waiver of notice. Business transacted at any special meeting of stockholders shall be limited to the purposes stated in the notice.

SECTION 5. The officer who has charge of the stock transfer books of the Corporation shall prepare and make, at the time and in the manner required by applicable law, a list of stockholders entitled to vote and shall make such list available for such purposes, at such places, at such times and to such persons as required by applicable law. The stock transfer books shall be the only evidence as to the identity of the stockholders entitled to examine the stock transfer books or to vote in person or by proxy at any meeting of stockholders.

SECTION 6. The holders of a majority of the voting power of the issued and outstanding stock of the Corporation entitled to vote thereat, present in person or represented by proxy, shall constitute a quorum for the transaction of business at any meeting of stockholders, except as otherwise provided by statute or by the Corporation's certificate of incorporation. The stockholders present and entitled to vote at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding the withdrawal of enough stockholders entitled to vote to leave less than a quorum then present and represented provided that the action taken (other than an adjournment) is approved by at least a majority of the holders of stock required to constitute a quorum. Any stockholders' meeting, annual or special, whether or not a quorum is present or represented, may be adjourned from time to time by the vote of the holders of a majority of the stock entitled to vote thereat, the holders of which are either present in person or represented by proxy, or the chairman of the meeting, but in the absence of a quorum no other business may be transacted at such meeting. At any adjourned meeting, at which a quorum shall be present or represented, any business may be transacted which might have been transacted at the meeting as originally notified, except for such business as was duly transacted at any earlier meeting. If the adjournment is for more than thirty (30) days, or if after adjournment a new record date is set, a notice of the adjourned meeting shall be given as in the case of an original meeting to each stockholder of record entitled to vote at the meeting.

SECTION 7. At each meeting of stockholders, the Chairman of the Board or, in his absence or inability to act, such other person as the board of directors may have designated shall call to order and act as chairman of the meeting. The Secretary or, in his absence or inability

to act, the person whom the chairman of the meeting shall appoint secretary of the meeting shall act as secretary of the meeting and keep the minutes thereof.

SECTION 8. The order of business and the procedure at all meetings of the stockholders shall be as determined by the chairman of the meeting, unless otherwise prescribed by law or regulation.

SECTION 9. Except as otherwise provided by statute or the Corporation's certificate of incorporation, each holder of common stock of the Corporation shall be entitled at each meeting of stockholders to one (1) vote for each share of such stock standing in his name on the record of stockholders of the Corporation

(a) on the date fixed pursuant to the provisions of Section 7 of Article V of these by-laws as the record date for the determination of the stockholders who shall be entitled to notice of and to vote at such meeting; or

(b) if no such record date shall have been so fixed, then at the close of business on the day next preceding the day on which notice thereof shall be given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held.

Each stockholder entitled to vote at any meeting of stockholders may authorize another person or persons to act for him by proxy, provided that such proxy shall comply with the requirements of Delaware law. No proxy shall be voted after three (3) years from its date, unless the proxy provides for a longer period. Any such proxy shall be delivered to the secretary of the meeting at or prior to the time designated in the order of business for so delivering such proxies. When a quorum is present at any meeting, the vote of the holders of a majority of the voting power of the issued and outstanding stock of the Corporation entitled to vote thereon, present in person or represented by proxy, shall decide any question brought before such meeting, unless the question is one upon which, by express provision of statute or of the Corporation's certificate of incorporation or of these by-laws, a different vote is required, in which case such express provision shall govern and control the decision of such question. On a vote by ballot, each ballot shall be signed by the stockholder voting, or by his proxy, if represented by proxy, and shall state the number of shares voted.

SECTION 10. The board of directors may, in advance of any meeting of stockholders, appoint one or more inspectors to act at, and make a written report of, such meeting or any adjournment thereof. If any of the inspectors so appointed shall fail to appear or act, the chairman of the meeting shall, or, if inspectors shall not have been appointed, the chairman of the meeting may, appoint one or more inspectors. Each inspector, before entering upon the discharge of his duties, shall take and sign an oath faithfully to execute the duties of inspector at such meeting with strict impartiality and according to the best of his ability. The inspectors shall determine the number of shares of capital stock of the Corporation outstanding and the voting power thereof, the number of shares represented at the meeting, the existence of a quorum and the authenticity, validity and effect of proxies, certify their determination of the number of shares represented at the meeting and shall receive votes or ballots, hear, determine and retain for a reasonable period a record of the disposition of, all challenges and questions arising in connection with the right to vote, count and tabulate all votes or ballots, determine the results and perform such acts as are proper to conduct the election or vote with fairness to all stockholders. If more than one inspector has been appointed, the decision, act or certificate of a majority of the inspectors is effective in all respects as the decision, act or certificate of all of the inspectors. On request of the chairman of the meeting, the inspector shall make a report in writing of any challenge, request or matter determined by them and shall execute a certificate of any fact found by them. No director or candidate for the office of director shall act as an inspector of election with respect to an election of directors. Inspectors need not be stockholders.

SECTION 11. Any action required or permitted to be taken at any annual or special meeting of the stockholders may be taken without a meeting, without prior notice and a vote, if a consent or consents in writing, setting forth the action so taken, shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted and shall be delivered to the Corporation by delivery to its registered office in Delaware, its principal place of business, or an officer or agent of the Corporation having custody of the book in which proceedings of meetings of stockholders are recorded. Delivery made to the Corporation's registered office shall be by hand or by certified or registered mail, return receipt requested. Where corporate action is taken in such manner by less than unanimous written consent, prompt written notice of the taking of such action shall be given to all stockholders who have not consented in writing thereto.

Every written consent shall bear the date of signature of each stockholder who signs the consent and no written consent shall be effective to take the corporate action referred to therein unless, within sixty days of the earliest dated consent delivered in the manner required by statute to the Corporation, written consents signed by a sufficient number of holders to take action are delivered to the Corporation by delivery to its registered office in Delaware, its principal place of business, or an officer or agent of the Corporation having custody of the book in which proceedings of meetings of stockholders are recorded. Delivery made to the Corporation's registered office shall be by hand or by certified or registered mail, return receipt requested.

ARTICLE III

BOARD OF DIRECTORS

SECTION 1. The number of directors which shall constitute the whole Board of Directors shall consist of one or more members, the exact number to be fixed from time to time by the board of directors. Except as provided in Sections 9 and 10 of this Article, each director shall be elected by the vote of the majority of the votes cast with respect to the director at any meeting for the election of directors at which a quorum is present, provided that if the number of nominees exceeds the number of directors to be elected, the directors shall be

elected by the vote of a plurality of the shares represented in person or by proxy at any such meeting and entitled to vote on the election of directors. For purposes of this Section, a majority of the votes cast means that the number of shares voted "for" the election of a director nominee must exceed the number of votes cast "against" the nominee. If a nominee that is an incumbent director does not receive a required majority of the votes cast, the director shall offer to tender his or her resignation to the Board. The Governance and Compensation Committee shall consider such offer and will make a recommendation to the Board on whether to accept or reject the resignation, or whether other action should be taken. The Board will consider the Committee's recommendation and will determine whether to accept such offer. In making their determinations, the Board and the Committee may consider any factors deemed relevant. The Board shall publicly disclose its decision and the rationale behind it within 90 days from the date of the certification of the election results. The director who tenders his or her resignation will not participate in the Board's or the Committee's decisions with respect to his or her resignation. In the event that no nominees for election to the Board receive a required majority of the votes cast, at an annual meeting, a special meeting of stockholders shall be called for an election of directors in the manner provided in these Bylaws. Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal.

SECTION 2. The business and affairs of the Corporation shall be managed by or under the direction of the board of directors. The board of directors may exercise all such authority and powers of the Corporation and do all such lawful acts and things as are not by statute, the Corporation's certificate of incorporation or these by-laws directed or required to be exercised or done by the stockholders.

SECTION 3. Meetings of the board of directors shall be held at such place or places, within or without the State of Delaware and either within or without the United States of America, as the board of directors may from time to time determine or as shall be specified in the notice of any such meeting.

SECTION 4. The board of directors shall meet for the purpose of organization, the election of officers and the transaction of other business, as soon as practicable after each annual meeting of stockholders. Notice of such meeting need not be given. In the event such annual meeting is not so held, the annual meeting of the board of directors may be held at such other time, within or without the State of Delaware and either within or without the United States of America, as shall be specified in a notice thereof given as provided in Section 7 of this Article III.

SECTION 5. Regular meetings of the board of directors shall be held at such time and place as the board of directors may fix. If any day fixed for a regular meeting shall be a legal holiday at the place where the meeting is to be held, then the meeting which would otherwise be held on that day shall be held at the same hour on the next succeeding business day. Notice of regular meetings of the board of directors need not be given.

SECTION 6. Special meetings of the board of directors may be called by the Chairman of the Board or the President and shall be called by the Secretary on the written request of a majority of the members of the Board of Directors.

SECTION 7. Notice of each special meeting of the board of directors shall be given by the President or the Secretary as hereinafter provided in this Section 7, in which notice shall be stated the time and place of the meeting. Except as otherwise required by these by-laws, such notice need not state the purpose or purposes of such meeting. Notice of each such meeting shall be mailed, postage prepaid, to each director, addressed to him at his residence or usual place of business, by first class mail, at least two (2) days before the time of the meeting, or shall be sent addressed to him at such place by telegraph, cable, telex, telefax, telecopier or other similar means, or be delivered to him personally or be given to him by telephone or other similar means, at least twelve (12) hours before the time of the meeting. A written waiver of notice signed by a director, whether before or after the time stated therein, shall be deemed equivalent to notice to such director. Attendance of a director at the meeting shall constitute a waiver of notice of such meeting by such director, except when such director attends a meeting for the express purpose of objecting, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened.

SECTION 8. At all meetings of the board of directors, a majority of the total number of directors shall be necessary and sufficient to constitute a quorum for the transaction of business and, except as otherwise expressly required by statute or the Corporation's certificate of incorporation or these by-laws, the act of a majority of the directors present at any meeting at which a quorum is present shall be the act of the board of directors. In the absence of a quorum at any meeting of the board of directors, a majority of the directors present thereat may adjourn such meeting to another time and place. Notice of the time and place of any such adjourned meeting shall be given to all of the directors unless such time and place were announced at the meeting at which the adjournment was taken, in which case such notice shall only be given to the directors who were not present thereat. At any adjourned meeting at which a quorum is present, any business may be transacted which might have been transacted at the meeting as originally called. The directors shall act only as a board and the individual directors shall have no power as such.

SECTION 9. Any director of the Corporation may resign at any time by giving written notice of his resignation to the Corporation. Any such resignation shall take effect at the time specified therein or, if the time when it shall become effective shall not be specified therein, immediately upon its tender. Unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective. Any vacancy in the board of directors caused by such resignation may be filled by a majority vote of the board of directors for the unexpired portion of the term.

SECTION 10. Any director of the Corporation may be removed, at any time, with or without cause, by the affirmative vote of the holders of record of a majority of the outstanding shares of stock entitled to

vote at a meeting of stockholders, and any vacancy in the board of directors caused by any such removal may be filled by the stockholders at said meeting in which the vacancy is created or, if not so filled, by a majority vote of the Board of Directors for the unexpired portion of the term.

SECTION 11. Unless restricted by the Corporation's certificate of incorporation, the board of directors may, by resolution passed by a majority of the entire board of directors, designate one or more committees, including an executive committee, each committee to consist of one or more of the directors of the Corporation. The board of directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. In the absence or disqualification of a member of a committee, a member or members thereof present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place or any such absent or disqualified member. Except to the extent restricted by statute or the Corporation's certificate of incorporation, each such committee, to the extent provided in the resolution creating it, shall have and may exercise all of the powers and authority of the board of directors, including, if such resolution so provides, the power to declare a dividend, to authorize the issuance of stock or to adopt a certificate of ownership and merger pursuant to section 253 of Title 8 of the Delaware Code, and may authorize the seal of the Corporation to be affixed to all papers which require it. Each such committee shall serve at the pleasure of the board of directors and have such name as may be determined from time to time by resolution adopted by the board of directors. Each committee shall keep regular minutes of its meetings and report the same to the board of directors.

SECTION 12. Any action required or permitted to be taken by the board of directors or any committee thereof may be taken without a meeting if all members of the board of directors or such committee, as the case may be, consent thereto in writing, and the writing or writings are filed with the minutes of the proceedings of the board of directors or such committee, as the case may be.

SECTION 13. Any one or more members of the board of directors or any committee of the board of directors may participate in a meeting of the board of directors or such committee by means of a conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Participation by such means shall constitute presence in person at a meeting.

SECTION 14. A director of the Corporation who is present at a meeting of the board of directors or any committee thereof at which action is taken shall be presumed to have assented to the action taken unless his dissent or abstention there from shall be entered in the minutes of the meeting or unless he shall file a written dissent from such action with the person acting as the secretary of the meeting before the adjournment thereof or shall forward such dissent by registered mail to the Secretary of the Corporation within five days after the date a copy of the minutes of the meeting is received. Such right to dissent shall not apply to a director who voted in favor of such action.

SECTION 15. The Board of Directors shall have the authority to fix the compensation of directors for services in any capacity.

ARTICLE IV

OFFICERS

SECTION 1. The officers of the Corporation shall be elected annually by the board of directors at the first meeting of the board held after each annual meeting of stockholders, or as soon thereafter as possible. The board of directors shall elect from among its number a Chairman of the Board. The board of directors shall also elect a President, a Secretary and a Treasurer, who need not be directors. If the board of directors wishes, it may also elect such other officers (including, without limitation, one or more Vice Presidents, one or more Assistant Treasurers and one or more Assistant Secretaries) as may be necessary or desirable for the business of the Corporation. Any two or more offices may be held by the same person. Each officer shall hold office until his successor shall have been duly elected and qualified, or until his death, resignation or removal, as hereinafter provided. A vacancy in any office because of death, resignation, removal, disqualification or otherwise, shall be filled only by a majority vote of the board of directors for the unexpired portion of the term.

SECTION 2. Any officer of the Corporation may resign at any time by giving written notice of his resignation to the Corporation. Any such resignation shall take effect at the time specified therein or, if the time when it shall become effective shall not be specified therein, immediately upon its tender. Unless otherwise specified therein, the acceptance of any such registration shall not be necessary to make it effective.

SECTION 3. Any officer of the Corporation may be removed, either with or without cause, at any time, by the board of directors at any meeting thereof, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.

SECTION. 4. The Chairman of the Board of Directors, if there be one, shall preside at all meetings of the stockholders and of the Board of Directors. During the absence or disability of the President, the Chairman of the Board of Directors shall exercise all the powers and discharge all the duties of the

President. The Chairman of the Board of Directors shall also perform such other duties and may exercise such other powers as from time to time may be assigned to him by these By-Laws or by the Board of Directors.

SECTION 5. The President shall, subject to the control of the Board of Directors and, if there be one, the Chairman of the Board of Directors, have general supervision of the business of the Corporation and shall see that all orders and resolutions of the Board of Directors are carried into effect. He shall execute all bonds, mortgages, contracts and other instruments of the Corporation requiring a seal, under the seal of the Corporation, except where required or permitted by law to be otherwise signed and executed and except that the other officers of the Corporation may sign and execute documents when so

authorized by these By-Laws, the Board of Directors or the President. In the absence or disability of the Chairman of the Board of Directors, or if there be none, the President shall preside at all meeting of the stockholders and the Board of Directors, the President shall be the chief executive and operating officer of the Corporation. He shall perform all duties incident to the office of chief executive and operating officer and such other duties as may from time to time be assigned to him by the Board of directors.

SECTION 6. Each Vice President, if any, shall perform all duties incident to his office and such other duties as from time to time may be assigned to him by the board of directors, the Chairman of the Board or the President.

SECTION 7. The Treasurer shall

(a) be the principal financial officer and principal accounting officer of the Corporation;

(b) have charge and custody of, and be responsible for, all the funds and securities of the Corporation;

(c) keep full and accurate accounts of receipts and disbursements in books belonging to the Corporation;

(d) deposit all moneys and other valuables to the credit of the Corporation in such depositories as may be designated by the board of directors or pursuant to its direction;

(e) receive, and give receipts for, moneys due and payable to the Corporation from any source whatsoever;

(f) disburse the funds of the Corporation and supervise the investment of its funds, taking proper vouchers therefore;

(g) render to the board of directors, whenever the board of directors may require, an accounting of the financial condition of the Corporation; and

(h) in general, perform all other duties incident to the office of Treasurer and such other duties as from time to time may be assigned to him by the board of directors or the President.

SECTION 8. Secretary. The Secretary shall

(a) keep or cause to be kept, in one or more books provided for the purpose, the minutes of all meetings of the board of directors, the committees of the board of directors and the stockholders;

(b) see that all notices are duly given in accordance with the provisions of these by-laws and as required by law;

(c) see that the books, reports, statements certificates and other documents and records required by law to be kept and filed are properly kept and filed; and

(d) in general, perform all other duties incident to the office of Secretary and such other duties as from time to time may be assigned to him by the board of directors or the President.

SECTION 9. The Assistant Treasurer, if any, or if there shall be more than one, the Assistant Treasurers in the order determined by the board of directors (or, if there be no such determination, then in the order of their election), shall, at the request of the President or the Treasurer or in the absence of the Treasurer or in the event of his inability or refusal to act, perform the duties of the Treasurer (and when so acting, shall have the powers of and be subject to the restrictions placed upon the Treasurer in respect of the performance of such duties) and shall perform such other duties as from time to time may be assigned by the board of directors or the President.

SECTION 10. The Assistant Secretary, if any, or if there be more than one, the Assistant Secretaries in the order determined by the board of directors (of, if there be no such determination, then in the order of their election),shall, at the request of the President or the Secretary or in the absence of the Secretary or in the event of his inability or refusal to act, perform the duties of the Secretary (and when so acting, shall have the powers of and be subject to the restrictions placed upon the Secretary in respect of the performance of such duties) and shall perform such other duties as from time to time may be assigned by the board of directors or the President.

SECTION 11. If required by the board of directors, any officer of the Corporation shall give a bond or other security for the faithful performance of his duties, in such amount and with such surety as the board of directors may require.

SECTION 12. The compensation of the officers of the Corporation for their services as such officers shall be fixed from time to time by the board of directors. An officer of the Corporation shall not be prevented from receiving compensation by reason of the fact that he is also a director of the Corporation.

ARTICLE V

STOCK CERTIFICATES AND THEIR TRANSFER

SECTION 1. Every holder of stock in the Corporation shall be entitled to have a certificate signed by, or in the name of the Corporation by the Chairman of the Board, the President or a Vice President and by the Treasurer or an Assistant Treasurer or the Secretary or an Assistant Secretary of the Corporation certifying the number of shares owned by him in the Corporation. If the Corporation shall be authorized to issue more than one class of stock or more than one series of any class, the designations, preferences and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preference and/or rights shall be set forth in full or summarized on the face or back of the certificate which the Corporation shall issue to represent such class or series of stock, provided that, except as otherwise provided in Section 202 of the General Corporation Law of the State of Delaware, in lieu of the foregoing requirements,

there may be set forth, on the face or back of the certificate which the Corporation shall issue to represent such class or series of stock, a statement that the Corporation will furnish without charge to each stockholder who so requests the designations, preferences and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights.

SECTION 2. Any or all of the signatures on a certificate may be a facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate shall have ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued by the Corporation with the same effect as if he were such officer, transfer agent or registrar at the date of issuance.

SECTION 3. The board of directors may direct that a new certificate or certificates be issued in place of any certificate or certificates theretofore issued by the Corporation alleged to have been lost, stolen or destroyed. When authorizing the issuance of a new certificate or certificates, the board of directors may, in its discretion and as a condition precedent to the issuance thereof, require the owner of such lost, stolen or destroyed certificate or certificates, or his legal representative, to give the Corporation a bond or other indemnity in such amount as it may direct sufficient to indemnify it against any claim that may be made against the Corporation on account of the alleged loss, theft or destruction of any such certificate or the issuance of such new certificate.

SECTION 4. Upon surrender to the Corporation or the transfer agent of the Corporation of a certificate for shares duly endorsed or accompanied by proper evidence of succession, assignment or authority to transfer, it shall be the duty of the Corporation to issue a new certificate to the person entitled thereto, cancel the old certificate and record the transaction upon its records; provided, however, that the Corporation shall be entitled to recognize and enforce any lawful restriction on transfer. Whenever any transfer of stock shall be made for collateral security, and not absolutely, it shall be so expressed in the entry of transfer if, when the certificates are presented to the Corporation for transfer, both the transferor and the transferee request the Corporation to do so. Persons whose stock is pledged shall be entitled to vote, unless in the transfer by the pledgor on the books of the Corporation he has expressly empowered the pledgee to vote thereon, in which case only the pledgee, or his proxy, may represent and vote such stock.

SECTION 5. The board of directors may appoint, or authorize any officer or officers to appoint, one or more transfer agents and one or more registrars.

SECTION 6. The board of directors may make such additional rules and regulations, not inconsistent with these by-laws, as it may deem expedient concerning the issuance, transfer and registration of certificates for shares of stock of the Corporation.

SECTION 7. In order that the Corporation may determine the stockholders entitled to notice of or to vote at any meeting of

stockholders or any adjournment thereof, or entitled to receive payment of any dividend or other distribution or any allotment of rights, or entitled to exercise any rights in respect of any change, conversion or exchange of stock or for the purpose of any other lawful action, the board of directors may fix, in advance, a record date, which shall not be more than sixty (60) nor less than ten (10) days before the date of such meeting, nor more than sixty (60) days prior to any other action. A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the board of directors fix a new record date for the adjourned meeting.

SECTION 8. The Corporation shall be entitled to recognize the exclusive right of a person registered on its records as the owner of shares of stock to receive dividends and to vote as such owner, shall be entitled to hold liable for calls and assessments a person registered on its records as the owner of shares of stock, and shall not be bound to recognize any equitable or other claim to or interest in such share or shares of stock on the part of any other person, whether or not it shall have express or other notice thereof, except as otherwise provided by the laws of Delaware.

ARTICLE VI

INDEMNIFICATION

SECTION 1. To the full extent authorized by law, the Corporation shall indemnify any person made, or threatened to be made, a party in any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he is or was a director or officer of the Corporation, or is serving or served any other corporation, or any partnership, joint venture, trust, employee benefit plan or other enterprise, in any such capacity at the request of the Corporation ("indemnitee") against expenses (including attorneys' and other fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection therewith.

SECTION 2. Expenses actually and reasonably incurred by an indemnitee in defending a civil or criminal action, suit or proceeding shall be paid by the Corporation in advance of the final disposition of such action, suit or proceeding upon an undertaking by or on behalf of such indemnitee to repay such amount if it shall ultimately be determined, by final judicial decision from which there is no further right of appeal, that he is not entitled to be indemnified by the Corporation. To be entitled to such advancement of expenses, the indemnitee shall cooperate in good faith with any request by the Corporation that common counsel be used by parties to such action or proceeding who are similarly situated unless it would be inappropriate to do so because of actual or potential conflicts between the interests of such parties.

SECTION 3. The Corporation may, to the extent authorized by the board of directors, grant rights of indemnification and advancement of expenses to any employee or agent of the Corporation to the full extent

of the provisions of this Article with respect to indemnification and advancement of expenses of directors and officers of the Corporation.

SECTION 4. The indemnification provided by this Article shall not be deemed exclusive of any other rights to which any person covered hereby may be entitled other than pursuant to this Article.

ARTICLE VII

GENERAL PROVISIONS

SECTION 1. Subject to the provisions of law and the Corporation's certificate of incorporation, dividends upon the shares of capital stock of the

Corporation may be declared by the board of directors at any regular or special meeting. Dividends may be paid in cash, in property or in shares of stock of the Corporation, unless otherwise provided by law or the Corporation's certificate of incorporation.

SECTION 2. The seal of the Corporation shall be in such form as shall be approved by the board of directors.

SECTION 3. The fiscal year of the Corporation shall begin the first day of June in each year and end on the next succeeding 31st day of May, or otherwise as the board of directors shall determine.

SECTION 4. All checks, notes, drafts or other orders for the payment of money of the Corporation shall be signed, endorsed or accepted in the name of the Corporation by such officer, officers, person or persons as from time to time may be designated by the board of directors or by an officer or officers authorized by the board of directors to make such designation.

SECTION 5. The board of directors may authorize any officer or officers, agent or agents, in the name and on behalf of the Corporation to enter into or execute and deliver any and all deeds, bonds, mortgages, contracts and other obligations or instruments, and such authority may be general or confined to specific instances.

SECTION 6. Unless otherwise provided by resolution of the board of directors, the Chairman of the Board or the President, from time to time, may (or may appoint one or more attorneys or agents to) cast the votes which the Corporation may be entitled to cast as a stockholder or otherwise in any other corporation, any of whose shares or securities may be held by the corporation, at meetings of the holders of the shares or other securities of such other corporation. In the event one or more attorneys or agents are appointed, the Chairman of the Board or the President, may instruct the person or persons so appointed as to the manner of casting such votes or giving such consent. The Chairman of the Board or the President may, or may instruct the attorneys or agents appointed to, execute or cause to be executed in the name and on behalf of the Corporation and under its seal or otherwise, such written proxies, consents, waivers or other instruments as may be necessary or proper in the circumstances.

SECTION 7. All nouns and pronouns and any variations thereof used herein shall be deemed to refer to the masculine, feminine or neuter, singular or plural, as the context may require.

ARTICLE VIII

AMENDMENTS

SECTION 1. These by-laws may be amended, altered or repealed by the stockholders or by the board of directors.

EXHIBIT 10(o)

PAYCHEX, INC.
OFFICER PERFORMANCE INCENTIVE PROGRAM
FOR THE YEAR ENDING MAY 31, 2007

PLAN DESCRIPTION

1. Participants: Officers of Paychex, Inc.

2. The maximum incentive for the Chief Executive Officer is 120% of base salary plus any bonus awards recommended by the Governance and Compensation Committee and approved by the Board of Directors for over-achievement of operating objectives. The maximum is 80% of base salary for Senior Vice Presidents and 55% for all other Officers.

3. Performance Criteria: The payment of cash bonus awards to participants shall be determined by the Board on a discretionary basis based primarily on how year-over-year revenue growth, year-over-year growth in operating income excluding stock-based compensation and interest on funds held for clients, and improvement in operating income excluding stock-based compensation and interest on funds held for clients as a percentage of service revenues for the fiscal year compared to the goals that are established annually by the Board of Directors.

4. Payment: Incentive payments to be paid in July 2007 after Board approval. Officer must be employed at the fiscal year end to be eligible for any bonus.

5. Changes and Termination: Bonus awards, changes to and termination of the Program is at the sole discretion of the Board.

EXHIBIT 21.1: SUBSIDIARIES OF THE REGISTRANT

SUBSIDIARIES OF PAYCHEX, INC. AS OF MAY 31, 2006

NAME OF SUBSIDIARIES	JURISDICTION OF INCORPORATION
Advantage Payroll Services, Inc.	Delaware
Business Benefits Administrators, Inc.	Massachusetts
Paychex Agency, Inc.	New York
Paychex Business Solutions, Inc.	Florida
Paychex Deutschland GmbH	Germany
Paychex Insurance Concepts, Inc.	New York
Paychex Investment Partnership LP (1)	Delaware
Paychex Management Corp.(2)	New York
Paychex of New York LLC (2)	Delaware
Paychex North America Inc.	Delaware
Paychex Securities Corporation	New York
Paychex Time & Attendance Inc.	Delaware
Prime Real Estate LLC	Delaware
PXC Inc.	New York
Rapid Payroll, Inc.	California

(1) Paychex Investment Partnership LP is 1% owned by Paychex, Inc. and 99% owned by PXC Inc.

(2) Paychex of New York LLC and Paychex Management Corp. are 100% owned by Paychex Investment Partnership LP.

Certain subsidiaries, which considered in the aggregate as a single subsidiary, that would not constitute a significant subsidiary, per Regulation S-X, Article 1, as of May 31, 2006, have been omitted from this exhibit.

EXHIBIT 23.1: CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the following Registration Statements of Paychex, Inc. of our reports dated July 13, 2006 with respect to the consolidated financial statements of Paychex, Inc., Paychex, Inc.'s management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Paychex, Inc., included in this Annual Report (Form 10-K) for the year ended May 31, 2006.

Form	Registration Statement No.	Description
S-8	No. 33-64389	1995 Stock Incentive Plan
S-8	No. 333-65191	1998 Stock Incentive Plan
S-8	No. 333-84055	401(k) Incentive Retirement Plan
S-8	No. 333-101074	2002 Stock Incentive Plan
S-8	No. 333-129571	Non-Qualified Stock Option Agreement
S-8	No. 333-129572	2002 Stock Incentive Plan, as amended and restated

/s/ Ernst & Young LLP

Cleveland, Ohio
July 17, 2006

EXHIBIT 24.1: POWER OF ATTORNEY

The undersigned Directors of Paychex, Inc., do hereby constitute and appoint Jonathan J. Judge their true and lawful attorney and agent, to execute the Paychex, Inc., Annual Report on Form 10-K for the fiscal year ended May 31, 2006, for us and in our names as Directors, to comply with the Securities Exchange Act of 1934, and the rules, regulations and requirements of the Securities and Exchange Commission, in connection therewith.

Dated: July 13, 2006	/s/ B. Thomas Golisano ------------------------------- B. Thomas Golisano
Dated: July 13, 2006	/s/ David J. S. Flaschen ------------------------------- David J. S. Flaschen
Dated: July 13, 2006	/s/ Phillip Horsley ------------------------------- Phillip Horsley
Dated: July 13, 2006	/s/ Grant M. Inman ------------------------------- Grant M. Inman
Dated: July 13, 2006	/s/ Pamela A. Joseph ------------------------------- Pamela A. Joseph
Dated: July 13, 2006	/s/ J. Robert Sebo ------------------------------- J. Robert Sebo
Dated: July 13, 2006	/s/ Joseph M. Tucci ------------------------------- Joseph M. Tucci

EXHIBIT 31.1: CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, JONATHAN J. JUDGE, certify that:

1. I have reviewed this Annual Report on Form 10-K of Paychex, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 21, 2006

/s/ Jonathan J. Judge

President and Chief Executive Officer

EXHIBIT 31.2: CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, JOHN M. MORPHY, certify that:

1. I have reviewed this Annual Report on Form 10-K of Paychex, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 21, 2006

/s/ John M. Morphy

Senior Vice President, Chief Financial Officer, and Secretary

EXHIBIT 32.1: CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Paychex, Inc. (the "Company") on Form 10-K for the fiscal year ended May 31, 2006 as filed with the Securities and Exchange Commission ("SEC") on the date hereof (the "Report"), I, JONATHAN J. JUDGE, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement has been provided to the Company and will be retained by the Company and furnished to the SEC upon request.

Date: July 21, 2006

/s/ Jonathan J. Judge
- ------------------------------------
Jonathan J. Judge
President and Chief Executive Officer

EXHIBIT 32.2: CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Paychex, Inc. (the "Company") on Form 10-K for the fiscal year ended May 31, 2006 as filed with the Securities and Exchange Commission ("SEC") on the date hereof (the "Report"), I, JOHN M. MORPHY, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

A signed original of this written statement has been provided to the Company and will be retained by the Company and furnished to the SEC upon request.

Date: July 21, 2006

/s/ John M. Morphy
- ---
John M. Morphy
Senior Vice President, Chief Financial Officer,
and Secretary