PAYCHEX INC
Form 10-Q
December 21, 2018
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 Q

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

THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended November 30, 2018

Commission file number 0-11330

PAYCHEX, INC.

911 Panorama Trail South

Rochester, New York 14625-2396

(585) 385-6666

A Delaware Corporation

IRS Employer Identification Number: 16-1124166

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Emerging growth company

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

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

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

Common Stock, $0.01 Par Value	359,091,176	Shares
CLASS	OUTSTANDING AS OF	November 30, 2018

PAYCHEX, INC.

Table of Contents

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)

In millions, except per share amounts

	For the three months ended November 30,		For the six months ended November 30,	
	2018	2017 As Adjusted(1)	2018	2017 As Adjusted(1)
Revenue:				
Management Solutions	$ 685.4	$ 653.5	$ 1,373.1	$ 1,319.4
PEO and Insurance Services	155.2	135.5	313.2	248.8
Total service revenue	$ 840.6	$ 789.0	$ 1,686.3	$ 1,568.2
Interest on funds held for clients	18.3	14.0	35.4	27.7
Total revenue	858.9	803.0	1,721.7	1,595.9
Expenses:				
Operating expenses	264.9	248.6	530.4	480.6
Selling, general and administrative expenses	286.8	251.3	563.8	494.9
Total expenses	551.7	499.9	1,094.2	975.5
Operating income	307.2	303.1	627.5	620.4
Investment income, net	2.1	1.7	4.4	3.8
Income before income taxes	309.3	304.8	631.9	624.2
Income taxes	73.5	106.0	152.5	215.0
Net income	$ 235.8	$ 198.8	$ 479.4	$ 409.2
Other comprehensive loss, net of tax	(11.6)	(33.6)	(11.2)	(29.2)
Comprehensive income	$ 224.2	$ 165.2	$ 468.2	$ 380.0
Basic earnings per share	$ 0.66	$ 0.55	$ 1.34	$ 1.14
Diluted earnings per share	$ 0.65	$ 0.55	$ 1.33	$ 1.13
Weighted-average common shares outstanding	359.1	359.1	359.1	359.0
Weighted-average common shares outstanding, assuming dilution	361.5	361.4	361.5	361.4

(1) Amounts have been adjusted to reflect the adoption of Accounting Standards Codification ("ASC") Topic 606, "Revenue from Contracts with Customers" ("ASC Topic 606").

See Notes to Consolidated Financial Statements.

1

Table of Contents

PAYCHEX, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

In millions, except per share amounts

	November 30, 2018	May 31, 2018 As Adjusted(1)
Assets		
Cash and cash equivalents	$ 510.6	$ 358.2
Corporate investments	248.4	66.0
Interest receivable	28.6	32.2
Accounts receivable, net of allowance for doubtful accounts	562.6	492.4
Prepaid income taxes	33.3	17.0
Prepaid expenses and other current assets	234.2	224.0
Current assets before funds held for clients	1,617.7	1,189.8
Funds held for clients	3,672.3	4,703.8
Total current assets	5,290.0	5,893.6
Long-term corporate investments	10.0	295.5
Property and equipment, net of accumulated depreciation	394.0	393.5
Intangible assets, net of accumulated amortization	128.0	141.4
Goodwill	810.6	814.0
Long-term deferred costs	354.0	361.0
Other long-term assets	15.8	16.4
Total assets	$ 7,002.4	$ 7,915.4
Liabilities		
Accounts payable	$ 70.6	$ 73.7
Accrued compensation and related items	307.9	320.6
Short-term borrowings	57.3	—
Deferred revenue	42.5	34.6
Other current liabilities	111.2	132.9
Current liabilities before client fund obligations	589.5	561.8
Client fund obligations	3,717.3	4,734.9
Total current liabilities	4,306.8	5,296.7
Accrued income taxes	19.7	18.4
Deferred income taxes	161.6	154.4
Other long-term liabilities	89.8	89.1
Total liabilities	4,577.9	5,558.6
Commitments and contingencies — Note M		

Stockholders' equity		
Common stock, $0.01 par value; Authorized: 600.0 shares; Issued and outstanding: 359.1 shares as of November 30, 2018 and 359.0 shares as of May 31, 2018	3.6	3.6
Additional paid-in capital	1,165.7	1,126.8
Retained earnings	1,302.6	1,262.6
Accumulated other comprehensive loss	(47.4)	(36.2)
Total stockholders' equity	2,424.5	2,356.8
Total liabilities and stockholders' equity	$ 7,002.4	$ 7,915.4

(1) Amounts have been adjusted to reflect the adoption of ASC Topic 606.

See Notes to Consolidated Financial Statements.

2

Table of Contents

PAYCHEX, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

In millions

	For the six months ended November 30,	
	2018	2017 As Adjusted(1)
Operating activities		
Net income	$ 479.4	$ 409.2
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization on property and equipment and intangible assets	72.7	65.7
Amortization of premiums and discounts on available-for-sale securities, net	27.7	33.8
Stock-based compensation costs	22.8	19.1
Provision for deferred income taxes	10.9	47.2
Provision for allowance for doubtful accounts	1.5	1.8
Net realized losses on sales of available-for-sale securities	0.2	—
Changes in operating assets and liabilities:		
Interest receivable	3.6	0.7
Accounts receivable	(71.6)	(8.5)
Prepaid expenses and other current assets	(26.7)	(25.8)
Accounts payable and other current liabilities	(30.2)	(35.5)
Deferred costs	7.3	10.6
Net change in other long-term assets and liabilities	(0.4)	1.1
Net cash provided by operating activities	497.2	519.4
Investing activities		
Purchases of available-for-sale securities	(21,248.8)	(20,324.3)
Proceeds from sales and maturities of available-for-sale securities	21,364.3	20,708.7
Net change in funds held for clients’ money market securities and other cash equivalents	985.1	(1,018.0)
Purchases of property and equipment	(60.8)	(95.5)
Acquisition of businesses, net of cash acquired	—	(17.9)
Purchases of other assets	(1.0)	(4.1)
Net cash provided by/(used in) investing activities	1,038.8	(751.1)
Financing activities		

Net change in client fund obligations	(1,017.6)	625.3
Net proceeds from short-term borrowings	57.3	133.4
Dividends paid	(402.7)	(358.9)
Repurchases of common shares	(32.8)	(94.1)
Activity related to equity-based plans	12.2	(1.4)
Net cash (used in)/provided by financing activities	(1,383.6)	304.3
Increase in cash and cash equivalents	152.4	72.6
Cash and cash equivalents, beginning of fiscal year	358.2	184.6
Cash and cash equivalents, end of period	$ 510.6	$ 257.2

(1) Amounts have been adjusted to reflect the adoption of ASC Topic 606.

See Notes to Consolidated Financial Statements.

PAYCHEX, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

November 30, 2018

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

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

Paychex, a Delaware corporation formed in 1979, reports as one segment. Substantially all of the Company's revenue is generated within the U.S. The Company also generates revenue within Europe, which represented approximately one percent of the Company's total revenue for both the three and six months ended November 30, 2018 and was less than one percent of the Company's total revenue for both the three and six months ended November 30, 2017. Long-lived assets in Europe were approximately 10% of total long-lived assets of the Company as of November 30, 2018 and May 31, 2018.

Basis of presentation: The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to the Quarterly Report on Form 10-Q (“Form 10-Q”) and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statement presentation. The consolidated financial statements include the consolidated accounts of the Company with all intercompany transactions eliminated. In the opinion of management, the information furnished herein reflects all adjustments (consisting of items of a normal recurring nature), which are necessary for a fair statement of the results for the interim period. These consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related Notes to Consolidated Financial Statements presented in the Company’s Annual Report on Form 10-K (“Form 10-K”) for the fiscal year ended May 31, 2018 (“fiscal 2018”). Operating results and cash flows for the six months ended November 30, 2018 are not necessarily indicative of the results that may be expected for other interim periods or for the fiscal year ending May 31, 2019 (“fiscal 2019”).

Effective June 1, 2018, the Company adopted the requirements of Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606),” as discussed in “Recently adopted accounting pronouncements.” All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standard, as indicated by the “As Adjusted” footnote.

Reclassifications: Certain prior period amounts have been reclassified to conform to the current period presentation in connection with the adoption of ASU No. 2014-09 and had no material effect on reported consolidated earnings.

PEO insurance reserves: As part of the professional employer organization (“PEO”) service, the Company offers workers' compensation insurance and health insurance to client companies for the benefit of client employees. For workers' compensation insurance, reserves are established to provide for the estimated costs of paying claims up to per occurrence liability limits. The Company’s maximum individual claims liability, excluding HR Outsourcing Holdings, Inc. (“HROI”), was $1.0 million and $1.3 million under its fiscal 2019 and fiscal 2018 workers' compensation insurance policies, respectively. HROI’s maximum individual claims liability was $0.5 million and $0.8 million under its workers’ compensation insurance policies for the annual periods ended September 30, 2018 and ending September 30, 2019, respectively.

Under the minimum premium insurance plan offering within the PEO, the Company's health benefits insurance reserves are established to provide for the payment of claims liability charges in accordance with its service contract with the insurance carrier. The Company's maximum individual claims liability, excluding HROI, was $0.3 million under both its calendar 2018 and 2017 minimum premium insurance plan policies. HROI’s maximum individual claims liability was $0.3 million under its minimum premium insurance plan policies for the annual periods ended June 30, 2018 and ending June 30, 2019. In addition, the Company also provides self-insured dental and vision plans.

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

Stock-based compensation costs: The Company has issued stock-based awards to employees and directors consisting of stock options, restricted stock awards, restricted stock units, performance shares, performance-based restricted stock, and performance-based stock options. The Company accounts for all stock-based awards to employees and directors as compensation costs in the consolidated financial statements based on their fair values measured as of the date of grant. These costs are recognized over the requisite service period. Stock-based compensation costs recognized were $11.9 million and $22.8 million for the three and six months ended November 30, 2018, respectively, as compared with $10.4 million and $19.1 million for the three and six months ended November 30, 2017. The methods and assumptions used in the determination of the fair value of stock-based awards are consistent with those described in the Company's fiscal 2018 Form 10-K.

Recently adopted accounting pronouncements: In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." This guidance, as amended by subsequent ASUs on the topic, outlines a single comprehensive model for determining revenue recognition for contracts with customers, and supersedes guidance on revenue recognition in ASC Topic 605, "Revenue Recognition." The Company adopted the new standard on June 1, 2018, utilizing the full retrospective method, which required the Company to recast each prior reporting period presented and included a cumulative adjustment to increase stockholder's equity by $262.9 million as of June 1, 2016. The Company has updated its control framework for new internal controls and made changes to existing controls related to the new standard.

Impact on Previously Reported Results

The provisions of ASU No. 2014-09 do not materially impact the timing or the amount of revenue the Company recognizes on an annual basis in its Consolidated Statements of Income and Comprehensive Income. However, it does have an impact on the timing and amount of revenue the Company recognizes on a quarterly basis due to changes in the way it accounts for certain revenues where performance obligations are satisfied at a point in time. The provisions of the new standard have a material impact on the Company's Consolidated Balance Sheets. The primary impact of adopting the new standard is on the Company's treatment of certain costs to obtain and fulfill contracts. In relation to those items, the new standard resulted in the Company deferring additional costs on its Consolidated Balance Sheets and amortizing them to the Consolidated Statements of Income and Comprehensive Income over the estimated average life of the client. Refer to Note B for further details.

The following table presents a recast of selected unaudited Consolidated Statements of Income and Comprehensive Income line items after giving effect to the adoption of ASU No. 2014-09:

For the three months ended
November 30, 2017

In millions, except per share amounts	As Previously Reported	Adjustments	As Adjusted
Service revenue	$ 812.5	$ (23.5)	$ 789.0
Operating expenses	248.7	(0.1)	248.6
Selling, general and administrative expenses	245.6	5.7	251.3
Total expenses	494.3	5.6	499.9
Operating income	332.2	(29.1)	303.1
Income taxes	116.9	(10.9)	106.0
Net income	$ 217.0	$ (18.2)	$ 198.8
Basic earnings per share	$ 0.60	$ (0.05)	$ 0.55
Diluted earnings per share	$ 0.60	$ (0.05)	$ 0.55

	For the six months ended November 30, 2017		
In millions, except per share amounts	As Previously Reported	Adjustments	As Adjusted
Service revenue	$ 1,615.6	$ (47.4)	$ 1,568.2
Operating expenses	480.8	(0.2)	480.6
Selling, general and administrative expenses	485.3	9.6	494.9
Total expenses	966.1	9.4	975.5
Operating income	677.2	(56.8)	620.4
Income taxes	236.2	(21.2)	215.0
Net income	$ 444.8	$ (35.6)	$ 409.2
Basic earnings per share	$ 1.24	$ (0.10)	$ 1.14
Diluted earnings per share	$ 1.23	$ (0.10)	$ 1.13

The following table presents a recast of selected unaudited Consolidated Balance Sheet line items after giving effect to the adoption of ASU No. 2014-09:

	May 31, 2018		
In millions	As Previously Reported	Adjustments	As Adjusted
Assets			
Accounts receivable, net of allowance for doubtful accounts	$ 531.4	$ (39.0)	$ 492.4

Prepaid expenses and other current assets	$ 75.8	$ 148.2	$ 224.0
Long-term deferred costs(1)	$ 18.5	$ 342.5	$ 361.0
Liabilities and stockholders' equity			
Accounts payable	$ 74.5	$ (0.8)	$ 73.7
Deferred revenue	$ 24.3	$ 10.3	$ 34.6
Deferred income taxes	$ 48.8	$ 105.6	$ 154.4
Other long-term liabilities	$ 84.8	$ 4.3	$ 89.1
Retained earnings	$ 930.3	$ 332.3	$ 1,262.6

(1) Amounts were previously reported as a component of other long-term assets on the Consolidated Balance Sheets included in the Company's fiscal 2018 Form 10-K. Long-term deferred costs are separately presented on the Consolidated Balance Sheets contained in this Form 10-Q.

The following table presents a recast of selected unaudited Consolidated Statement of Cash Flow line items after giving effect to the adoption of ASU No. 2014-09:

	For the six months ended November 30, 2017		
In millions	As Previously Reported	Adjustments	As Adjusted
Cash flows from operating activities			
Net income	$ 444.8	$ (35.6)	$ 409.2
Provision for deferred income taxes	$ 68.4	$ (21.2)	$ 47.2
Accounts receivable	$ (56.5)	$ 48.0	$ (8.5)
Accounts payable and other current liabilities	$ (34.3)	$ (1.2)	$ (35.5)
Deferred costs	$ —	$ 10.6	$ 10.6
Net change in other long-term assets and liabilities	$ 1.7	$ (0.6)	$ 1.1

In June 2018, the Company also adopted the following ASUs, none of which had a material impact on its consolidated financial statements:

- ASU No. 2017-05, "Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets."

- ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)."

· ASU No. 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory."

· ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force)."

· ASU No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities."

Recently issued accounting pronouncements: In November 2018, the FASB issued ASU No. 2018-18, "Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606." ASU No. 2018-18 was issued to resolve the diversity in practice concerning the manner in which entities account for transactions based on their assessment of the economics of a collaborative arrangement. This guidance is effective for public entities for fiscal years beginning after December 15, 2019, and for interim periods within those fiscal years, with early adoption permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2020. The Company is currently evaluating the potential effects of this guidance on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-15, "Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (a consensus of the FASB Emerging Issues Task Force)." ASU No. 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). This guidance is effective for fiscal years beginning after December 15, 2019, and for interim periods within those fiscal years, with early adoption permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2020. The Company is currently evaluating the potential effects of this guidance on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement." ASU No. 2018-13 modified the disclosure requirements in Topic 820, "Fair Value Measurement," based on the FASB Concepts Statement, "Conceptual Framework for Financial Reporting – Chapter 8: Notes to Financial Statements," including consideration of costs and benefits. This guidance is effective for fiscal years beginning after December 15, 2019, and for interim periods within those fiscal years, with early adoption permitted. This guidance is applicable to the Company's fiscal year beginning June 1, 2020. The Company is currently evaluating the potential effects of this guidance on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." This guidance, as amended by subsequent ASUs on the topic, improves transparency and comparability among companies by recognizing lease assets and lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU No. 2016-02 is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2018, with early adoption permitted. The Company will adopt ASU No. 2016-02 in its fiscal year beginning June 1, 2019, and currently anticipates using the alternative transition method provided by the

FASB in ASU No. 2018-11, "Leases (Topic 842): Targeted Improvements." Under this transition method, the Company will initially apply the new standard at adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings on June 1, 2019.

The Company is gathering data and assessing the impact of the new lease accounting standard and the Company anticipates that the adoption of the new lease accounting standard will result in the Company recording additional assets and liabilities on its Consolidated Balance Sheets. The Company is still in the process of quantifying the impact the new standard will have on its Consolidated Balance Sheets. However, the Company does not anticipate that the new standard will have a material impact on its Consolidated Statements of Income and Comprehensive Income. In addition, the Company is in the process of completing its evaluation of available practical expedients and the impact of the new guidance on its business processes, systems, and controls.

Other recent authoritative guidance issued by the FASB (including technical corrections to the ASC), the American Institute of Certified Public Accountants, and the Securities Exchange Commission ("SEC") during the six months ended November 30, 2018 did not, or are not expected to, have a material effect on the Company's consolidated financial statements.

Note B: Service Revenue

Service revenue is primarily attributable to fees for providing services to the Company's clients and is recognized when control of the promised services are transferred to its clients, in an amount that reflects the consideration it expects to receive in exchange for such services. The Company's service revenue is largely attributable to 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 Company's contracts generally have a term of 30 days as they are cancellable at any time by either party with 30-days' notice of termination. Sales and other applicable taxes are excluded from service revenue.

Based upon similar operational and economic characteristics, the Company's service revenue is disaggregated by Management Solutions and PEO and Insurance Services as reported on the Company's Consolidated Statements of Income and Comprehensive Income. The Company believes these revenue categories depict how the nature, amount, timing, and uncertainty of its revenue and cash flows are affected by economic factors.

Revenue earned from delivery service for the distribution of certain client payroll checks and reports is included in Management Solutions revenue on the Company's Consolidated Statements of Income and Comprehensive Income. Delivery service revenue is recognized at a point in time following the delivery of payroll checks, reports, quarter-end packages, and tax returns to the Company's clients.

The following table, consistent with the Consolidated Statements of Income and Comprehensive Income, disaggregates service revenue by Management Solutions and PEO and Insurance Services:

	For the three months ended November 30,		For the six months ended November 30,	
In millions	2018	2017 As Adjusted(1)	2018	2017 As Adjusted(1)
Management Solutions	$ 685.4	$ 653.5	$ 1,373.1	$ 1,319.4
PEO and Insurance Services	155.2	135.5	313.2	248.8
Total service revenue	$ 840.6	$ 789.0	$ 1,686.3	$ 1,568.2

(1) Amounts have been adjusted to reflect the adoption of ASC Topic 606.

Management Solutions Revenue

Management Solutions revenue is primarily derived from the Company's payroll processing, payroll-related ancillary services and HR outsourcing solutions. Clients can select services on an á la carte basis or as part of various product bundles. The Company's offerings often leverage the information gathered in its base payroll processing service, allowing it to provide comprehensive outsourcing services covering the HCM spectrum. Management Solutions revenue is generally recognized over time as services are performed and the customer simultaneously receives and controls the benefits from these services.

PEO and Insurance Services Revenue

PEO services are sold through the Company's registered and licensed subsidiaries, Paychex Business Solutions, LLC and HROI, and offer businesses a combined package of services that includes payroll, employer compliance, HR and employee benefits administration, risk management outsourcing, and the on-site availability of a professionally trained HR representative, among other services. The Company serves as a co-employer of its clients' employees, offers health insurance coverage to client employees, and assumes the risks and rewards of workers' compensation insurance and certain health insurance benefit offerings. PEO revenue is recognized over time as the services are performed and the customer simultaneously receives and controls the benefits from these services. PEO revenue is reported net of certain direct pass-through costs billed and incurred, which include payroll wages, payroll taxes, including state unemployment insurance, and certain health insurance benefit premiums, primarily costs related to our guaranteed cost benefit plans. For guaranteed cost benefit plans where the Company does not retain risk, it is acting as the agent for revenue recognition purposes and revenues are recorded net of the premiums paid to the insurance carrier. Approximately 60% of the client worksite employees that participate in the Company's benefit plans are enrolled in guaranteed cost benefit plans where the Company does not retain risk. For workers' compensation and certain benefit plans where the Company retains risk, it is acting as the principal for revenue recognition purposes and revenues and costs are recorded on a gross basis. Approximately 40% of the client worksite employees that participate in the

Company's health insurance offerings are enrolled in these benefit plans.

Insurance services are sold through the Company's licensed insurance agency, Paychex Insurance Agency, Inc., which provides insurance through a variety of carriers, while allowing companies to expand their employee benefit offerings at an affordable cost. Insurance offerings include property and casualty coverage such as workers' compensation, business-owner policies, commercial auto, and health and benefits coverage, including health, dental, vision, and life. Insurance services revenue is recognized over time as services are performed and the customer simultaneously receives and controls the benefits from these services.

Contract Balances

The timing of revenue recognition for Management Solutions and PEO and Insurance Services is consistent with the invoicing of clients as they both occur during the respective client payroll period for which the services are provided. Therefore, the Company does not recognize a contract asset or liability resulting from the timing of revenue recognition and invoicing.

Advance payments received for certain of the Company's service offerings for set-up fees are considered a material right. Therefore, the Company defers revenue associated with these performance obligations, which exceed one year, and subsequently recognizes these as future services are provided, over approximately three to four years.

Changes in deferred revenue related to material right performance obligations were as follows:

In millions	For the three months ended November 30, 2018	For the six months ended November 30, 2018
Balance, beginning of period	$ 45.7	$ 46.4
Deferral of revenue	7.1	13.2
Recognition of unearned revenue	(6.8)	(13.6)
Balance, end of period	$ 46.0	$ 46.0

Deferred revenue related to material right performance obligations is reported in the deferred revenue and other long-term liabilities line items on the Company's Consolidated Balance Sheets contained in this Form 10-Q. The Company expects to recognize $12.8 million of deferred revenue related to material right performance obligations in the remainder of fiscal 2019, $18.5 million of such deferred revenue during our fiscal year ending May 31, 2020, and

$14.7 million of such deferred revenue thereafter.

Assets Recognized from the Costs to Obtain and Fulfill Contracts

The Company recognizes an asset for the incremental costs of obtaining a contract with a client if it is expected that the amortization period will be longer than one year. The Company determined that certain selling and commission costs meet the capitalization criteria under ASC Subtopic 340-40, "Other Assets and Deferred Costs: Contracts with Customers" ("ASC 340-40"). Prior to the adoption of ASU No. 2014-09 these costs were deferred up to an amount equal to the set-up fee revenue deferred and any costs in excess of that amount were recognized as expense when incurred. The Company also recognizes an asset for the costs to fulfill a contract with a client if the costs are specifically identifiable, generate or enhance resources used to satisfy future performance obligations, and are expected to be recovered. The Company has determined that substantially all costs related to implementation activities are administrative in nature and meet the capitalization criteria under ASC 340-40. These capitalized costs to fulfill a contract principally relate to upfront direct costs that are expected to be recovered and enhance our ability to satisfy future performance obligations.

The assets related to both costs to obtain and costs to fulfill contracts with clients are capitalized and amortized using an accelerated method to closely align with the pattern of client attrition over the estimated life of the client relationship. Deferred costs to obtain and fulfill contracts are reported in the prepaid expenses and other current assets and long-term deferred costs line items on the Company's Consolidated Balance Sheets. Amortization expense related to costs to obtain and fulfill a contract are included in operating and selling, general, and administrative expenses in the Company's Consolidated Statements of Income and Comprehensive Income. The Company regularly reviews its deferred costs and did not recognize an impairment loss during the six months ended November 30, 2018.

Changes in deferred costs to obtain and fulfill contracts were as follows: