

## How to unlock profit potential:

a l s k d j f h g p q o w i e j  
w u e r y d t o e i r u c n v d  
f k g l d o s i r p r o t i s i  
u g u b **M a x i m i z e** o e p l  
o t i j g H v n m d k f s l d r  
y e h r u e u w j s j q g b l k  
x z a e i f u m l y m v r z p q  
a m z n x c b v a v n w j i l x  
q i w o e i r t y n g h d j s v  
b z x v n v **C a p i t a l** e w m  
g n k s d f b z k j b i e o y q  
n a d k h g o u i w r t y m n g

## Company Profile

With 2008 revenues of \$1.7 billion, Administaff is the nation's leading Professional Employer Organization (PEO), serving as an outsourced human resources department for small and medium-sized businesses throughout the United States. At year-end 2008, Administaff had more than 6,200 client companies, 116,000 worksite employees and 2,000 corporate employees. The Company also had four service centers and 51 sales offices in 24 major markets.

Administaff's common stock is listed on the New York Stock Exchange and traded under the symbol "ASF." Headquartered in Houston, Texas, the Company is accredited by the Employer Services Assurance Corporation and is an active member of the National Association of Professional Employer Organizations.

## Financial Highlights

	2008	Year ended December 31,			
		2007	2006	2005	2004
		<i>(in thousands, except per share and statistical data)</i>			
<b>Income Statement Data:</b>					
Revenues <sup>(1)</sup> . . . . .	\$ 1,724,434	\$ 1,569,977	\$ 1,389,464	\$ 1,169,612	\$ 969,527
Gross profit . . . . .	343,739	305,922	282,729	235,756	197,694
Operating income . . . . .	64,982	62,214	61,565	43,767	22,131
Net income . . . . .	45,780	47,492	46,506	29,983	19,210
Diluted net income per share . . . . .	\$ 1.79	\$ 1.74	\$ 1.64	\$ 1.12	\$ 0.72
<b>Balance Sheet Data:</b>					
Working capital . . . . .	\$ 98,414	\$ 97,180	\$ 128,401	\$ 93,235	\$ 47,500
Total assets . . . . .	616,840	560,651	561,515	495,439	355,388
Total debt/capital lease obligations . . . . .	537	1,166	1,749	34,890	36,539
Total stockholders' equity . . . . .	208,479	198,675	228,445	182,429	126,529
Cash dividends per share . . . . .	0.48	0.44	0.36	0.28	---
<b>Statistical Data:</b>					
Average number of worksite employees paid per month during period . . . . .	116,957	110,291	100,675	88,780	77,936
Revenues per worksite employee per month <sup>(2)</sup> . . . . .	\$ 1,229	\$ 1,186	\$ 1,150	\$ 1,098	\$ 1,037
Gross profit per worksite employee per month . . . . .	\$ 245	\$ 231	\$ 234	\$ 221	\$ 211
Operating income per worksite employee per month . . . . .	\$ 46	\$ 47	\$ 51	\$ 41	\$ 24

(1) Gross billings of \$10.372 billion, \$9.437 billion, \$8.055 billion, \$6.633 billion and \$5.377 billion, less worksite employee payroll cost of \$8.648 billion, \$7.867 billion, \$6.666 billion, \$5.463 billion and \$4.407 billion, respectively.

(2) Gross billings of \$7,391, \$7,130, \$6,667, \$6,226 and \$5,749 per worksite employee per month, less payroll cost of \$6,162, \$5,944, \$5,517, \$5,128 and \$4,712 per worksite employee per month, respectively.

# *Fellow Shareholders*

Paul J. Sarvadi  
Chairman and  
Chief Executive Officer



Administaff's strong financial position, dedicated staff and proven business model enabled the Company to perform successfully against a backdrop of historic economic challenges in 2008. During the past 12 months, Administaff improved client retention levels, realized record client satisfaction ratings and substantially grew its sales staff while achieving excellent financial results.

We enter 2009 with an operating plan designed to profitably manage through the recession and intend to leverage our fiscal strength to take advantage of opportunities created by this demanding business cycle.

## **2008 Financial Performance**

Revenues for the year increased 9.8 percent, to \$1.7 billion, due to a 6.0 percent increase in the average number of worksite employees paid, as well as a 3.6 percent increase in revenues per worksite employee per month. The continued growth of the Company, as indicated by these results, also reflects record client satisfaction levels of over 93 percent for the year.

Gross profit increased 12.4 percent to \$343.7 million, and the Company reported net income and diluted net earnings per share of \$45.8 million and \$1.79, compared to \$47.5 million and \$1.74 in 2007. The negative impact of lower interest rates alone reduced interest income, increased workers' compensation costs and increased the Company's effective income tax rate, thereby reducing earnings per share by \$0.19 share for 2008. Excluding the impact of lower interest rates, earnings per share would have reached \$1.98, near the top end of our implied EPS range forecast at the beginning of the year.

During 2008, we repurchased \$38.1 million of the Company's shares. In August, the Company announced an 18 percent increase in the quarterly dividend, from \$0.11 to \$0.13 per share, and as a result paid dividends totaling \$12.4 million for the year. We generated \$87.7 million of EBITDA and ended the year with working capital of \$98.4 million.

## Improved Client Retention

At the start of 2008, we initiated a companywide effort to improve client retention. When we began the program, many of the economic challenges of 2008 had yet to be revealed, but the sensitivity of our staff to this important initiative and the subsequent ideas submitted by employees proved extremely worthwhile. This aggressive plan of action resulted in a year-over-year improvement in client retention of 12.6 percent in the face of a weak economy.

## Record Client Satisfaction Levels

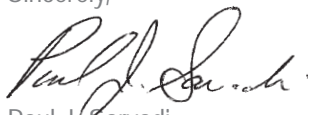
The 12-month average response for our 2008 client satisfaction survey produced an overall rating of over 93 percent, representing the highest level in the Company's history for this key metric. Results of this magnitude reflect the daily commitment to client service across our entire organization and would be noteworthy at any time, but even more so during the economic turmoil of 2008. Not only does this achievement support our efforts to improve client retention, but it is also an important measurement of success in a time when human resources needs increase in response to a more challenging business environment.

## Increased Sales Staff

We entered 2009 with more than 335 trained sales representatives, the largest sales force in our 23-year history, representing a 20 percent increase over the 278 sales staff at the start of 2008. While the number of trained sales personnel is the key leading indicator for the future growth of a company, our increase in this area going into 2009 positions us to increase sales activity levels and therefore moderate the effects of any significant layoffs within our client base.

In closing, I want to express management's genuine appreciation for the dedication, service and commitment of our corporate employees during these difficult economic times. Because of their faithful support, Administaff has been able to continue making its suite of HR services one of the most comprehensive and valuable offerings in the marketplace today. In addition, the counsel provided by our Board of Directors has helped guide the Company through a volatile 2008, while maintaining focus on achieving our corporate goals. Administaff looks forward to proactively meeting the challenges of 2009 and advancing the Company across a variety of fronts.

Sincerely,



Paul J. Sarvadi

Chairman and Chief Executive Officer

March 24, 2009

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-K**

(Mark One)

- Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2008.

or

- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 1-13998

**Administaff, Inc.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

76-0479645  
(I.R.S. Employer  
Identification No.)

19001 Crescent Springs Drive  
Kingwood, Texas  
(Address of principal executive offices)

77339  
(Zip Code)

Registrant's Telephone Number, Including Area Code: (281) 358-8986

Securities Registered Pursuant to Section 12(b) of the Act:

Common Stock, par value \$0.01 per share  
Rights to Purchase Series A Junior Participating Preferred Stock  
(Title of class)

New York Stock Exchange  
New York Stock Exchange  
(Name of Exchange on Which Registered)

Securities Registered Pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  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, a non-accelerated filer, or a smaller reporting company. See the definition of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

As of February 4, 2009, 25,141,489 shares of the registrant’s common stock, par value \$0.01 per share, were outstanding. As of the last business day of the registrant’s most recently completed second quarter, the aggregate market value of the common stock held by non-affiliates (based upon the June 30, 2008, closing price of the common stock as reported by the New York Stock Exchange) was approximately \$627 million.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III information is incorporated by reference from the proxy statement for the annual meeting of stockholders to be held May 5, 2009, which the registrant intends to file within 120 days of the end of the fiscal year.

---

---

## TABLE OF CONTENTS

### Part I

Item 1.	Business.....	2
Item 1A.	Risk Factors.....	16
Item 1B.	Unresolved Staff Comments .....	16
Item 2.	Properties.....	16
Item 3.	Legal Proceedings.....	17
Item 4.	Submission of Matters to a Vote of Security Holders.....	17
Item S-K 401(b).	Executive Officers of the Registrant .....	18

### Part II

Item 5.	Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities .....	20
Item 6.	Selected Financial Data.....	22
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations.....	23
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk.....	43
Item 8.	Financial Statements and Supplementary Data .....	43
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure .....	43
Item 9A.	Controls and Procedures.....	43
Item 9B.	Other Information .....	43

### Part III

Item 10.	Directors, Executive Officers and Corporate Governance.....	44
Item 11.	Executive Compensation.....	44
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters .....	44
Item 13.	Certain Relationships and Related Transactions, and Director Independence .....	44
Item 14.	Principal Accounting Fees and Services .....	44

### Part IV

Item 15.	Exhibits, Financial Statement Schedules .....	45
----------	---	----

## PART I

Unless otherwise indicated, “Administaff,” “the Company,” “we,” “our” and “us” are used in this annual report to refer to the businesses of Administaff, Inc. and its consolidated subsidiaries. This annual report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify such forward-looking statements by the words “expects,” “intends,” “plans,” “projects,” “believes,” “estimates,” “likely,” “possibly,” “probably,” “goal,” “objective,” “assume,” “outlook,” “guidance,” “predicts,” “appears,” “indicator” and similar expressions. In the normal course of business, in an effort to help keep our stockholders and the public informed about our operations we may, from time to time, issue such forward-looking statements, either orally or in writing. Generally, these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of such plans or strategies, or projections involving anticipated revenues, earnings or other aspects of operating results. We base the forward-looking statements on our current expectations, estimates and projections. We caution you that these statements are not guarantees of future performance and involve risks, uncertainties and assumptions that we cannot predict. In addition, we have based many of these forward-looking statements on assumptions about future events that may prove to be inaccurate. Therefore, the actual results of the future events described in such forward-looking statements in this annual report, or elsewhere, could differ materially from those stated in such forward-looking statements. Among the factors that could cause actual results to differ materially are the risks and uncertainties discussed in this annual report, including, without limitation, factors discussed in Item 1, “Business,” Item 1A, “Risk Factors,” and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” including the factors discussed under the caption “Factors That May Affect Future Results and the Market Price of Common Stock,” beginning on page 38.

### ITEM 1. BUSINESS.

#### General

Administaff is a professional employer organization (“PEO”) that provides a comprehensive Personnel Management System<sup>SM</sup> encompassing a broad range of services, including benefits and payroll administration, health and workers’ compensation insurance programs, personnel records management, employer liability management, employee recruiting and selection, employee performance management and employee training and development services to small and medium-sized businesses in strategically selected markets. We were organized as a corporation in 1986 and have provided PEO services since inception. We also perform recordkeeping services for defined contribution plans and offer an online Web site for human resource products, services and information, as well as small business software applications.

Our principal executive offices are located at 19001 Crescent Springs Drive, Kingwood, Texas 77339. Our telephone number at that address is (281) 358-8986 and the Company’s Web site address is <http://www.administaff.com>. Our stock is traded on the New York Stock Exchange under the symbol “ASF.” Periodic SEC filings, including our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and if applicable, amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are available through our Web site free of charge as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC.

Our Personnel Management System is designed to improve the productivity and profitability of small and medium-sized businesses. It relieves business owners and key executives of many employer-related administrative and regulatory burdens, which enables them to focus on the core competencies of their businesses. It also promotes employee performance through human resource management techniques that improve employee satisfaction. We provide the Personnel Management System by entering into a Client Service Agreement (“CSA”), which establishes a three-party relationship whereby we and our client act as co-employers of the employees who work at the client’s location (“worksite employees”). Under the CSA, we assume responsibility for personnel administration and compliance with most employment-related governmental regulations, while the client retains the employees’ services in its business and remains the employer for various other purposes. We charge a comprehensive service fee (“comprehensive service fee” or “gross billing”), which is invoiced concurrently with the processing of payroll for the worksite employees of the client. The comprehensive service fee consists of the payroll of our worksite employees and a markup computed as a percentage of the payroll cost of the worksite employees.



We accomplish the objectives of the Personnel Management System through a High Touch/High Tech approach to service delivery. In advisory areas, such as recruiting, employee performance management and employee training, we employ a high touch approach designed to ensure that our clients receive the personal attention and expertise needed to create a customized human resources solution. For transactional processing, we employ a high tech approach that provides secure, convenient information exchange among Administrators, our clients and our worksite employees, creating efficiencies for all parties. The primary component of the high tech portion of our strategy is the Employee Service Center (“ESC”). The ESC is our Web-based interactive PEO service delivery platform, which is designed to provide automated, personalized PEO services to our clients and worksite employees.

As of December 31, 2008, we had 51 sales offices in 24 markets. Our long-term strategy is to operate approximately 90 sales offices located in 40 strategically selected markets. We opened three new sales offices in 2008 and currently have no plans to open any additional sales offices during 2009.

Our national expansion strategy also includes regionalized data processing for payroll and benefits transactions and localized face-to-face human resource services. As of December 31, 2008, we had four regional service centers, and had human resource and client service personnel located in a majority of our 24 sales markets, which serviced an average of 118,748 worksite employees per month in the fourth quarter of 2008.

### **PEO Industry**

The PEO industry began to evolve in the early 1980s largely in response to the burdens placed on small and medium-sized employers by an increasingly complex legal and regulatory environment. While various service providers were available to assist these businesses with specific tasks, PEOs emerged as providers of a more comprehensive range of services relating to the employer/employee relationship. In a PEO arrangement, the PEO assumes broad aspects of the employer/employee relationship. Because PEOs provide employer-related services to a large number of employees, they can achieve economies of scale that allow them to perform employment-related functions more efficiently, provide a greater variety of employee benefits and devote more attention to human resources management than a client can individually.

We believe the key factors driving demand for PEO services include:

- the focus on growth and productivity of the small and medium-sized business community in the United States, utilizing outsourcing to concentrate on core competencies;
- the need to provide competitive health care and related benefits to attract and retain employees;
- the increasing costs associated with health and workers’ compensation insurance coverage, workplace safety programs, employee-related complaints and litigation; and
- complex regulation of employment issues and the related costs of compliance, including the allocation of time and effort to such functions by owners and key executives.

A significant factor in the development of the PEO industry has been increasing recognition and acceptance of PEOs and the co-employer relationship by federal and state governmental authorities. Administrators and other industry leaders, in concert with the National Association of Professional Employer Organizations (“NAPEO”), have worked with the relevant governmental entities for the establishment of a regulatory framework that protects clients and employees, discourages unscrupulous and financially unsound companies, and promotes further development of the industry. Currently, 34 states have enacted legislation either recognizing PEOs or requiring licensing, registration, or certification, and several others are considering such regulation. Such laws vary from state to state but generally provide for monitoring the fiscal responsibility of PEOs. State regulation assists in screening insufficiently capitalized PEO operations and helps to resolve interpretive issues concerning employee status for specific purposes under applicable state law. We have actively supported such regulatory efforts and are currently recognized, licensed, registered, certified or pursuing registration in all 34 of these states. The cost of compliance with these regulations is not material to our financial position or results of operations.

## Service Offerings

### *PEO Services*

We serve small and medium-sized businesses by providing our Personnel Management System, which encompasses a broad range of services, including:

- benefits and payroll administration;
- health and workers' compensation insurance programs;
- personnel records management;
- employer liability management;
- employee recruiting and selection;
- employee performance management; and
- training and development services.

The Personnel Management System is designed to attract and retain high-quality employees, while relieving client owners and key executives of many employer-related administrative and regulatory burdens. Among the employment-related laws and regulations that may affect a client are the following:

- Internal Revenue Code (the "Code");
- Federal Income Contribution Act (FICA);
- Federal Unemployment Tax Act (FUTA);
- Fair Labor Standards Act (FLSA)\*;
- Employee Retirement Income Security Act, as amended (ERISA);
- Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA);
- Immigration Reform and Control Act (IRCA);
- Title VII (Civil Rights Act of 1964)\*;
- Americans with Disabilities Act (ADA)\*;
- Age Discrimination in Employment Act (ADEA)\*;
- The Family and Medical Leave Act (FMLA)\*;
- Health Insurance Portability and Accountability Act (HIPAA);
- Drug-Free Workplace Act\*;
- Occupational Safety and Health Act (OSHA)\*;
- Worker Adjustment and Retraining Notification Act (WARN);
- Uniformed Services Employment and Reemployment Rights Act (USERRA);
- State unemployment and employment security laws; and
- State workers' compensation laws.

\* And similar state laws

While these regulations are complex, and in some instances overlapping, we assist our clients in achieving compliance with these regulations by providing services in four primary categories:

- administrative functions;
- benefit plans administration;
- personnel management; and
- employer liability management.

All of the following services are included in the Personnel Management System and are available to all clients:

*Administrative Functions.* Administrative functions encompass a wide variety of processing and record keeping tasks, mostly related to payroll administration and government compliance. Specific examples include:

- payroll processing;
- payroll tax deposits;
- quarterly payroll tax reporting;
- employee file maintenance;
- unemployment claims processing; and
- workers' compensation claims reporting.

*Benefit Plans Administration.* We maintain several benefit plans including the following types of programs:

- group health coverage;
- a health care flexible spending account plan;
- an educational assistance program;
- an adoption assistance program;
- group term life insurance;
- universal life insurance coverage;
- accidental death and dismemberment insurance coverage;
- short-term and long-term disability insurance coverage;
- a 401(k) retirement plan; and
- a cafeteria plan.

The group health plan includes medical, dental, vision, a worklife program and a prescription drug program. All benefit plans are provided to eligible employees based on the specific eligibility provisions of each plan. We are the policyholder responsible for the costs and premiums associated with any group insurance policies that provide benefits under these plans and act as plan sponsor and administrator of the plans. We negotiate the terms and costs of the plans, maintain the plans in accordance with applicable federal and state regulations and serve as liaison for the delivery of such benefits to worksite employees. We believe this variety and quality of benefit plans are generally not available to employees in our small and medium-sized business target market and are usually offered only by larger companies that can spread program costs over a much larger group of employees. As a result, we believe the availability of these benefit plans provides our clients with a competitive advantage that small and medium-sized businesses are typically unable to attain on their own.

*Personnel Management.* We provide a wide variety of personnel management services that give our clients access to resources normally found only in the human resources departments of large companies. All clients have access to our comprehensive personnel guide, which sets forth a systematic approach to administering personnel policies and practices, including recruiting, discipline and termination procedures. Other human resources services we provide include:

- drafting and reviewing personnel policies and employee handbooks;
- designing job descriptions;
- performing prospective employee screening and background investigations;
- designing performance appraisal processes and forms;
- professional development and issues-oriented training;
- employee counseling;
- substance abuse awareness training;
- drug testing;
- outplacement services; and
- compensation guidance.

*Employer Liability Management.* Under the CSA, we assume many of the employment-related responsibilities associated with the administrative functions, benefit plans administration and personnel management services we provide. For many of those employment-related responsibilities that are the responsibility of the client or we share with our clients, we can assist our clients in managing and limiting exposure. This includes first time and ongoing safety-related risk management reviews, as well as the implementation of safety programs designed to reduce workers' compensation claims. We also provide guidance to clients for avoiding liability claims for discrimination, sexual harassment and civil rights violations, and participate in termination decisions to attempt to minimize liability on those grounds. We employ in-house and external counsel, specializing in several areas of employment law, who have broad experience in disputes concerning the employer/employee relationship and provide support to our human resources service specialists. As part of our comprehensive service, we also maintain employment practice liability insurance coverage for ourselves and our clients, monitor changing government regulations and notify clients of the potential effect of such changes on employer liability.

*Employee Service Center<sup>SM</sup>.* The Employee Service Center ("ESC") is our Web-based interactive PEO service delivery platform, which is designed to provide automated, personalized PEO content and services to our clients and worksite employees. The ESC provides a wide range of functionality, including:

- WebPayroll<sup>SM</sup> for the submission and approval of payroll data;
- client-specific payroll information and reports;
- employee information, including online check stubs and pay history reports;
- employee-specific benefits content, including summary plan descriptions and enrollment status;
- access to 401(k) plan information through the Retirement Service Center<sup>SM</sup>;
- online human resources forms;
- best practices human resource management process maps and process overviews;
- an online personnel guide;
- e-Learning Web-based training;
- online recruiting services;
- links to benefits providers and other key vendors; and
- frequently asked questions.

The ESC also contains Marketplace<sup>SM</sup>, an eCommerce portal that brings a wide range of product and service offerings from best-of-class providers to our clients, worksite employees and their families. Marketplace offerings include:

- financial services;
- technology solutions;
- communications services;
- travel services;
- leisure and entertainment services;
- retail services;
- gifts and rewards;
- insurance services;
- real estate services;
- research and consulting services; and
- other business and consumer products and services.

MarketPlace also features the Client Network<sup>SM</sup>, where our clients can offer their products and services to one another.

*HR Software Products.* In December 2005, we acquired HRTools.com, an online Web site for human resources products, services and information. The acquisition also included small business software applications related to job descriptions, performance reviews, and personnel policies and procedures. The applications are sold primarily to small business customers through online subscription arrangements, packaged software ordered through

the HRTools.com Web site, or through various reseller arrangements. During 2007, we embarked on a strategy to redevelop the technological platform to a “software as a service” delivery model.

*Employment Screening Services.* In April 2008, we acquired the operations of USDataLink, Ltd., an employment screening services company. The acquisition allows us to leverage our HR service capabilities to our PEO customers, through operating synergies. USDataLink offers a customized approach to background-check reporting for companies that outsource this portion of their employment-screening process. Services include criminal records checks; verifying employment history or education; conducting driving record, civil record and credit history checks; and confirming extraordinary credentials.

### **Client Service Agreement**

All PEO clients execute an Administaff Client Service Agreement (“CSA”). The CSA generally provides for an on-going relationship, subject to termination by Administaff or the client upon 30 days written notice or upon shorter notice in the event of default. The CSA establishes our comprehensive service fee, which is subject to periodic adjustments to account for changes in the composition of the client’s workforce, employee benefit election changes and statutory changes that affect our costs. Under the provisions of the CSA, clients active in January of any year are obligated to pay the estimated payroll tax component of the comprehensive service fee in a manner that reflects the pattern of incurred payroll tax costs. This practice aligns clients’ payments to Administaff for payroll taxes with Administaff’s obligations to make payments to tax authorities, which are higher in the earlier part of the year, and decrease as limits on wages subject to payroll tax, are reached. New clients enrolling subsequent to January of any year are invoiced at a relatively constant rate throughout the remaining portion of the year, resulting in Administaff’s improving profitability over the course of the year for those clients because of the typical pattern of incurred payroll tax costs.

The CSA also establishes the division of responsibilities between Administaff and the client as co-employers. Pursuant to the CSA, we are responsible for personnel administration and are liable for compliance with certain employment-related government regulations. In addition, we assume liability for payment of salaries and wages (as well as related payroll taxes) of our worksite employees and responsibility for providing specified employee benefits to such persons. These liabilities are not contingent on the prepayment by the client of the associated comprehensive service fee and, as a result of our employment relationship with each of our worksite employees, we are liable for payment of salary and wages to the worksite employees as reported by the client and are responsible for providing specified employee benefits to such persons, regardless of whether the client pays the associated comprehensive service fee. The client retains the employees’ services and remains liable for complying with certain government regulations, compliance with which requires control of the worksite or daily supervisory responsibility or is otherwise beyond our ability to assume. A third group of responsibilities and liabilities are shared by Administaff and the client where such joint responsibility is appropriate. The specific division of applicable responsibilities under the majority of CSAs are as follows:

#### Administaff

- Payment of wages and salaries as reported by the client and related tax reporting and remittance (local, state and federal withholding, FICA, FUTA, state unemployment);
- Workers’ compensation compliance, procurement, management and reporting;
- Compliance with COBRA, HIPAA and ERISA (for each employee benefit plan sponsored solely by Administaff), as well as monitoring changes in other governmental regulations governing the employer/employee relationship and updating the client when necessary; and
- Employee benefits administration of plans sponsored solely by Administaff.

## Client

- Payment, through Administrative staff, of commissions, bonuses, paid leaves of absence and severance payments;
- Payment and related tax reporting and remittance of non-qualified deferred compensation and equity based compensation;
- Assignment to, and ownership of, all client intellectual property rights;
- Compliance with OSHA regulations, EPA regulations, FLSA, WARN, USERRA and state and local equivalents and compliance with government contracting provisions;
- Compliance with the National Labor Relations Act (“NLRA”), including all organizing efforts and expenses related to a collective bargaining agreement and related benefits;
- Professional licensing requirements, fidelity bonding and professional liability insurance;
- Products produced and/or services provided; and
- COBRA, HIPAA and ERISA compliance for client-sponsored benefit plans.

## Joint

- Implementation of policies and practices relating to the employee/employer relationship; and
- Compliance with all federal, state and local employment laws, including, but not limited to Title VII of the Civil Rights Act of 1964, ADEA, Title I of ADA, FMLA, the Consumer Credit Protection Act, and immigration laws and regulations.

We maintain employers’ practice liability insurance coverages (including coverages for our clients) to manage our exposure for various employee-related claims, and as a result, the costs in excess of insurance premiums we incur with respect to this exposure have historically been insignificant to our operating results.

Because we are a co-employer with the client for some purposes, it is possible that we could incur liability for violations of such laws, even if we are not responsible for the conduct giving rise to such liability. The CSA addresses this issue by providing that the client will indemnify us for liability incurred to the extent the liability is attributable to conduct by the client. Notwithstanding this contractual right to indemnification, it is possible that we could be unable to collect on a claim for indemnification and may therefore be ultimately responsible for satisfying the liability in question.

In most instances, clients are required to remit their comprehensive service fees no later than one day prior to the applicable payroll date by wire transfer or automated clearinghouse transaction. Although we are ultimately liable, as the employer for payroll purposes, to pay employees for work previously performed, we retain the ability to terminate immediately the CSA and associated worksite employees or to require prepayment, letters of credit or other collateral upon deterioration in a client’s financial condition or upon non-payment by a client. These rights, the periodic nature of payroll and the overall quality of our client base have resulted in an excellent overall collections history.

## **Customers**

Administrative staff provides a value-added, full-service human resources solution we believe is most suitable to a specific segment of the small and medium-sized business community. We target successful businesses with 10 to 2,000 employees that recognize the advantage in the strategic use of high-performance human resource practices. We refer to customers with 150 to 2,000 employees as mid-market customers. These customers, which represent 12% of the total customer base in December 2008, are marketed to and serviced by dedicated sales and service personnel. We have set a long-term goal to serve approximately 10% of the overall small and medium sized business community. We serve clients and worksite employees located throughout the United States. For the year ended December 31, 2008, Houston, our original market, accounted for approximately 14% of our worksite employees, with other Texas markets contributing an additional 17%. By region, our revenue growth over 2007 and revenue distribution for the year ended December 31, 2008 were as follows:

	<b><u>Revenue Growth</u></b>	<b><u>% of Total Revenues</u></b>
Northeast .....	16.6%	21.1%
Southeast .....	10.2%	10.6%
Central .....	12.9%	14.5%
Southwest .....	6.7%	33.0%
West .....	6.2%	20.0%
Other revenue .....	11.3%	0.8%

As part of our client selection strategy, we generally do not offer our services to businesses falling within certain specified NAICS (North American Industry Classification System) codes, essentially eliminating certain industries we believe present a higher employer risk such as employee injury, high turnover or litigation. All prospective clients are evaluated individually on the basis of workers' compensation risk, group medical history (where permitted by law), unemployment history, operating stability and human resource practices.

Our client base is broadly distributed throughout a wide variety of industries including:

- Computer and information services – 21%;
- Management, administration and consulting services – 16%;
- Finance, insurance and real estate – 14%;
- Manufacturing – 8%;
- Engineering, accounting and legal services – 7%;
- Wholesale trade – 7%;
- Construction – 6%;
- Medical services – 6%;
- Retail trade – 5%;
- Transportation – 2%; and
- Other – 8%.

This diverse client base lowers our exposure to downturns or volatility in any particular industry. However, our performance could be affected by a downturn in one of these industries or by general economic conditions within the small and medium-sized business community.

We focus heavily on client retention. During 2008, our retention rate was approximately 79%. Administraff's client retention record over the last five years reflects that approximately 76% of our clients remain for more than one year, and that the retention rate improves for clients who remain with us for longer periods, up to approximately 80% for clients in their fifth year with Administraff. The average annual retention rate over the last five years was approximately 79%. Client attrition is attributable to a variety of factors, including: (i) client non-renewal due to price or service factors; (ii) client business failure, sale, merger, or disposition; (iii) our termination of the CSA resulting from the client's non-compliance or inability to make timely payments; and (iv) competition from other PEOs or business services firms.

### **Marketing and Sales**

As of December 31, 2008, we had 51 sales offices located in 24 markets. Our long-term goal is to operate 90 sales offices in 40 strategically selected markets. Our sales offices typically consist of six to eight sales representatives, a district sales manager and an office administrator. To take advantage of economic efficiencies, multiple sales offices may share a physical location. Administraff's markets and their respective year of entry are as follows:

<u>Market</u>	<u>Sales Offices</u>	<u>Initial Entry Date</u>
Houston	5	1986
San Antonio	1	1989
Austin	1	1989
Orlando	1	1989
Dallas/Fort Worth	4	1993
Atlanta	4	1994
Phoenix	2	1995
Chicago	2	1995
Washington D.C.	3	1995
Denver	2	1996
Los Angeles	5	1997
Charlotte	1	1997
St. Louis	1	1998
San Francisco	3	1998
New York	4	1999
Baltimore	1	2000
New Jersey	2	2000
San Diego	1	2001
Boston	2	2001
Minneapolis	2	2002
Cleveland	1	2002
Raleigh	1	2006
Jacksonville	1	2007
Kansas City	1	2007

Our existing and future markets were identified using a systematic market evaluation and selection process. We continue to evaluate a broad range of factors in the selection process, using a market selection model that weights various criteria we believe are reliable predictors of successful penetration based on our experience. Among the factors we consider are:

- market size, in terms of small and medium-sized businesses engaged in selected industries that meet our risk profile;
- market receptivity to PEO services, including the regulatory environment and relevant history with other PEO providers;
- existing relationships within a given market, such as vendor or client relationships;
- expansion cost issues, such as advertising and overhead costs;
- direct cost issues that bear on our effectiveness in controlling and managing the cost of our services, such as workers' compensation and health insurance costs, unemployment risks and various legal and other factors;
- a comparison of the services we offer to alternatives available to small and medium-sized businesses in the relevant market, such as the cost to the target clients of procuring services directly or through other PEOs; and
- long-term strategy issues, such as the general perception of markets and our estimate of the long-term revenue growth potential of the market.

Each of our expansion markets, beginning with Dallas in 1993, was selected in this manner.

Our marketing strategy is based on the application of techniques that have produced consistent and predictable results in the past. We develop a mix of national and local advertising media and a placement strategy tailored to each individual market. After selecting a market and developing our marketing mix, but prior to entering



the market, we engage in an organized media and public relations campaign to prepare the market for our entry and to begin the process of generating sales leads. We market our services through various business promotions and a broad range of media outlets, including television, radio, newspapers, periodicals, direct mail and the Internet. We employ public relations firms for most of our markets as well as advertising consultants to coordinate and implement our marketing campaigns. We have developed an inventory of television, radio and newsprint advertisements, which are utilized in this effort. We continuously seek to develop new marketing approaches and campaigns to capitalize on changes in the competitive landscape for our PEO service and to more successfully reach our target market.

In 2004, we entered into an agreement with the Professional Golf Association Champions Tour to become the title sponsor of the annual Administristaff Small Business Classic professional golf tournament held in Houston, Texas. In addition, we have entered into a lifetime arrangement with Arnold Palmer to be our national spokesperson, which may be terminated upon notice by either party. Our marketing campaigns use this event and the relationship with Mr. Palmer as a focal point of our brand marketing efforts.

Our organic growth model generates sales leads from five primary sources: direct sales efforts, advertising, referrals, marketing alliances and the Internet. These leads result in initial presentations to prospective clients, and ultimately, prospective client census reports. A prospective client's census report reflects information gathered by the sales representative about the prospect's employees, including job classification, state of employment, workers' compensation claims history, group medical information (where permitted by law), salary and desired level of benefits. This information is entered into our customized bid system, which applies Administristaff's proprietary pricing model to the census data, leading to the preparation of a bid. Concurrent with this process, we evaluate the prospective client's workers' compensation, health insurance, employer practices and financial stability from a risk management perspective. Upon completion of a favorable risk evaluation, the sales representative presents the bid and attempts to enroll the prospect. Our selling process typically takes approximately 90 days for clients with less than 150 employees, and up to approximately 180 days for larger clients.

## **Competition**

Administristaff provides a value-added, full-service human resources solution we believe is most suitable to a specific segment of the small and medium-sized business community. This full-service approach is exemplified by our commitment to provide a high level of service and technology personnel, which has produced a ratio of corporate staff to worksite employees (the "staff support ratio") that is higher than average for the PEO industry. Based on an analysis of the 2005 through 2007 annual NAPEO surveys of the PEO industry, we have successfully leveraged our full-service approach into significantly higher returns for Administristaff on a per worksite employee per month basis. During the three-year period from 2005 through 2007, our staff support ratio averaged 47% higher than the PEO industry average, while gross profit per worksite employee and operating income per worksite employee exceeded industry averages by 126% and 151%, respectively.

Competition in the PEO industry revolves primarily around quality of services, scope of services, choice and quality of benefits packages, reputation and price. We believe reputation, national presence, regulatory expertise, financial resources, risk management and information technology capabilities distinguish leading PEOs from the rest of the industry. We also believe we compete favorably in these areas.

Due to the differing geographic regions and market segments in which most PEOs operate, and the relatively low level of market penetration by the industry, we consider our primary competition to be the traditional in-house provision of human resource services. The PEO industry is highly fragmented, and we believe Administristaff is one of the largest PEOs in the United States. Our largest national competitors include Gevity HR and PEO divisions of large business services companies such as Automatic Data Processing, Inc. and Paychex, Inc. In addition, we compete to some extent with: i) fee-for-service providers such as payroll processors and human resource consultants; ii) independent business outsourcing companies; and iii) large regional PEOs in certain areas of the country. As Administristaff and other large PEOs expand nationally, we expect that competition may intensify.

## Vendor Relationships

Administrative staff provides benefits to its worksite employees under arrangements with a variety of vendors. We consider our contracts with UnitedHealthcare (“United”) and member insurance companies of ACE American Insurance Company (“ACE”) to be the most significant elements of our employee benefits package. These contracts would be the most difficult to replace.

We provide group health insurance coverage to our worksite employees through a national network of carriers including United, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California, Hawaii Medical Service Association and Tufts, all of which provide fully insured policies or service contracts. The health insurance contract with United provides approximately 92% of our health insurance coverage and expires on December 31, 2010, subject to cancellation by either party upon 180 days notice. For a discussion of our contract with United, please read Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates – Benefits Costs” on page 25.

Our workers’ compensation coverage (the “ACE Program”) is currently provided through ACE. Under our arrangement with ACE, we bear the economic burden for the first \$1 million layer of claims per occurrence. ACE bears the economic burden for all claims in excess of such first \$1 million layer. The ACE Program is a fully insured policy whereby ACE has the responsibility to pay all claims incurred under the policy regardless of whether we satisfy our responsibilities. For additional discussion of our policy with ACE, please read Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates – Workers’ Compensation Costs” on page 26.

## Information Technology

Administrative staff utilizes a variety of information technology capabilities to provide its human resource services to clients and worksite employees and for its own administrative and management information requirements.

Administrative staff Information Management System (“AIMS”) is our proprietary PEO information system and utilizes both purchased and internally developed software applications. This system manages transactions and information unique to the PEO industry and to Administrative staff, including:

- worksite employee enrollment;
- human resource management;
- benefits and defined contribution plan administration;
- payroll processing;
- client invoicing and collection;
- management information and reporting; and
- sales bid calculations.

Central to the system is a transaction processing system that allows us to process a high volume of payroll, invoice, and bid transactions that meet the specific needs of our clients and prospects. We administer our employee benefits through a proprietary application designed to process employee eligibility and enrollments, manage carrier relationships, and maintain a variety of plan offerings. Our retirement services operations are conducted utilizing an industry leading retirement plan administration application in a third-party hosted environment. We utilize commercially available software for other business functions such as finance and accounting, contract and litigation management, sales force activity management and customer relationship management.

The Employee Service Center is our proprietary web-based PEO service delivery platform. With its integration into AIMS, the ESC is designed to provide automated, personalized PEO content and services to our clients and worksite employees. For a description of the functionality provided through the ESC, please read “PEO Services – Employee Service Center” on page 6.

Administaff's primary data center is located at our corporate headquarters in Kingwood, Texas (a suburb of Houston). Substantially all of our business applications, telecommunications equipment and network equipment are hosted in this data center. We maintain a disaster recovery data center in a leased facility in Bryan, Texas. This data center is fully equipped with the hardware and software necessary to run all of our critical business applications and has sufficient capacity to handle all of our operations for short periods of time, if required. Periodically, we perform testing to ensure the disaster recovery capabilities remain effective and available.

We have invested substantially in our network infrastructure to ensure appropriate connectivity exists between our service centers in Atlanta, Dallas, Houston and Los Angeles, our district sales offices, our disaster recovery facility and our corporate offices, and to provide appropriate Internet connectivity to conduct business through the Employee Service Center. The network infrastructure is provided through industry standard core network hardware and via high-speed network services provided by multiple vendors.

We have incorporated a variety of measures to maintain the security and privacy of the information managed through our systems and applications. These measures include industry standard technologies designed to protect, monitor and assess the network environment; best practice security policies and procedures; and standard access controls designed to control access to sensitive and private information.

### **Industry Regulation**

Administaff's operations are affected by numerous federal and state laws relating to tax and employment matters. By entering into a co-employer relationship with our worksite employees, we assume certain obligations and responsibilities of an employer under these federal and state laws. Because many of these federal and state laws were enacted prior to the development of nontraditional employment relationships, such as PEOs, temporary employment and outsourcing arrangements, many of these laws do not specifically address the obligations and responsibilities of nontraditional employers. Currently, 34 states have passed laws that recognize PEOs or require licensing, registration or certification requirements for PEOs, and several others are considering such regulation.

Certain federal and state statutes and regulations use the terms "employee leasing" or "staff leasing" to describe the arrangement among a PEO and its clients and worksite employees. The terms "employee leasing," "staff leasing" and "professional employer arrangements" are generally synonymous in such contexts and describe the arrangements we enter with our clients and worksite employees.

As an employer, we are subject to federal statutes and regulations governing the employer/employee relationship. Subject to the issues discussed below, we believe that our operations are in compliance, in all material respects, with all applicable federal statutes and regulations.

### ***Employee Benefit Plans***

We offer various employee benefits plans to eligible employees, including our worksite employees. These plans include:

- a 401(k) retirement plan;
- a cafeteria plan under Code Section 125;
- a group health plan which includes medical, dental, vision, prescription and worklife programs;
- a welfare benefits plan which includes life insurance and disability programs;
- a health care flexible spending plan;
- an educational assistance program; and
- an adoption assistance program.

Generally, employee benefit plans are subject to provisions of both the Internal Revenue Code and ERISA.

*Employer Status.* In order to qualify for favorable tax treatment under the Code, the plans must be established and maintained by an employer for the exclusive benefit of its employees. Generally, an entity is an

“employer” of individuals for federal employment tax purposes if an employment relationship exists between the entity and the individuals under the common law test of employment. In addition, the officers of a corporation are deemed to be employees of that corporation for federal employment tax purposes. The common law test of employment, as applied by the IRS, involves an examination of approximately 20 factors to ascertain whether an employment relationship exists between a worker and a purported employer. Generally, the test is applied to determine whether an individual is an independent contractor or an employee for federal employment tax purposes and not to determine whether each of two or more companies is a “co-employer.” Substantial weight is typically given to the question of whether the purported employer has the right to direct and control the details of an individual’s work. Among the factors that appear to have been considered more important by the IRS are:

- the employer’s degree of behavioral control (the extent of instructions, training and the nature of the work);
- the financial control or the economic aspects of the relationship; and
- the intended relationship of the parties (whether employee benefits are provided, whether any contracts exist, whether services are ongoing or for a project, whether there are any penalties for discharge/termination, and the frequency of the business activity).

*ERISA Requirements.* Employee pension and welfare benefit plans are also governed by ERISA. ERISA defines “employer” as “any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan.” ERISA defines the term “employee” as “any individual employed by an employer.” The United States Supreme Court has held that the common law test of employment must be applied to determine whether an individual is an employee or an independent contractor under ERISA. A definitive judicial interpretation of “employer” in the context of a PEO or employee leasing arrangement has not been established.

If Administrstaff were found not to be an employer with respect to worksite employees for ERISA purposes, its plans would not comply with ERISA. Further, as a result of such finding Administrstaff and its plans would not enjoy, with respect to worksite employees, the preemption of state laws provided by ERISA and could be subject to varying state laws and regulations, as well as to claims based upon state common laws. Even if such a finding were made, we believe we would not be materially adversely affected because we could continue to make available similar benefits at comparable costs.

In addition to ERISA and the Code provisions discussed herein, issues related to the relationship between Administrstaff and its worksite employees may also arise under other federal laws, including other federal income tax laws.

*401(k) Retirement Plans.* The Company’s 401(k) Retirement Plans are operated pursuant to guidance provided by the Internal Revenue Service under Revenue Procedure 2002-21 and Revenue Procedure 2003-86, each of which provides guidance for the operation of defined contribution plans maintained by PEOs that benefit worksite employees. This guidance provides qualification standards for PEO plans which, if met, negate the inquiry of common law employer status for purposes of the exclusive benefit rule.

### ***Federal Employment Taxes***

As a co-employer, Administrstaff assumes responsibility and liability for the payment of federal and state employment taxes with respect to wages and salaries paid to our worksite employees. There are essentially three types of federal employment tax obligations:

- withholding of income tax requirements governed by Code Section 3401, et seq.;
- obligations under FICA, governed by Code Section 3101, et seq.; and
- obligations under FUTA, governed by Code Section 3301, et seq.

Under these Code sections, employers have the obligation to withhold and remit the employer portion and, where applicable, the employee portion of these taxes.

Code Section 3401, which applies to federal income tax withholding requirements, contains an exception to the general common law test applied to determine whether an entity is an “employer” for purposes of federal income tax withholding. Section 3401(d)(1) states that if the person for whom services are rendered does not have control of the payment of wages, the “employer” for this purpose is the person having control of the payment of wages. The Treasury regulations issued under Section 3401(d)(1) state that a third party can be deemed to be the employer of workers under this section for income tax withholding purposes where the person for whom services are rendered does not have legal control of the payment of wages. While Section 3401(d) (1) has been examined by several courts, its ultimate scope has not been delineated. Moreover, the IRS has to date relied extensively on the common law test of employment in determining liability for failure to comply with federal income tax withholding requirements.

Accordingly, while we believe that we can assume the withholding obligations for worksite employees, in the event we fail to meet these obligations, the client may be held ultimately liable for those obligations. While this interpretive issue has not to our knowledge discouraged clients from enrolling with Administaff, there can be no assurance that a definitive adverse resolution of this issue would not do so in the future. These interpretive uncertainties may also impact our ability to report employment taxes on our own account rather than the accounts of our clients.

### ***State Unemployment Taxes***

We record our state unemployment (“SUI”) tax expense based on taxable wages and tax rates assigned by each state. State unemployment tax rates vary by state and are determined, in part, based on prior years’ compensation experience in each state. In addition, states have the ability under law to increase unemployment tax rates to cover deficiencies in the unemployment tax funds. Rate notices are typically provided by the states during the first quarter of each year; however, some notices are received later. Until we receive the final tax rate notices, we estimate our expected SUI rate in those particular states.

### **State Regulation**

While many states do not explicitly regulate PEOs, 34 states have adopted provisions for licensing, registration, certification or recognition of PEOs, and several others are considering such regulation. Such laws vary from state to state but generally provide for monitoring the fiscal responsibility of PEOs, and in some cases codify and clarify the co-employment relationship for unemployment, workers’ compensation and other purposes under state law. The Company is in compliance with the requirements in all 34 states. Regardless of whether a state has licensing, registration or certification requirements for PEOs, we must comply with a number of other state and local regulations that could impact our operations.

### **Corporate Office Employees**

We had approximately 2,060 corporate office and sales employees as of December 31, 2008. We believe our relations with our corporate office and sales employees are good. None of our corporate office and sales employees are covered by a collective bargaining agreement.

### **Intellectual Property**

Administaff currently has registered trademarks, copyrights and other intellectual property. Although the Administaff mark is the most material trademark to our business, our trademarks as a whole are also of considerable importance to us.

## **ITEM 1A. RISK FACTORS.**

Information on the Company's risk factors is included in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations — Factors that May Affect Future Results and the Market Price of Common Stock" on page 38.

## **ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None.

## **ITEM 2. PROPERTIES.**

We believe our current facilities are adequate for the purposes for which they are intended and they provide sufficient capacity to accommodate our expansion goals. We will continue to evaluate the need for additional facilities based on the rate of growth in worksite employees, the geographic distribution of the worksite employee base and our long-term service delivery requirements.

### **Corporate Facilities**

Our corporate headquarters is located in Kingwood, Texas, in a 327,000 square foot office campus-style facility. This 28-acre company-owned office campus includes approximately nine acres of undeveloped land for future expansion. All development and support operations are located in the Kingwood facility, along with our record retention center and primary data processing center.

In December 2008, we acquired a one-third acre parcel of land to construct a conference facility in Georgia.

### **Service Centers**

We currently have four regional service centers located in Atlanta, Dallas, Houston and Los Angeles. Each service center is designed to service approximately 40,000 worksite employees at full capacity.

The Atlanta service center, which currently services approximately 31% of our worksite employee base, is located in a 40,000 square foot facility under lease until 2014.

The Dallas service center, which currently services approximately 22% of our worksite employee base, is located in a 47,500 square foot facility, which is under lease until 2016.

The Houston service center, which currently services approximately 24% of our worksite employee base, is located in a 60,600 square foot facility under lease until 2014. In addition to the service center operations, the facility also contains corporate support operations.

The Los Angeles service center, which currently services approximately 23% of our worksite employee base, is located in a 45,000 square foot facility under lease until 2012.

### **Sales Offices**

As of December 31, 2008, we had sales and service personnel in 39 facilities located in 24 sales markets throughout the United States. All of the facilities are leased facilities, and some of these facilities are shared by multiple sales offices and/or client service personnel. As of December 31, 2008, we had 51 sales offices in these 24 markets. To take advantage of economic efficiencies, multiple sales offices may share a physical location. Each sales office is typically staffed by six to eight sales representatives, a district sales manager and an office administrator. In addition, we have placed certain client service personnel in a majority of our sales markets to provide high-quality, localized service to our clients in those major markets. We expect to continue placing various client service personnel in sales markets as a critical mass of clients is attained in each market.

**ITEM 3. LEGAL PROCEEDINGS.**

We are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to our business that we believe would not have a material adverse effect on our financial condition or results of operations. Please read Note 10 to financial statements, which is incorporated herein by reference.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

No matters were submitted to a vote of our security holders, through solicitation of proxies or otherwise, during the quarter ended December 31, 2008.

## ITEM S-K 401 (b). EXECUTIVE OFFICERS OF THE REGISTRANT.

The following table sets forth the names, ages (as of February 9, 2009) and positions of the Company's executive officers:

Name	Age	Position
Paul J. Sarvadi.....	52	Chairman of the Board and Chief Executive Officer
Richard G. Rawson.....	60	President
A. Steve Arizpe.....	51	Executive Vice President, Client Services and Chief Operating Officer
Jay E. Mincks.....	55	Executive Vice President, Sales and Marketing
Douglas S. Sharp.....	47	Senior Vice President, Finance, Chief Financial Officer and Treasurer
Daniel D. Herink.....	42	Senior Vice President, Legal, General Counsel and Secretary

Paul J. Sarvadi has served as Chairman of the Board and Chief Executive Officer since August 2003. Mr. Sarvadi co-founded Administaff in 1986 and served as Vice President and Treasurer of the Company from its inception in 1986 through April 1987, as Vice President from April 1987 through 1989 and as President and Chief Executive Officer from 1989 to August 2003. Prior to founding Administaff, Mr. Sarvadi started and operated several small businesses. Mr. Sarvadi has served as President of NAPEO and was a member of its Board of Directors for five years. He also served as President of the Texas Chapter of NAPEO for three of the first four years of its existence. Mr. Sarvadi was selected as the 2001 National Ernst & Young Entrepreneur Of The Year<sup>®</sup> for service industries. In 2004, he received the Conn Family Distinguished New Venture Leader Award from Mays Business School at Texas A&M University. In 2007, he was inducted into the Texas Business Hall of Fame.

Richard G. Rawson has served as President since August 2003. He served as Executive Vice President, Administration, Chief Financial Officer and Treasurer from February 1997 to August 2003. He joined Administaff in 1989 as Senior Vice President, Chief Financial Officer, and Treasurer. He previously served as a Senior Financial Officer and Controller for several companies in the manufacturing and seismic data processing industries. Mr. Rawson has served as President, First Vice President, Second Vice President and Treasurer of NAPEO as well as Chairman of the NAPEO Accounting Practices Committee. Mr. Rawson also serves on the University of Houston's C.T. Bauer College of Business Dean's Executive Advisory Board and on the Board of Directors of the YMCA of Greater Houston.

A. Steve Arizpe has served as Executive Vice President of Client Services and Chief Operating Officer since August 2003. He joined Administaff in 1989 and has served in a variety of roles, including Houston Sales Manager, Regional Sales Manager and Vice President of Sales. Prior to joining Administaff, Mr. Arizpe served in sales and sales management roles for two large corporations.

Jay E. Mincks has served as Executive Vice President of Sales and Marketing since January 1999. Mr. Mincks served as Vice President of Sales and Marketing from February 1997 through January 1999. He joined Administaff in 1990 and has served in a variety of other roles, including Houston Sales Manager and Regional Sales Manager for the Western United States. Prior to joining Administaff, Mr. Mincks served in a variety of positions, including management positions, in the sales and sales training fields with various large companies.

Douglas S. Sharp has served as Senior Vice President of Finance, Chief Financial Officer and Treasurer since May 2008. He served as Vice President of Finance, Chief Financial Officer and Treasurer from August 2003 until May 2008. Mr. Sharp joined Administaff in January 2000 as Vice President of Finance and Controller. From July 1994 until he joined Administaff, he served as Chief Financial Officer for Rimkus Consulting Group, Inc. Prior to that, he served as Controller for a small publicly held company; as Controller for a large software company; and as an Audit Manager for Ernst & Young LLP. Mr. Sharp has served as a member of the Accounting Practices Committee of NAPEO.



Daniel D. Herink has served as Senior Vice President of Legal, General Counsel and Secretary since May 2008. He served as Vice President of Legal, General Counsel and Secretary from May 2007 until May 2008. Mr. Herink joined Administaff in 2000 as Assistant General Counsel and was promoted to Associate General Counsel in 2002. In his prior responsibilities with Administaff, Mr. Herink led the Company's litigation and property and casualty insurance practice areas and also worked extensively on transactional matters. He previously served as an attorney at Rodriguez, Colvin & Chaney, L.L.P. and McGinnis, Lochridge & Kilgore, L.L.P. He was named a "Texas Super Lawyers – Rising Star" by *Texas Monthly* in 2005 and 2007. Mr. Herink is also a certified public accountant.

## PART II

### ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF SECURITIES.

#### Price Range of Common Stock

Our common stock is traded on the New York Stock Exchange under the symbol "ASF." As of February 4, 2009, there were 360 holders of record of the common stock. This number does not include stockholders for whom shares were held in "nominee" or "street name." The following table sets forth the high and low sales prices for the common stock as reported on the New York Stock Exchange transactional tape.

2008	High	Low	Dividends Per Share
First Quarter .....	\$ 31.60	\$ 22.82	\$ 0.11
Second Quarter.....	31.60	23.55	0.11
Third Quarter.....	30.00	24.75	0.13
Fourth Quarter.....	27.16	13.36	0.13
2007			
First Quarter .....	\$ 43.66	\$ 33.19	\$ 0.11
Second Quarter.....	37.66	31.28	0.11
Third Quarter.....	37.96	29.96	0.11
Fourth Quarter.....	41.87	27.63	0.11

#### Dividend Policy

During 2008 and 2007, the Company paid dividends of \$12.4 million and \$11.9 million, respectively. The payment of dividends is made at the discretion of our Board of Directors and depends upon our operating results, financial condition, capital requirements, general business conditions and such other factors as our Board of Directors deems relevant.

#### Issuer Purchases of Equity Securities

The following table provides information about our purchases of Administaff common stock during the three months ended December 31, 2008:

Period	Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program <sup>(2)</sup>	Maximum Number of Shares that May Yet be Purchased Under the Program <sup>(2)</sup>
10/01/2008 – 10/31/2008	771,773	\$ 20.01	11,886,498	613,502
11/01/2008 – 11/30/2008	157,370	14.83	12,043,868	456,132
12/01/2008 – 12/31/2008	45,000	15.28	12,088,868	411,132
Total	974,143	\$ 18.96	12,088,868	411,132

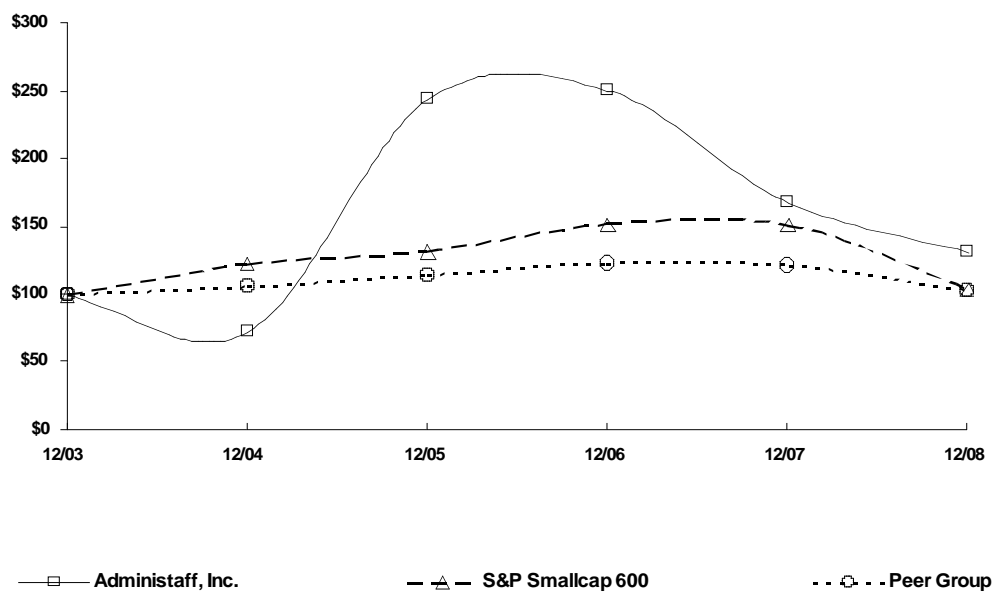
- (1) Since 1999, our Board of Directors has approved the repurchase of up to an aggregate amount of 12,500,000 shares of Administaff common stock, of which 12,088,868 shares had been repurchased as of December 31, 2008. During the three months ended December 31, 2008, we purchased 974,143 shares of our common stock.
- (2) Unless terminated earlier by resolution of the Board of Directors, the repurchase program will expire when we have repurchased all shares authorized for repurchase under the repurchase program.

## Performance Graph

The following graph compares our cumulative total stockholder return since December 31, 2003 with the Standard & Poor's Small Cap 600 Stock Index and a peer group index composed of other companies with similar business models (Peer Group.) The graph assumes that the value of the investment in our common stock and each index (including reinvestment of dividends) was \$100 on December 31, 2003.

### COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\*

Among Administaff, Inc., The S&P Smallcap 600 Index  
And A Peer Group



\*\$100 invested on 12/31/03 in stock & index-including reinvestment of dividends.  
Fiscal year ending December 31.

Copyright © 2009 S&P, a division of The McGraw-Hill Companies Inc. All rights reserved.

	12/03	12/04	12/05	12/06	12/07	12/08
<b>Administaff, Inc.</b>	100.00	72.55	244.86	251.25	168.26	131.78
<b>S&amp;P Smallcap 600</b>	100.00	122.65	132.07	152.04	151.58	104.48
<b>Peer Group</b>	100.00	105.62	114.27	122.99	121.39	103.23

This peer group is comprised of the following companies: Automatic Data Processing, Gevity HR, Inc. and Paychex, Inc. The total return for each member of this peer group has been weighted to each member's stock market capitalization.

## ITEM 6. SELECTED FINANCIAL DATA.

The selected consolidated financial data set forth below should be read in conjunction with the Consolidated Financial Statements and accompanying Notes and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations," on page 23.

	<u>Year ended December 31,</u>				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
	<u>(in thousands, except per share and statistical data)</u>				
<b>Income Statement Data:</b>					
Revenues <sup>(1)</sup> .....	\$ 1,724,434	\$ 1,569,977	\$ 1,389,464	\$ 1,169,612	\$ 969,527
Gross profit .....	343,739	305,922	282,729	235,756	197,694
Operating income .....	64,982	62,214	61,565	43,767	22,131
Net income .....	45,780	47,492	46,506	29,983	19,210
Diluted net income per share .....	\$ 1.79	\$ 1.74	\$ 1.64	\$ 1.12	\$ 0.72
<b>Balance Sheet Data:</b>					
Working capital .....	\$ 98,414	\$ 97,180	\$ 128,401	\$ 93,235	\$ 47,500
Total assets .....	616,840	560,651	561,515	495,439	355,388
Total debt/capital lease obligations .....	537	1,166	1,749	34,890	36,539
Total stockholders' equity .....	208,479	198,675	228,445	182,429	126,529
Cash dividends per share .....	0.48	0.44	0.36	0.28	—
<b>Statistical Data:</b>					
Average number of worksite employees paid per month during period .....	116,957	110,291	100,675	88,780	77,936
Revenues per worksite employee per month <sup>(2)</sup> .....	\$ 1,229	\$ 1,186	\$ 1,150	\$ 1,098	\$ 1,037
Gross profit per worksite employee per month .....	\$ 245	\$ 231	\$ 234	\$ 221	\$ 211
Operating income per worksite employee per month .....	\$ 46	\$ 47	\$ 51	\$ 41	\$ 24

(1) Gross billings of \$10.372 billion, \$9.437 billion, \$8.055 billion, \$6.633 billion and \$5.377 billion, less worksite employee payroll cost of \$8.648 billion, \$7.867 billion, \$6.666 billion, \$5.463 billion and \$4.407 billion, respectively.

(2) Gross billings of \$7,391, \$7,130, \$6,667, \$6,226 and \$5,749 per worksite employee per month, less payroll cost of \$6,162, \$5,944, \$5,517, \$5,128 and \$4,712 per worksite employee per month, respectively.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

You should read the following discussion in conjunction with our Consolidated Financial Statements and related Notes included elsewhere in this annual report. Historical results are not necessarily indicative of trends in operating results for any future period.

The statements contained in this annual report that are not historical facts are forward-looking statements that involve a number of risks and uncertainties. The actual results of the future events described in such forward-looking statements in this annual report could differ materially from those stated in such forward-looking statements. Among the factors that could cause actual results to differ materially are the risks and uncertainties discussed in this Item 7 under "Factors that May Affect Future Results and the Market Price of Common Stock" on page 38 and the uncertainties set forth from time to time in our other public reports and filings and public statements.

### **Overview**

We provide a comprehensive Personnel Management System that encompasses a broad range of services, including benefits and payroll administration, health and workers' compensation insurance programs, personnel records management, employer liability management, employee recruiting and selection, employee performance management, and employee training and development services. Our long-term strategy continues to be aggregating the best small businesses in the United States on the common platform of our unique human resource service offering, thereby leveraging our buying power to provide additional valuable services to clients. Our overall operating results can be measured in terms of revenues, payroll costs, gross profit or operating income per worksite employee per month. We often use the average number of worksite employees paid during a period as our unit of measurement in analyzing and discussing our results of operations.

Our key objectives for 2008 were to continue to grow the number of paid worksite employees while appropriately pricing our service offering and to invest in future growth opportunities, such as sales and service personnel, and new products and initiatives such as mid-market enhancements and the HRTools.com software redevelopment. We ended 2008 averaging 118,748 paid worksite employees in the fourth quarter, which represents a 2.9% increase over the fourth quarter of 2007. Our average number of worksite employees paid for the full year increased 6.0% over 2007 to 116,957.

Our 2008 average gross profit per worksite employee per month was \$245, a \$14 increase over 2007. Higher gross profit per worksite employee in 2008 compared to 2007 was primarily the result of a 3.6% pricing increase offset by a 3.0% direct cost increase.

Operating expenses increased by 14.4% in 2008 to \$278.8 million. Operating expenses increased due primarily to investments in sales and service personnel, and new products and initiatives for the current and future growth of our business. On a per worksite employee per month basis, operating expenses increased from \$184 in 2007 to \$199 in 2008.

Our net income in 2008 was \$45.8 million, a \$1.7 million decrease compared to 2007. This decrease included a \$4.7 million decline in interest income as a result of lower interest rates.

We ended 2008 with working capital of \$98.4 million. During 2008, we repurchased 1,731,025 shares of our common stock at a total cost of \$38.1 million and paid \$12.4 million in dividends.

### ***Revenues***

We account for our revenues in accordance with Emerging Issues Task Force ("EITF") 99-19, *Reporting Revenues Gross as a Principal Versus Net as an Agent*. Our gross billings to clients include the payroll cost of each worksite employee at the client location and a markup computed as a percentage of each worksite employee's payroll cost. We invoice the gross billings concurrently with each periodic payroll of our worksite employees. Revenues, which exclude the payroll cost component of gross billings, and therefore, consist solely of the markup, are recognized ratably over the payroll period as worksite employees perform their service at the client worksite.

This markup includes pricing components associated with our estimates of payroll taxes, benefits and workers' compensation costs, plus a separate component related to our HR services. We include revenues that have been recognized but not invoiced in unbilled accounts receivable on our Consolidated Balance Sheets.

Our revenues are primarily dependent on the number of clients enrolled, the resulting number of worksite employees paid each period and the number of worksite employees enrolled in our benefit plans. Because our total markup is computed as a percentage of payroll cost, revenues are also affected by the payroll cost of worksite employees, which may fluctuate based on the composition of the worksite employee base, inflationary effects on wage levels and differences in the local economies of our markets.

### ***Direct Costs***

The primary direct costs associated with our revenue generating activities are:

- employment-related taxes ("payroll taxes");
- costs of employee benefit plans; and
- workers' compensation costs.

Payroll taxes consist of the employer's portion of Social Security and Medicare taxes under FICA, federal unemployment taxes and state unemployment taxes. Payroll taxes are generally paid as a percentage of payroll cost. The federal tax rates are defined by federal regulations. State unemployment tax rates are subject to claim histories and vary from state to state.

Employee benefits costs are comprised primarily of health insurance premiums and claims costs (including dental and pharmacy costs), but also include costs of other employee benefits such as life insurance, vision care, disability insurance, education assistance, adoption assistance, a flexible spending account and a worklife program.

Workers' compensation costs include administrative and risk charges paid to the insurance carrier, and claims costs, which are driven primarily by the frequency and severity of claims.

### ***Gross Profit***

Our gross profit per worksite employee is primarily determined by our ability to accurately estimate and control direct costs and our ability to incorporate changes in these costs into the gross billings charged to clients, which are subject to contractual arrangements that are typically renewed annually. We use gross profit per worksite employee per month as our principal measurement of relative performance at the gross profit level.

### ***Operating Expenses***

- *Salaries, wages and payroll taxes* – Salaries, wages and payroll taxes are primarily a function of the number of corporate employees and their associated average pay and any additional incentive compensation. Our corporate employees include client services, sales and marketing, benefits, legal, finance, information technology and administrative support personnel.
- *Stock-based compensation* – Our stock-based compensation primarily relates to the recognition of non-cash compensation expense over the vesting period of restricted stock awards.
- *General and administrative expenses* – Our general and administrative expenses primarily include:
  - rent expenses related to our service centers and sales offices;
  - outside professional service fees related to legal, consulting and accounting services;
  - administrative costs, such as postage, printing and supplies;
  - employee travel expenses; and
  - repairs and maintenance costs associated with our facilities and technology infrastructure.

- *Commissions* – Commission expense consists of amounts paid to sales personnel. Commissions for sales personnel are based on a percentage of revenue generated by such personnel.
- *Advertising* – Advertising expense primarily consists of media advertising and other business promotions in our current and anticipated sales markets, including the Administaff Small Business Classic sponsorship.
- *Depreciation and amortization* – Depreciation and amortization expense is primarily a function of our capital investments in corporate facilities, service centers, sales offices and technology infrastructure.

### ***Income Taxes***

Administaff's provision for income taxes typically differs from the U.S. statutory rate of 35%, due primarily to state income taxes and non-deductible expenses. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities used for financial reporting purposes and the amounts used for income tax purposes. Significant items resulting in deferred income taxes include prepaid assets, accruals for workers' compensation expenses and depreciation. Changes in these items are reflected in our financial statements through a deferred income tax provision.

### **Critical Accounting Policies and Estimates**

Administaff's 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 accounting principles generally accepted in the United States. The preparation of these financial statements requires our management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate these estimates, including those related to health and workers' compensation insurance claims experience, client bad debts, income taxes, property and equipment, goodwill and other intangibles, and contingent liabilities. We base these estimates on historical experience and on various other assumptions that management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe the following accounting policies are critical and/or require significant judgments and estimates used in the preparation of our Consolidated Financial Statements:

- *Benefits costs* – We provide group health insurance coverage to our worksite employees through a national network of carriers including UnitedHealthcare ("United"), PacifiCare, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California, Hawaii Medical Service Association and Tufts, all of which provide fully insured policies or service contracts.

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

Additionally, since the plan's inception, under the terms of the contract, United establishes cash funding rates 90 days in advance of the beginning of a reporting quarter. If the Plan Costs for a reporting quarter are greater than the premiums paid and owed to United, a deficit in the plan would be incurred and we would accrue a liability for the excess costs on our Consolidated Balance Sheet. On the other hand, if the Plan Costs for the reporting quarter are less than the premiums paid and owed to United, a surplus in the plan would be incurred and we would record an asset for the excess premiums on our Consolidated Balance Sheet. In April 2007, Administaff

and United entered into a three-year arrangement, which reduced the required accumulated cash surplus in the plan from \$11.0 million to \$9.0 million and included a \$3.3 million administrative fee credit, which was recorded as a reduction of benefits costs in the second quarter of 2007. The terms of the arrangement require us to maintain an accumulated cash surplus in the plan of \$9.0 million, which is reported as long-term prepaid insurance. As of December 31, 2008, Plan Costs were less than the premiums paid and owed to United by \$30.8 million. As this amount is in excess of the agreed-upon \$9.0 million surplus maintenance level, the \$21.8 million balance is included in prepaid insurance, a current asset, on our Consolidated Balance Sheet. The premiums owed to United at December 31, 2008, were \$11.4 million, which is included in accrued health insurance costs, a current liability, on our Consolidated Balance Sheet.

We believe the use of recent claims activity is representative of incurred and paid trends during the reporting period. The estimated completion rate used to compute incurred but not reported claims involves a significant level of judgment. Accordingly, an increase (or decrease) in the completion rates used to estimate the incurred claims would result in an increase (or decrease) in benefits costs and net income would decrease (or increase) accordingly.

The following table illustrates the sensitivity of changes in the completion rates on our estimate of total benefit costs of \$714.1 million in 2008:

<b><u>Change in Completion Rate</u></b>	<b><u>Change in Benefits Costs (in thousands)</u></b>	<b><u>Change in Net Income (in thousands)</u></b>
(2.5)%	\$ (11,440)	\$ 7,276
(1.0)%	(4,576)	2,910
1.0%	4,576	(2,910)
2.5%	11,440	(7,276)

- *Workers' compensation costs* – Since October 1, 2007, our workers' compensation coverage has been provided through our arrangement with ACE Group of Companies ("ACE"). Under our arrangement with ACE (the "ACE Program"), we bear the economic burden for the first \$1 million layer of claims per occurrence. ACE bears the economic burden for all claims in excess of such first \$1 million layer. The ACE Program is a fully insured policy whereby ACE has the responsibility to pay all claims incurred under the policy regardless of whether we satisfy our responsibilities. Prior to our current relationship with ACE, our coverage from September 1, 2003 through September 30, 2007 was provided through selected member insurance companies of American International Group, Inc. (the "AIG Program"). The AIG Program coverage and structure was consistent with the ACE Program.

Because we bear the economic burden of the first \$1 million layer of claims per occurrence, such claims, which are the primary component of our workers' compensation costs, are recorded in the period incurred. Workers compensation insurance includes ongoing healthcare and indemnity coverage whereby claims are paid over numerous years following the date of injury. Accordingly, the accrual of related incurred costs in each reporting period includes estimates, which take into account the ongoing development of claims and therefore requires a significant level of judgment.

We employ a third party actuary to estimate our loss development rate, which is primarily based upon the nature of worksite employees' job responsibilities, the location of worksite employees, the historical frequency and severity of workers compensation claims, and an estimate of future cost trends. Each reporting period, changes in the actuarial assumptions resulting from changes in actual claims experience and other trends are incorporated into the Company's workers' compensation claims cost estimates. During the years ended December 31, 2008 and 2007, Administaff reduced accrued workers' compensation costs by \$9.8 million and \$19.6 million, respectively, for changes in estimated losses related to prior reporting periods. Workers' compensation cost estimates are discounted to present value at a rate based upon the U.S. Treasury rates that correspond with the weighted average estimated claim payout period (the average discount rate utilized in 2008 and 2007 was 2.6% and 4.5%, respectively) and are accreted over the estimated claim payment period and included as a component of direct costs in our Consolidated Statements of Operations.



Our claim trends could be greater than or less than our prior estimates, in which case we would revise our claims estimates and record an adjustment to workers' compensation costs in the period such determination is made. If we were to experience any significant changes in actuarial assumptions, our loss development rates could increase (or decrease) which would result in an increase (or decrease) in workers' compensation costs and a resulting decrease (or increase) in net income reported in our Consolidated Statement of Operations.

The following table illustrates the sensitivity of changes in the loss development rate on our estimate of workers' compensation costs totaling \$49.8 million in 2008:

<u>Change in Loss Development Rate</u>	<u>Change in Workers' Compensation Costs (in thousands)</u>	<u>Change in Net Income (in thousands)</u>
(5.0)%	\$ (2,175)	\$ 1,383
(2.5)%	(1,087)	692
2.5%	1,087	(692)
5.0%	2,175	(1,383)

At the beginning of each policy period, the insurance carrier establishes monthly funding requirements comprised of premium costs and funds to be set aside for payment of future claims ("claim funds"). The level of claim funds is primarily based upon anticipated worksite employee payroll levels and expected workers' compensation loss rates, as determined by the carrier. Monies funded into the program for incurred claims expected to be paid within one year are recorded as restricted cash, a short-term asset, while the remainder of claim funds are included in deposits, a long-term asset in our Consolidated Balance Sheets. As of December 31, 2008, we had restricted cash of \$36.5 million and deposits of \$56.4 million. We have estimated and accrued \$83.1 million in incurred workers' compensation claim costs as of December 31, 2008.

Our estimate of incurred claim costs expected to be paid within one year are recorded as accrued workers' compensation costs and included in short-term liabilities, while our estimate of incurred claim costs expected to be paid beyond one year are included in long-term liabilities on our Consolidated Balance Sheets.

- *Contingent liabilities* – We accrue and disclose contingent liabilities in our Consolidated Financial Statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 5, *Accounting for Contingencies*. SFAS No. 5 requires accrual of contingent liabilities that are considered probable to occur and that can be reasonably estimated. For contingent liabilities that are considered reasonably possible to occur, financial statement disclosure is required, including the range of possible loss if it can be reasonably determined. From time to time we disclose in our financial statements issues that we believe are reasonably possible to occur, although we cannot determine the range of possible loss in all cases. As issues develop, we evaluate the probability of future loss and the potential range of such losses. If such evaluation were to determine that a loss was probable and the loss could be reasonably estimated, we would be required to accrue our estimated loss, which would reduce net income in the period that such determination was made.
- *Deferred taxes* – We have recorded a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, our ability to realize our deferred tax assets could change from our current estimates. If we determine that we would be able to realize our deferred tax assets in the future in excess of the net recorded amount, an adjustment to reduce the valuation allowance would increase net income in the period that such determination is made. Likewise, should we determine that we will not be able to realize all or part of our net deferred tax assets in the future, an adjustment to increase the valuation allowance would reduce net income in the period such determination is made.
- *Allowance for doubtful accounts* – We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to pay their comprehensive service fees. We believe that the success of our business is heavily dependent on our ability to collect these comprehensive service fees for several reasons, including:

- the fact that we are at risk for the payment of our direct costs and worksite employee payroll costs regardless of whether our clients pay their comprehensive service fees;
- the large volume and dollar amount of transactions we process; and
- the periodic and recurring nature of payroll, upon which the comprehensive service fees are based.

To mitigate this risk, we have established very tight credit policies. We generally require our clients to pay their comprehensive service fees no later than one day prior to the applicable payroll date. In addition, we maintain the right to terminate the Client Service Agreement and associated worksite employees or to require prepayment, letters of credit or other collateral if a client's financial position deteriorates or if the client does not pay the comprehensive service fee. As a result of these efforts, losses related to customer nonpayment have historically been low as a percentage of revenues. However, if our clients' financial condition were to deteriorate rapidly, resulting in nonpayment, our accounts receivable balances could grow and we could be required to provide for additional allowances, which would decrease net income in the period that such determination was made.

- *Property and equipment* – Our property and equipment relate primarily to our facilities and related improvements, furniture and fixtures, computer hardware and software and capitalized software development costs. These costs are depreciated or amortized over the estimated useful lives of the assets. If we determine that the useful lives of these assets will be shorter than we currently estimate, our depreciation and amortization expense could be accelerated, which would decrease net income in the periods of such a determination. In addition, we periodically evaluate these costs for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. If events or circumstances were to indicate that any of our long-lived assets might be impaired, we would assess recoverability based on the estimated undiscounted future cash flows to be generated from the applicable asset. In addition, we may record an impairment loss, which would reduce net income, to the extent that the carrying value of the asset exceeded the fair value of the asset. Fair value is generally determined using an estimate of discounted future net cash flows from operating activities or upon disposal of the asset. In 2007, we began a plan to redevelop the HRTools.com software platform and intend to dispose of the software acquired in 2005. Accordingly, we reduced the carrying amount of the legacy software to its net realizable value, resulting in an impairment loss of \$1.2 million during 2007.
- *Goodwill and other intangibles* – Our acquisitions of HRTools.com and USDataLink included certain identifiable intangible assets and goodwill implied in the purchase price. The goodwill and intangible assets are subject to the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* (“SFAS 142”). In accordance with SFAS 142, goodwill is tested for impairment on an annual basis and between annual tests in certain circumstances, and written down when impaired. Furthermore, SFAS 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. Our purchased intangible assets are carried at cost less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets, five to ten years.

### *New Accounting Pronouncements*

In September 2006, FASB Statement 157, *Fair Value Measurements* (“SFAS 157”) was issued. SFAS 157 establishes a framework for measuring fair value by providing a standard definition of fair value as it applies to assets and liabilities. SFAS 157, which does not require any new fair value measurements, clarifies the application of other accounting pronouncements that require or permit fair value measurements. Our effective date was initially January 1, 2008. However, the FASB has released FASB Staff Position No. *FAS 157-b, Effective Date of FASB Statement No. 157*, which delayed the effective date of Statement 157 for all non-financial assets and non-financial liabilities until fiscal years beginning after November 15, 2008. Accordingly, we adopted SFAS 157 on January 1, 2008 for our financial assets and liabilities only. The adoption of SFAS 157 for our financial assets and liabilities did not have a material impact on our consolidated financial statements and we do not anticipate a material impact when applied to our non-financial assets and liabilities.

In December 2007, the FASB Statement 141R, *Business Combinations* (“SFAS 141R”) was issued. SFAS 141R replaces SFAS 141. SFAS 141R requires the acquirer of a business to recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at fair value. SFAS 141R also requires transactions costs related to the business combination to be expensed as incurred. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of

the first annual reporting period beginning on or after December 15, 2008. Our effective date was January 1, 2009. We have not yet determined the impact of SFAS 141R, if any, on our consolidated financial statements, because the impact of SFAS 141R is fact-specific and will not be invoked until we acquire a business after the effective date.

In June 2008, the FASB issued Emerging Issue Task Force (“EITF”) EITF 03-6-1, *“Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities.”* (“EITF 03-6-1”) was issued. EITF 03-6-1 concludes that unvested restricted share awards that pay nonforfeitable cash dividends are participating securities and are subject to the two-class method of computing earnings per share. Our effective date for EITF 03-6-1 was January 1, 2009. We do not anticipate the adoption of EITF 03-6-1 will have a material impact on our Consolidated Financial Statements.

In October 2008, the FASB Staff Position No. FAS 157-3, *“Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active”* (“FAS 157-3”). FAS 157-3 clarifies the methods employed in determining the fair value for financial assets when a market for such assets is not active. FSP No. FAS 157-3 was effective immediately. The adoption of FAS 157-3 did not have a significant impact on our Consolidated Financial Statements.

## Results of Operations

### Year Ended December 31, 2008 Compared to Year Ended December 31, 2007.

The following table presents certain information related to the Company's results of operations for the years ended December 31, 2008 and 2007.

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>% change</u>
	(in thousands, except per share and statistical data)		
Revenues (gross billings of \$10.372 billion and \$9.437 billion less worksite employee payroll cost of \$8.648 billion and \$7.867 billion, respectively) .....	\$ 1,724,434	\$1,569,977	9.8%
Gross profit.....	343,739	305,922	12.4%
Operating expenses.....	278,757	243,708	14.4%
Operating income.....	64,982	62,214	4.4%
Other income (expense).....	7,035	11,225	(37.3)%
Net income .....	45,780	47,492	(3.6)%
Diluted net income per share of common stock .....	1.79	1.74	2.9%

#### Statistical Data:

Average number of worksite employees paid per month....	116,957	110,291	6.0%
Revenues per worksite employee per month <sup>(1)</sup> .....	\$ 1,229	\$ 1,186	3.6%
Gross profit per worksite employee per month .....	245	231	6.1%
Operating expenses per worksite employee per month.....	199	184	8.2%
Operating income per worksite employee per month.....	46	47	(2.1)%
Net income per worksite employee per month .....	33	36	(8.3)%

<sup>(1)</sup> Gross billings of \$7,391 and \$7,130 per worksite employee per month less payroll cost of \$6,162 and \$5,944 per worksite employee per month, respectively.

#### Revenues

Our revenues, which represent gross billings net of worksite employee payroll cost, increased 9.8% over 2007 due to a 6.0% increase in the average number of worksite employees paid per month and a 3.6%, or \$43, increase in revenues per worksite employee per month. The 3.6% increase in revenues per worksite employee per month was due primarily to increases in the benefits pricing and payroll tax components related to our direct costs.

By region, our revenue growth over 2007 and revenue distribution for years ended December 31, 2008 and 2007 were as follows:

	<u>Year ended December 31,</u>			<u>Year ended December 31,</u>	
	<u>2008</u>	<u>2007</u>	<u>% change</u>	<u>2008</u>	<u>2007</u>
	(in thousands)			(% of total revenue)	
Northeast .....	\$ 363,268	\$ 311,468	16.6%	21.1%	19.8%
Southeast .....	183,091	166,115	10.2%	10.6%	10.6%
Central .....	249,145	220,728	12.9%	14.5%	14.1%
Southwest .....	569,655	533,893	6.7%	33.0%	34.0%
West.....	345,736	325,613	6.2%	20.0%	20.7%
Other revenues .....	<u>13,539</u>	<u>12,160</u>	11.3%	<u>0.8%</u>	<u>0.8%</u>
Total revenues.....	<u>\$1,724,434</u>	<u>\$1,569,977</u>	9.8%	<u>100.0%</u>	<u>100.0%</u>

Our unit growth rate is affected by three primary sources – new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During the first nine months of 2008, our unit growth rate over 2007 was 7.2%. During the fourth quarter of 2008, our growth rate slowed to 2.9% as the net change in existing clients and client retention declined as compared to the fourth quarter of 2007. The net result was a 6% increase in number of worksite employees paid in 2008 as compared to 2007.

The decline in U.S. economic activity and associated reductions in employment levels in the latter half of 2008 has impacted the Company's small business customer base and target market. In January 2009, the Company's average number of paid worksite employees declined 4.4% from the fourth quarter of 2008 to 113,571, as the net employee reductions within the existing client base and number of client terminations exceeded new client sales.

### ***Gross Profit***

Gross profit increased 12.4% to \$343.7 million compared to 2007. The average gross profit per worksite employee increased 6.1% to \$245 per month in 2008 versus \$231 in 2007. Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by increasing revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses.

While our revenues per worksite employee per month increased 3.6%, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, increased 3.0% to \$984 per worksite employee per month in 2008 versus \$955 in 2007. The primary direct cost components changed as follows:

- *Benefits costs* – The cost of group health insurance and related employee benefits increased \$15 per worksite employee per month, or 2.5% on a per covered employee basis, compared to 2007. The 2008 benefits costs reflect the impact of costs saving associated with plan design changes implemented on January 1, 2008. The percentage of worksite employees covered under our health insurance plan was 73.5% in 2008 versus 73.2% in 2007. Please read “—Critical Accounting Policies and Estimates – Benefits Costs” on page 25 for a discussion of our accounting for health insurance costs.
- *Workers' compensation costs* – Workers' compensation costs increased \$8 per worksite employee per month compared to 2007. As a percentage of non-bonus payroll cost, workers' compensation costs increased to 0.63% in 2008 from 0.51% in 2007. During 2008, the Company recorded reductions in workers' compensation costs of \$9.8 million, or 0.13% of non-bonus payroll costs, for changes in estimated losses, compared to \$19.6 million, or 0.28% of non-bonus payroll costs in 2007. Please read “—Critical Accounting Policies and Estimates – Workers' Compensation Costs” on page 26 for a discussion of our accounting for workers' compensation costs.
- *Payroll tax costs* – Payroll taxes increased \$8 per worksite employee per month compared to 2007, due to a 3.7% increase in average payroll cost per worksite employee per month. Payroll taxes as a percentage of payroll cost decreased from 7.06% in 2007 to 6.94% in 2008, due to higher average payroll and lower state unemployment tax rates in 2008.

## *Operating Expenses*

The following table presents certain information related to our operating expenses for the years ended December 31, 2008 and 2007.

	<u>Year ended December 31,</u>			<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>% change</u>	<u>2008</u>	<u>2007</u>	<u>% change</u>
	<u>(in thousands)</u>			<u>(per worksite employee per month)</u>		
Salaries, wages and payroll taxes	\$ 153,538	\$ 131,648	16.6%	\$ 110	\$ 99	11.1%
Stock-based compensation	9,970	7,513	32.7%	7	6	16.7%
General and administrative expenses	69,348	62,453	11.0%	49	47	4.3%
Commissions	12,665	11,795	7.4%	9	9	—
Advertising	17,666	14,143	24.9%	13	11	18.2%
Depreciation and amortization	<u>15,570</u>	<u>16,156</u>	(3.6)%	<u>11</u>	<u>12</u>	(8.3)%
Total operating expenses	<u>\$ 278,757</u>	<u>\$ 243,708</u>	14.4%	<u>\$ 199</u>	<u>\$ 184</u>	8.2%

Operating expenses increased 14.4% to \$278.8 million. Operating expenses per worksite employee per month increased 8.2% to \$199 in 2008 versus \$184 in 2007. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 16.6%, or \$11, per worksite employee per month compared to 2007. During 2008, the number of corporate employees increased 11.7%, including a 15.9% increase in sales representatives. The average pay for corporate employees increased 5.3% as compared to 2007.
- Stock-based compensation increased \$1 per worksite employee per month. Stock-based compensation expense represents the vesting of restricted stock awards and the annual stock grant made to non-employee directors. Please read Note 1 to the Consolidated Financial Statements on page F-17 for additional information.
- General and administrative expenses increased 11.0%, or \$2 per worksite employee per month, due primarily to: (i) consulting fees associated with the HRTools.com software development and enhancement initiatives; (ii) expenses associated with the opening and relocating of sales offices; and (iii) increased travel expenses.
- Commissions expense increased 7.4%, but remained flat on a per worksite employee per month basis compared to 2007.
- Advertising costs increased 24.9%, or \$2 per worksite employee per month compared to 2007, due to an increase in business promotions and sponsorships designed to increase lead generation activity.
- Depreciation and amortization expense decreased 3.6%, or \$1 per worksite employee per month. During 2007, a \$1.2 million impairment charge related to software associated with the 2005 acquisition of HRTools.com was included in depreciation and amortization.

## *Other Income*

Other income decreased to \$7.0 million in 2008 compared to \$11.2 million in 2007, due to the significant decline in interest rates and a shift to more conservative investments due to deteriorating market conditions.

## *Income Tax Expense*

During 2008 we incurred federal and state income tax expense of \$26.2 million on pre-tax income of \$72.0 million. Our provision for income taxes differed from the US statutory rate of 35% primarily due to state income taxes and non-deductible expenses, offset by tax-exempt interest income. Our effective income tax rate was 36.4% in the 2008 period compared to 35.3% in the 2007 period, due to a decline in tax-exempt interest income associated with the decision to shift our current investment holdings from municipal bond funds into more liquid investment funds.

### *Net Income*

Net income for 2008 was \$45.8 million, or \$1.79 per diluted share, compared to \$47.5 million, or \$1.74 per diluted share in 2007. On a per worksite employee per month basis, net income decreased 8.3% to \$33 in 2008 from \$36 in 2007.

### **Results of Operations**

#### *Year Ended December 31, 2007 Compared to Year Ended December 31, 2006.*

The following table presents certain information related to the Company's results of operations for the years ended December 31, 2007 and 2006.

	<b>Year ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>% change</b>
	<b>(in thousands, except per share and statistical data)</b>		
Revenues (gross billings of \$9.437 billion and \$8.055 billion less worksite employee payroll cost of \$7.867 billion and \$6.666 billion, respectively) .....	\$ 1,569,977	\$1,389,464	13.0%
Gross profit.....	305,922	282,729	8.2%
Operating expenses.....	243,708	221,164	10.2%
Operating income.....	62,214	61,565	1.1%
Other income (expense).....	11,225	10,517	6.7%
Net income .....	47,492	46,506	2.1%
Diluted net income per share of common stock .....	1.74	1.64	6.1%
<b>Statistical Data:</b>			
Average number of worksite employees paid per month....	110,291	100,675	9.6%
Revenues per worksite employee per month <sup>(1)</sup> .....	\$ 1,186	\$ 1,150	3.1%
Gross profit per worksite employee per month .....	231	234	(1.3)%
Operating expenses per worksite employee per month.....	184	183	0.5%
Operating income per worksite employee per month.....	47	51	(7.8)%
Net income from continuing operations per worksite employee per month.....	36	38	(5.3)%

<sup>(1)</sup> Gross billings of \$7,130 and \$6,667 per worksite employee per month less payroll cost of \$5,944 and \$5,517 per worksite employee per month, respectively.

### **Revenues**

Our revenues, which represent gross billings net of worksite employee payroll cost, increased 13.0% over 2006 due to a 9.6% increase in the average number of worksite employees paid per month and a 3.1%, or \$36, increase in revenues per worksite employee per month. The 3.1% increase in revenues per worksite employee per month was due primarily to increases in the payroll tax and benefit pricing components related to our direct costs.

By region, our revenue growth over 2006 and revenue distribution for years ended December 31, 2007 and 2006 were as follows:

	<u>Year ended December 31,</u>			<u>Year ended December 31,</u>	
	<u>2007</u>	<u>2006</u>	<u>% change</u>	<u>2007</u>	<u>2006</u>
	<u>(in thousands)</u>			<u>(% of total revenue)</u>	
Northeast .....	\$ 311,468	\$ 256,187	21.6%	19.8%	18.5%
Southeast .....	166,115	149,370	11.2%	10.6%	10.8%
Central .....	220,728	199,034	10.9%	14.1%	14.3%
Southwest .....	533,893	461,388	15.7%	34.0%	33.2%
West .....	325,613	313,317	3.9%	20.7%	22.5%
Other revenues .....	<u>12,160</u>	<u>10,168</u>	19.6%	<u>0.8%</u>	<u>0.7%</u>
Total revenues.....	<u>\$1,569,977</u>	<u>\$1,389,464</u>	13.0%	<u>100.0%</u>	<u>100.0%</u>

Our unit growth rate is affected by three primary sources – new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During 2007, the 9.6% increase in the average number of worksite employees paid per month resulted primarily from improvements in new client sales and the net change in existing clients.

### ***Gross Profit***

Gross profit increased 8.2% to \$305.9 million compared to 2006. The average gross profit per worksite employee decreased 1.3% to \$231 per month in 2007 versus \$234 in 2006. Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by increasing revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses.

While our revenues per worksite employee per month increased 3.1%, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, increased 4.3% to \$955 per worksite employee per month in 2007 versus \$916 in 2006. The primary direct cost components changed as follows:

- *Benefits costs* – The cost of group health insurance and related employee benefits increased \$41 per worksite employee per month, or 8.3% on a per covered employee basis, compared to 2006. The percentage of worksite employees covered under our health insurance plan was 73.2% in 2007 versus 72.7% in 2006. Please read “—Critical Accounting Policies and Estimates – Benefits Costs” on page 25 for a discussion of our accounting for health insurance costs.
- *Workers' compensation costs* – Workers' compensation costs decreased \$19 per worksite employee per month compared to 2006. As a percentage of non-bonus payroll cost, workers' compensation costs decreased to 0.51% in 2007 from 0.92% in 2006, primarily as a result of favorable trends in both the frequency and severity of workers' compensation claims. During 2007, the Company recorded reductions in workers' compensation costs of \$19.6 million, or 0.28% of non-bonus payroll costs, for changes in estimated losses and tax surcharges, compared to \$6.4 million, or 0.11% of non-bonus payroll costs in 2006. Please read “—Critical Accounting Policies and Estimates – Workers' Compensation Costs” on page 26 for a discussion of our accounting for workers' compensation costs.
- *Payroll tax costs* – Payroll taxes increased \$18 per worksite employee per month compared to 2006, due to a 7.7% increase in average payroll cost per worksite employee per month. Payroll taxes as a percentage of payroll cost decreased from 7.27% in 2006 to 7.06% in 2007, due to: (i) lower state unemployment tax rates in 2007, including a \$2.9 million, or 0.04% as a percentage of payroll costs, state unemployment tax refund from the State of Texas, and (ii) increased payroll averages and bonus levels. The 2006 rate includes a \$3.3 million payroll tax reduction, or 0.05% as a percentage of payroll costs, related to the California state unemployment tax matter.



### *Operating Expenses*

The following table presents certain information related to our operating expenses for the years ended December 31, 2007 and 2006.

	<u>Year ended December 31,</u>			<u>Year ended December 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>% change</u>	<u>2007</u>	<u>2006</u>	<u>% change</u>
	(in thousands)			(per worksite employee per month)		
Salaries, wages and payroll taxes	\$ 131,648	\$ 119,963	9.7%	\$ 99	\$ 99	—
Stock-based compensation	7,513	3,411	120.3%	6	3	100.0%
General and administrative expenses	62,453	57,409	8.8%	47	48	(2.1)%
Commissions	11,795	10,968	7.5%	9	9	—
Advertising	14,143	13,975	1.2%	11	11	—
Depreciation and amortization	<u>16,156</u>	<u>15,438</u>	4.7%	<u>12</u>	<u>13</u>	(7.7)%
Total operating expenses	<u>\$ 243,708</u>	<u>\$ 221,164</u>	10.2%	<u>\$ 184</u>	<u>\$ 183</u>	0.5%

Operating expenses increased 10.2% to \$243.7 million. Operating expenses per worksite employee per month increased 0.5% to \$184 in 2007 versus \$183 in 2006. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 9.7%, but remained flat on a per worksite employee per month basis compared to 2006. During 2007, the number of corporate employees increased 7.7%, and the average non-bonus pay for corporate employees increased 4.9% as compared to 2006.
- Stock-based compensation increased \$3 per worksite employee per month. Stock-based compensation expense represents the vesting of restricted stock awards and the annual stock grant made to non-employee directors. Please read Note 1 to the Consolidated Financial Statements on page F-17 for additional information.
- General and administrative expenses increased 8.8% due primarily to higher expenses associated with the increase in corporate and worksite employee headcount, such as travel, printing and rent. General and administrative expenses decreased \$1 per worksite employee per month compared to 2006.
- Commissions expense increased 7.5%, but remained flat on a per worksite employee per month basis compared to 2006.
- Advertising costs increased 1.2%, but remained flat on a per worksite employee basis as compared to 2006.
- Depreciation and amortization expense increased 4.7%, due primarily to the \$1.2 million impairment charge related to software associated with the 2005 acquisition of HRTools.com, but declined \$1 on a per worksite employee per month basis versus 2006.

### *Other Income (Expense)*

Other income (expense) increased to \$11.2 million in 2007 compared to \$10.5 million in 2006. Interest expense decreased \$1.0 million as compared to 2006, due to the repayment in May 2006 of the \$32.3 million outstanding variable-rate mortgage on our corporate headquarters.

### *Income Tax Expense*

During 2007 we incurred federal and state income tax expense of \$25.9 million on pre-tax income of \$73.4 million. Our provision for income taxes differed from the US statutory rate of 35% primarily due to state income taxes and non-deductible expenses, offset by tax-exempt interest income. Our effective income tax rate was 35.3% in the 2007 period compared to 35.5% in the 2006 period.

## *Net Income*

Net income for 2007 was \$47.5 million, or \$1.74 per diluted share, compared to \$46.5 million, or \$1.64 per diluted share in 2006. On a per worksite employee per month basis, net income decreased 5.3% to \$36 in 2007 from \$38 in 2006.

## **Non-GAAP Financial Measures**

Non-bonus payroll cost is a non-GAAP financial measure that excludes the impact of bonus payrolls paid to our worksite employees. Bonus payroll cost varies from period to period, but has no direct impact to our ultimate workers' compensation costs under the current program. As a result, our management refers to non-bonus payroll cost in analyzing, reporting and forecasting our workers' compensation costs. Non-GAAP financial measures are not prepared in accordance with generally accepted accounting principles ("GAAP") and may be different from non-GAAP financial measures used by other companies. Non-GAAP financial measures should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP. We include these non-GAAP financial measures because we believe they are useful to investors in allowing for greater transparency related to the costs incurred under our current workers' compensation program. Investors are encouraged to review the reconciliation of the non-GAAP financial measures used to their most directly comparable GAAP financial measures as provided in the table below.

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>% Change</u>
	<u>(in thousands, except per worksite employee)</u>		
GAAP to non-GAAP reconciliation:			
Payroll cost (GAAP)	\$8,647,774	\$7,866,792	9.9%
Less: bonus payroll cost	<u>809,474</u>	<u>845,149</u>	(4.2)%
Non-Bonus payroll cost	<u>\$7,838,300</u>	<u>\$7,021,643</u>	11.6%
Payroll cost per worksite employee (GAAP)	\$ 6,162	\$ 5,944	3.7%
Less: Bonus payroll cost per worksite employee	<u>577</u>	<u>639</u>	(9.7)%
Non-bonus payroll cost per worksite employee	<u>\$ 5,585</u>	<u>\$ 5,305</u>	5.3%

## **Liquidity and Capital Resources**

We periodically evaluate our liquidity requirements, capital needs and availability of resources in view of, among other things, our expansion plans, debt service requirements and other operating cash needs. To meet short- and long-term liquidity requirements, including payment of direct and operating expenses and repaying debt, we rely primarily on cash from operations. However, we have in the past sought, and may in the future seek, to raise additional capital or take other steps to increase or manage our liquidity and capital resources. We had \$252.4 million in cash and cash equivalents and marketable securities at December 31, 2008, of which approximately \$108.8 million was payable in early January 2009 for withheld federal and state income taxes, employment taxes and other payroll deductions, and \$49.3 million in customer prepayments that were payable in January 2009. At December 31, 2008, we had working capital of \$98.4 million compared to \$97.2 million at December 31, 2007. We currently believe that our cash on hand, marketable securities and cash flows from operations will be adequate to meet our liquidity requirements for 2009. We will rely on these same sources, as well as public and private debt or equity financing, to meet our longer-term liquidity and capital needs.

### ***Cash Flows From Operating Activities***

Our cash flows from operating activities in 2008 of \$117.8 million reflected a increase of \$42.8 million from 2007. Our primary source of cash from operations is the comprehensive service fee and payroll funding we collect from our clients. The level of cash and cash equivalents, and thus our reported cash flows from operating activities are significantly impacted by various external and internal factors, which are reflected in part by the changes in our balance sheet accounts. These include the following:

- *Timing of client payments / payrolls* – We typically collect our comprehensive service fee, along with the client’s payroll funding, from clients at least one day prior to the payment of worksite employee payrolls and associated payroll taxes. Therefore, the last business day of a reporting period has a substantial impact on our reporting of operating cash flows. For example, many worksite employees are paid on Fridays and at month-end; therefore, operating cash flows decrease in the reporting periods that end on a Friday. In the year ended December 31, 2008, which ended on a Wednesday, client prepayments were \$49.3 million and accrued worksite employee payroll was \$130.0 million. In the year ended December 31, 2007, which ended on a Monday, client prepayments were \$15.5 million and accrued worksite employee payroll was \$110.4 million.
- *Workers’ compensation plan funding* – Effective October 1, 2007, the Company entered into an arrangement with ACE Group of Companies (“ACE”) to provide workers’ compensation insurance coverage (“ACE Program”), with coverage and a program structure consistent with the AIG Program. AIG remains the carrier for all claim activity incurred between September 1, 2003 and September 30, 2007. Under our arrangements with our insurance carriers, we make monthly payments comprised of premium costs and funds to be set aside for payment of future claims (“claim funds”). These pre-determined amounts are stipulated in our agreements with our carriers, and are based primarily on anticipated worksite employee payroll levels and workers compensation loss rates during the policy year. Changes in payroll levels from that which was anticipated in the arrangements can result in changes in the amount of the cash payments, which will impact our reporting of operating cash flows. Our claim funds paid, based upon anticipated worksite employee payroll levels and workers’ compensation loss rates, were \$45.4 million in 2008 and \$45.2 million for the 2007 period. However, our estimates of workers’ compensation loss costs were \$34.7 million and \$19.9 million in 2008 and 2007, respectively. Additionally, during the years ended December 31, 2008 and 2007, AIG returned \$19.8 million and \$24.3 million, respectively, to Administaff for the return of excess funding related to prior policy periods beginning in 2003.
- *Medical plan funding* – Our healthcare contract with United establishes participant cash funding rates 90 days in advance of the beginning of a reporting quarter. Therefore, changes in the participation level of the United Plan have a direct impact on our operating cash flows. In addition, changes to the funding rates, which are solely determined by United based primarily upon recent claim history and anticipated cost trends, also have a significant impact on our operating cash flows. Since inception of the United Plan, premiums paid and owed to United have exceeded Plan Costs, resulting in a \$30.8 million surplus, \$21.8 million of which is reflected as a current asset, and \$9.0 million of which is reflected as a long-term asset on our Consolidated Balance Sheets at December 31, 2008. The premiums owed to United at December 31, 2008, were \$11.4 million, which is included in accrued health insurance costs, a current liability, on our Consolidated Balance Sheet.
- *Operating results* – Our net income has a significant impact on our operating cash flows. Our net income decreased to \$45.8 million in 2008 from \$47.5 million in 2007. Please read “Results of Operations – Year Ended December 31, 2008 Compared to Year Ended December 31, 2007” on page 30.

#### ***Cash Flows From Investing Activities***

Our cash flows from investing activities were \$44.3 million during 2008. We liquidated approximately \$74.6 million in marketable securities and reinvested the funds in cash equivalents in an effort to invest in more conservative investments due to deteriorating market conditions. We invested \$26.7 million in capital expenditures, including \$10.5 million in computer hardware and software, \$9.6 million for an aircraft and \$6.6 million in facility improvements. In addition, we acquired USDatalink, an employee screening company, for \$3.8 million.

#### ***Cash Flows Used In Financing Activities***

Cash flows used in financing activities were \$45.7 million during 2008. We repurchased \$38.1 million in treasury stock and paid \$12.4 million in dividends, offset by the receipt of \$3.2 million in stock option exercise proceeds.

### ***Contractual Obligations and Commercial Commitments***

The following table summarizes our contractual obligations and commercial commitments as of December 31, 2008, and the effect they are expected to have on our liquidity and capital resources (in thousands):

<b><u>Contractual obligations:</u></b>	<b><u>Total</u></b>	<b><u>Less than 1 Year</u></b>	<b><u>1-3 Years</u></b>	<b><u>3-5 Years</u></b>	<b><u>More than 5 Years</u></b>
Capital lease obligations	\$ 537	\$ 537	\$ —	\$ —	\$ —
Non-cancelable operating leases	65,655	13,662	24,650	17,943	9,400
Purchase obligations <sup>(1)</sup>	12,820	8,240	4,090	340	150
Other long-term liabilities:					
Accrued workers' compensation claim costs <sup>(2)</sup>	<u>83,055</u>	<u>36,466</u>	<u>19,379</u>	<u>19,064</u>	<u>8,146</u>
Total contractual cash obligations	<u>\$ 162,067</u>	<u>\$ 58,905</u>	<u>\$ 48,119</u>	<u>\$ 37,347</u>	<u>\$ 17,696</u>

(1) The table includes purchase obligations associated with non-cancelable contracts individually greater than \$100,000 and one year.

(2) Accrued workers' compensation claim costs include the short and long-term amounts. For more information, please read "Critical Accounting Policies and Estimates – Workers' Compensation Costs," on page 26.

### **Seasonality, Inflation and Quarterly Fluctuations**

We believe the effects of inflation have not had a significant impact on our results of operations or financial condition.

### **Factors That May Affect Future Results and the Market Price of Common Stock**

#### ***Current Economic Conditions May Adversely Affect our Industry, Business and Results of Operations***

The United States economy is currently in a recession and undergoing a period of slowdown with unprecedented volatility. The future economic environment may continue to be less favorable than that of recent years. In addition, recent disruptions in national and international credit markets have led to a scarcity of credit, tighter lending standards and higher interest rates on business loans. A prolonged economic downturn or a continuing scarcity of credit could adversely affect the financial condition and levels of business activity of our clients. This may in turn have a corresponding negative impact on our operating results as some of our clients may suffer business failures, and others may react to worsening conditions by reducing their employee headcount, lowering their wage and bonus levels, lowering their spending on other human resources benefits and services or determining not to outsource those services to us. In addition, worsening economic conditions may impair our ability to attract new clients. If any of these circumstances remain in effect for an extended period of time, there could be a material adverse effect on our financial results.

The decline in U.S. economic activity and associated reductions in employment levels in the latter half of 2008 has impacted the Company's small business customer base and target market. In January 2009, the Company's average number of paid worksite employees declined 4.4% from the fourth quarter of 2008 to 113,571, as the net employee reductions within the existing client base and number of client terminations exceeded new client sales.

#### ***We Assume Liability for Worksite Employee Payroll, Payroll Taxes and Benefits Costs and are Responsible for their Payment Regardless of the Amount Billed to or Paid by Our Clients***

Under the CSA, we become a co-employer of worksite employees and assume the obligations to pay the salaries, wages and related benefits costs and payroll taxes of such worksite employees. We assume such obligations as a principal, not as an agent of the client. Our obligations include responsibility for:

- payment of the salaries and wages for work performed by worksite employees, regardless of whether the client timely pays us the associated service fee;

- withholding and payment of federal and state payroll taxes with respect to wages and salaries reported by Administaff; and
- providing benefits to worksite employees even if our costs to provide such benefits exceed the fees the client pays us.

If a client does not pay us, or if the costs of benefits we provide to worksite employees exceed the fees a client pays us, our ultimate liability for worksite employee payroll and benefits costs could have a material adverse effect on our financial condition or results of operations.

***Increases in Health Insurance Premiums or Inability to Secure Replacement Contracts on Competitive Terms Could Have a Material Adverse Effect on Our Financial Condition or Results of Operations***

Maintaining health insurance plans that cover worksite employees is a significant part of our business. Our primary health insurance contract expires on December 31, 2010, subject to cancellation by either party upon 180 days notice. In the event we are unable to secure replacement contracts on competitive terms, significant disruption to our business could occur.

Health insurance premiums are in part determined by our claims experience and comprise a significant portion of our direct costs. We employ extensive risk management procedures in an attempt to control our claims incidence and structure our benefits contracts to provide as much cost stability as possible. However, if we experience a sudden and unexpected large increase in claim activity, our health insurance costs could increase. Contractual arrangements with our clients limit our ability to incorporate such increases into service fees, which could result in a delay before such increases could be reflected in service fees. As a result, such increases could have a material adverse effect on our financial condition or results of operations. For additional information related to our health insurance costs, please read Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates – Benefits Costs,” on page 25.

***Increases in Workers’ Compensation Costs or Inability to Secure Replacement Coverage on Competitive Terms Could Lead to a Significant Disruption to Our Business***

Our workers’ compensation coverage (the “ACE Program”) is currently provided through member insurance companies of ACE American Insurance Company (“ACE”). Under our arrangement with ACE, we bear the economic burden for the first \$1 million layer of claims per occurrence. ACE bears the economic burden for all claims in excess of such first \$1 million layer. The ACE Program is a fully insured policy whereby ACE has the responsibility to pay all claims incurred under the policy regardless of whether we satisfy our responsibilities. For additional discussion of our policy with ACE, please read Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates – Workers’ Compensation Costs” on page 26.

The current workers’ compensation coverage with ACE expires on September 30, 2009. In the event we are unable to secure replacement coverage on competitive terms, significant disruption to our business could occur.

***Our Captive Insurance Subsidiary Tax Status Could be Challenged Resulting in an Acceleration of Income Tax Payments***

In conjunction with the formation of the current workers’ compensation program in 2003, we formed a wholly owned captive insurance subsidiary (the “Captive”). We recognize the Captive as an insurance company for federal income tax purposes, with respect to our consolidated federal income tax return. In the event the Internal Revenue Service (“IRS”) were to determine that the Captive does not qualify as an insurance company, we could be required to make accelerated income tax payments to the IRS that we otherwise would have deferred until future periods.

***Our Ability to Adjust and Collect Service Fees for Increases in Unemployment Tax Rates May be Limited***

We record our state unemployment tax expense based on taxable wages and tax rates assigned by each state. State unemployment tax rates vary by state and are determined, in part, based on prior years' compensation experience in each state. Should our claim experience increase, our unemployment tax rates could increase. In addition, some states have the ability under law to increase unemployment tax rates retroactively to cover deficiencies in the unemployment fund. Generally, our contractual agreements allow us to incorporate such increases into our service fees. However, our ability to fully adjust service fees in our billing systems and collect such increases over the remaining term of the customers' contracts could be limited, resulting in a potential tax increase not being fully recovered. As a result, such increases could have a material adverse effect on our financial condition or results of operations.

***Our Contracts May be Cancelled on Short Notice. Our Inability to Renew Client Contracts or Attract New Clients Could Materially and Adversely Affect Our Financial Conditions and Results of Operations***

Our standard CSA can generally be cancelled by us or the client with 30 days notice. Accordingly, the short-term nature of the CSA makes us vulnerable to potential cancellations by existing clients, which could materially and adversely affect our financial condition and results of operations. In addition, our results of operations are dependent in part upon our ability to retain or replace our clients upon the termination or cancellation of the CSA. Our client attrition rate was approximately 21% in 2008. There can be no assurance that the number of contract cancellations will continue at these levels or increase in the future due to various factors, including but not limited to, economic conditions in the markets we operate.

***Competition from Established Competitors and New Market Entrants with Greater Resources that May Enable Them to Offer Services at More Competitive Prices***

The PEO industry is highly fragmented. Many PEOs have limited operations and fewer than 1,000 worksite employees, but there are several industry participants that are comparable to our size. We also encounter competition from "fee for service" companies such as payroll processing firms, insurance companies and human resource consultants. Several of our competitors are PEO divisions of large business services companies, such as Automatic Data Processing, Inc. and Paychex, Inc. Such companies have substantially greater resources than Administaff. Accordingly, the PEO divisions of such companies may be able to provide their PEO services at more competitive prices than we may be able to offer. Moreover, we expect that as the PEO industry grows and its regulatory framework becomes better established, well-organized competition with greater resources than us may enter the PEO market, possibly including large "fee for service" companies currently providing a more limited range of services.

***We May be Subject to Liabilities for Client and Employee Actions***

A number of legal issues remain unresolved with respect to the co-employment arrangement between a PEO and its worksite employees, including questions concerning the ultimate liability for violations of employment and discrimination laws. Our CSA establishes the contractual division of responsibilities between Administaff and our clients for various personnel management matters, including compliance with and liability under various governmental regulations.

We maintain certain general insurance coverages (including coverages for our clients) to manage certain exposure for various employee-related claims, and as a result, the costs in excess of insurance premiums we incur with respect to this exposure have historically been insignificant to our operating results.

Because we act as a co-employer, we may be subject to liability for violations of various employment and discrimination laws despite these contractual provisions, even if we do not participate in such violations. Although the CSA provides that the client is to indemnify us for any liability attributable to the client's conduct, we may not be able to collect on such a contractual indemnification claim and thus may be responsible for satisfying such liabilities. In addition, worksite employees may be deemed to be our agents, which may subject us to liability for the actions of such worksite employees.

***Changes in Federal, State and Local Regulation or Our Inability to Obtain Licenses under New Regulatory Regimes Could Have a Material Adverse Effect on Our Results of Operations or Financial Condition***

As a major employer, our operations are affected by numerous federal, state and local laws and regulations relating to labor, tax, benefit and employment matters. By entering into a co-employer relationship with employees assigned to work at client locations, we assume certain obligations and responsibilities of an employer under these laws. However, many of these laws (such as ERISA and federal and state employment tax laws) do not specifically address the obligations and responsibilities of non-traditional employers such as PEOs, and the definition of “employer” under these laws is not uniform. In addition, many of the states in which we operate have not addressed the PEO relationship for purposes of compliance with applicable state laws governing the employer/employee relationship. Any adverse application of new or existing federal or state laws to the PEO relationship with our worksite employees could have a material adverse effect on our results of operations or financial condition.

While many states do not explicitly regulate PEOs, 34 states have passed laws that have recognition, licensing, certification or registration requirements for PEOs, and several other states are considering such regulation. Such laws vary from state to state, but generally provide for monitoring the fiscal responsibility of PEOs, and in some cases codify and clarify the co-employment relationship for unemployment, workers’ compensation and other purposes under state law. While we generally support licensing regulation because it serves to validate the PEO relationship, we may not be able to satisfy licensing requirements or other applicable regulations for all states. In addition, there can be no assurance that we will be able to renew our licenses in all states.

***Geographic Market Concentration Makes Our Results of Operations Vulnerable to Economic Factors Specific to Texas***

While we have sales offices in 24 markets, our Houston and Texas (including Houston) markets accounted for approximately 14% and 31%, respectively, of our worksite employees for the year ended December 31, 2008. Accordingly, while we have a goal of expanding in our current and future markets outside of Texas, for the foreseeable future, a significant portion of our revenues may be subject to economic factors specific to Texas (including Houston).

***A Determination that a Client is Liable for Employment Taxes Not Paid by a PEO May Discourage Clients from Contracting with Us in the Future***

Under the CSA, we assume sole responsibility and liability for paying federal employment taxes imposed under the Code with respect to wages and salaries we pay our worksite employees. There are essentially three types of federal employment tax obligations:

- income tax withholding requirements;
- obligations under the Federal Income Contribution Act (“FICA”); and
- obligations under the Federal Unemployment Tax Act (“FUTA”).

Under the Code, employers have the obligation to withhold and remit the employer portion and, where applicable, the employee portion of these taxes. Most states impose similar employment tax obligations on the employer. While the CSA provides that we have sole legal responsibility for making these tax contributions, the IRS or applicable state taxing authority could conclude that such liability cannot be completely transferred to us. Accordingly, in the event that we fail to meet our tax withholding and payment obligations, the client may be held jointly and severally liable for those obligations. While this interpretive issue has not, to our knowledge, discouraged clients from enrolling with Administaff, a definitive adverse resolution of this issue may discourage clients from enrolling in the future.

***Potential Disclosure of Sensitive or Private Information Could Damage Our Reputation and Impact Our Operating Results***

Unauthorized access or unintentional disclosure of personal information could damage our reputation and operating results. While we strive to comply with all applicable data protection laws and regulations, and maintain stringent privacy and security policies and procedures, any failure or perceived failure to adequately protect sensitive information may result in negative publicity and / or proceedings or actions against us by government entities or others, which could potentially have an adverse affect on our business.

Forty-four states have enacted notification rules concerning privacy and data protection. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have a material effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

***The Failure of Our Insurance Carriers Could Have a Material Adverse Effect on Us***

During the third quarter of 2008, it was publicly reported that American International Group, Inc. (“AIG Parent”) experienced significant financial difficulties, and the United States Federal Reserve has approved emergency financial assistance to AIG Parent. Selected member insurance companies of AIG Parent (the “Selected Member Carriers”) provide employment practices liability (“EPL”) insurance to Administaff and our clients, and also remain as the carriers for all workers’ compensation claim activity incurred between September 1, 2003 and September 30, 2007. As of December 31, 2008, AIG held funds of \$39.4 million, which is included in restricted cash and deposits on the Company’s Consolidated Balance Sheet, to pay remaining claims under the AIG workers’ compensation program. Although AIG Parent has publicly stated that its Selected Member Carriers remain well-capitalized and financially secure, in the event that the Selected Member Carriers fail and are placed into receivership or a similar proceeding, the claim funds held by AIG would not necessarily be used to pay the Company’s remaining workers’ compensation claims. Instead, the claims could be paid by guaranty associations that have been established by most states, many of which could in turn attempt to return the liability for such claims to Administaff. Moreover, in the event of a failure of the carrier providing the EPL insurance, Administaff may be responsible for the payment of any such claims. Any such events could have a material adverse effect on Administaff’s financial condition and results of operations.

In 2003, facing continued capital constraints and a series of downgrades from various rating agencies, our former workers’ compensation insurance carrier for the two-year period ending September 2003, Lumbermens Mutual Casualty Company, a unit of Kemper Insurance Companies (“Kemper”), made the decision to substantially cease underwriting operations and voluntarily entered into “run-off.” A “run-off” is the professional management of an insurance company’s discontinued distressed or nonrenewed lines of insurance and associated liabilities outside of a judicial proceeding. In the event the run-off process is not successful and Kemper is forced into receivership or a similar proceeding, most states have established guaranty funds to pay remaining claims. However, the guaranty associations in some states, including Texas, have asserted that state law returns the liability for open claims under such policies to the insured, as we experienced when another former insurance carrier, Reliance National Indemnity Co., declared bankruptcy in 2001. In that case, the Texas state guaranty association asserted that it was entitled to full reimbursement from us for workers’ compensation benefits paid by the association. Although we settled that dispute within the limits of insurance coverage we had secured to cover potential claims returned to us related to the Reliance policies, we have no similar insurance coverage for the Kemper claims. If one or more states were to assert that liability for open claims with Kemper should be returned to us, we may be required to make a payment to the state covering estimated claims attributable to us. Any such payment would reduce net income, which may have a material adverse effect on net income in the reported period.

For additional information about our workers’ compensation insurance, please read “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies and Estimates — Workers’ Compensation Costs” on page 26.



## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We are primarily exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on the market values of our cash equivalent short-term investments and our available-for-sale marketable securities. The cash equivalent short-term investments consist primarily of overnight investments, which are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned on these investments. The available-for-sale marketable securities are subject to interest rate risk because these securities generally include a fixed interest rate. As a result, the market values of these securities are affected by changes in prevailing interest rates.

We attempt to limit our exposure to interest rate risk primarily through diversification and low investment turnover. Our investment policy is designed to minimize after-tax interest income while preserving our principal investment.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

The information required by this Item 8 is contained in a separate section of this Annual Report. See “Index to Consolidated Financial Statements” on page F-1.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None.

## **ITEM 9A. CONTROLS AND PROCEDURES.**

### **Evaluation of Disclosure Controls and Procedures**

In accordance with Exchange Act Rules 13a-15 and 15a-15, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 2008.

### **Design and Evaluation of Internal Control Over Financial Reporting**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we included a report of management’s assessment of the design and effectiveness of our internal controls as part of this Annual Report on Form 10-K for the fiscal year ended December 31, 2008. Ernst & Young, LLP, our independent registered public accounting firm, also attested to our internal control over financial reporting. Management’s report and the independent registered public accounting firm’s attestation report are included in our 2008 Consolidated Financial Statements on pages F-3 and F-4 under the captions entitled “Management’s Report on Internal Control Over Financial Reporting” and “Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting,” and are incorporated herein by reference.

There has been no change in our internal controls over financial reporting that occurred during the three months ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

## **ITEM 9B. OTHER INFORMATION.**

None.

## PART III

### ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

Some of the information required by this item is incorporated by reference to the information set forth under the captions “Proposal Number 1: Election of Directors – Nominees – Class II Directors (For Terms Expiring at the 2012 Annual Meeting),” “– Directors Remaining in Office,” and “– Section 16(a) Beneficial Ownership Reporting Compliance” in our definitive Proxy Statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this report (the “Administaff Proxy Statement”).

#### *Code of Business Conduct and Ethics*

Our Board of Directors adopted our Code of Business Conduct and Ethics (the “Code of Ethics”), which meets the requirements of Rule 303.A of the New York Stock Exchange Listed Company Manual and Item 406 of Regulation S-K. You can access our Code of Ethics on the Corporate Governance page of our Web site at [www.administaff.com](http://www.administaff.com). Any stockholder who so requests may obtain a printed copy of the Code of Ethics from Administaff. Changes in and waivers to the Code of Ethics for the Company’s directors, executive officers and certain senior financial officers will be posted on our Internet Web site within five business days and maintained for at least twelve months.

### ITEM 11. EXECUTIVE COMPENSATION.

The information required by this item is incorporated by reference to the information set forth under the captions “Proposal Number 1: Election of Directors – Director Compensation” and “—Executive Compensation” in the Administaff Proxy Statement.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information required by this item is incorporated by reference to the information set forth under the caption “Security Ownership of Certain Beneficial Owners and Management” in the Administaff Proxy Statement.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.

The information required by this item is incorporated by reference to the information set forth under the caption “Proposal Number 1: Election of Directors – Certain Relationships and Related Transactions” in the Administaff Proxy Statement.

### ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

The information required by this item is incorporated by reference to the information set forth under the caption “Proposal Number 2: Ratification and Appointment of Independent Public Accountants – Fees of Ernst & Young LLP” and “—Finance, Risk Management and Audit Committee Pre-Approval Policy for Audit and Non-Audit Services” in the Administaff Proxy Statement.

## PART IV

### ITEM 15. EXHIBITS FINANCIAL STATEMENT SCHEDULES.

(a) 1. Financial Statements of the Company

The Consolidated Financial Statements listed by the Registrant on the accompanying Index to Consolidated Financial Statements (see page F-1) are filed as part of this Annual Report.

(a) 2. Financial Statement Schedules

The required information is included in the Consolidated Financial Statements or Notes thereto.

(a) 3. List of Exhibits

3.1 Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 (No. 33-96952)).

3.2 Amended and Restated Bylaws of Administaff, Inc. dated November 13, 2007 (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed on November 16, 2007).

3.3 Certificate of Designation of Series A Junior Participating Preferred Stock setting forth the terms of the Preferred Stock (included as Exhibit A to the Rights Agreement).

4.1 Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-1 (No. 33-96952)).

4.2 Rights Agreement dated as of November 13, 2007 between Administaff, Inc. and Mellon Investor Services, LLC, as Rights Agent (the "Rights Agreement") (incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed on November 16, 2007).

4.3 Form of Rights Certificate (included as Exhibit B to the Rights Agreement).

10.1† Administaff, Inc. 1997 Incentive Plan (incorporated by reference to Exhibit 99.1 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).

10.2† First Amendment to the Administaff, Inc. 1997 Incentive Plan (incorporated by reference to Exhibit 99.2 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).

10.3† Second Amendment to the Administaff, Inc. 1997 Incentive Plan (incorporated by reference to Exhibit 99.3 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).

10.4† Third Amendment to the Administaff, Inc. 1997 Incentive Plan (incorporated by reference to Exhibit 99.4 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).

10.5† Fourth Amendment to the Administaff, Inc. 1997 Incentive Plan (incorporated by reference to Exhibit 99.5 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).

10.6† Administaff, Inc. 2001 Incentive Plan, as amended and restated (incorporated by reference to Exhibit 10.1 to the Registrant's Form 10-Q filed for the quarter ended June 30, 2006).

10.7† Form of Incentive Stock Option Agreement (1997 Plan) (incorporated by reference to Exhibit 10.7 to the Registrant's Form 10-K filed for the year ended December 31, 2004).

10.8† Form of Incentive Stock Option Agreement (2001 Plan – 3 year vesting) (incorporated by reference to Exhibit 10.8 to the Registrant's Form 10-K filed for the year ended December 31, 2004).

10.9† Form of Incentive Stock Option Agreement (2001 Plan – 5 year vesting) (incorporated by reference to Exhibit 10.9 to the Registrant's Form 10-K filed for the year ended December 31, 2004).

10.10† Form of Director Stock Option Agreement (Initial Grant) (incorporated by reference to Exhibit 10.10 to the Registrant's Form 10-K filed for the year ended December 31, 2004).

- 10.11† Form of Director Stock Option Agreement (Annual Grant) (incorporated by reference to Exhibit 10.11 to the Registrant's Form 10-K filed for the year ended December 31, 2004).
- 10.12† Form of Restricted Stock Agreement (incorporated by reference to Exhibit 10.12 to the Registrant's Form 10-K filed for the year ended December 31, 2004).
- 10.13 Administraff, Inc. Nonqualified Stock Option Plan (incorporated by reference to Exhibit 99.6 to the Registrant's Registration Statement on Form S-8 (No. 333-85151)).
- 10.14 First Amendment to Administraff, Inc. Nonqualified Stock Option Plan, effective August 7, 2001 (incorporated by reference to Exhibit 10.8 to the Registrant's Form 10-K for the year ended December 31, 2002).
- 10.15 Second Amendment to Administraff, Inc. Nonqualified Stock Option Plan, effective January 28, 2003 (incorporated by reference to Exhibit 10.9 to the Registrant's Form 10-K for the year ended December 31, 2002).
- 10.16 Administraff, Inc. Amended and Restated Employee Stock Purchase Plan effective April 1, 2002 (incorporated by reference to Exhibit 10.10 to the Registrant's Form 10-K for the year ended December 31, 2002).
- 10.17 First Amendment to Administraff, Inc. Amended and Restated Employee Stock Purchase Plan, effective July 31, 2002 (incorporated by reference to Exhibit 10.11 to the Registrant's Form 10-K for the year ended December 31, 2002).
- 10.18 Second Amendment to Administraff, Inc. Amended and Restated Employee Stock Purchase Plan, effective August 15, 2003 (incorporated by reference to Exhibit 10.12 to the Registrant's Form 10-K for the year ended December 31, 2003).
- 10.19† Board of Directors Compensation Arrangements (incorporated by reference to Form 8-K dated February 7, 2005).
- 10.20 Administraff, Inc. 2008 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form S-8 (No. 333-151275)).
- 10.21(+) Minimum Premium Financial Agreement by and between Administraff of Texas, Inc. and United Healthcare Insurance Company, Hartford, Connecticut (incorporated by reference to Exhibit 10.3 to the Registrant's Form 10-Q for the quarter ended June 30, 2002).
- 10.22(+) Minimum Premium Administrative Services Agreement by and between Administraff of Texas, Inc. and United Healthcare Insurance Company, Hartford, Connecticut (incorporated by reference to Exhibit 10.4 to the Registrant's Form 10-Q for the quarter ended June 30, 2002).
- 10.23(+) Amended and Restated Security Deposit Agreement by and between Administraff of Texas, Inc. and United Healthcare Insurance Company, Hartford, Connecticut (incorporated by reference to Exhibit 10.5 to the Registrant's Form 10-Q for the quarter ended June 30, 2002).
- 10.24(+) Amendment to Various Agreements between United Healthcare Insurance Company and Administraff of Texas, Inc. (incorporated by reference to Exhibit 10.1 to the Registrant's Form 10-Q for the quarter ended June 30, 2005).
- 10.25 Houston Service Center Operating Lease Amendment (incorporated by reference to Exhibit 10.27 to the Registrant's Form 10-K for the year ended December 31, 2004).
- 10.26(+) Letter Agreement dated April 21, 2007, between Administraff of Texas, Inc. and United Healthcare Insurance Company (incorporated by reference to Exhibit 10.1 to the Registrant's Form 10-Q for the quarter ended June 30, 2007).
- 10.27(+) Amendment to Minimum Premium Financial Agreement, as amended and restated effective January 1, 2005, by and between Administraff of Texas, Inc., and United Healthcare Insurance Company (incorporated by reference to Exhibit 10.2 to the Registrant's Form 10-Q for the quarter ended June 30, 2007).

- 10.28(+) Amendment to Minimum Premium Administrative Services Agreement, as amended and restated effective January 1, 2005, by and between Administaff of Texas, Inc., and UnitedHealthcare Insurance Company (incorporated by reference to Exhibit 10.3 to the Registrant's Form 10-Q for the quarter ended June 30, 2007).
- 21.1\* Subsidiaries of Administaff, Inc.
- 23.1\* Consent of Independent Registered Public Accounting Firm.
- 24.1\* Powers of Attorney.
- 31.1\* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

---

\* Filed herewith.

† Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K.

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

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Administaff, Inc. has duly caused this report to be signed in its behalf by the undersigned, thereunto duly authorized, on February 9, 2009.

ADMINISTAFF, INC.

By: /s/ Douglas S. Sharp  
Douglas S. Sharp  
Senior Vice President, Finance  
Chief Financial Officer and Treasurer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of Administaff, Inc. in the capacities indicated on February 9, 2009:

<u>Signature</u>	<u>Title</u>
<u>/s/ Paul J. Sarvadi</u> Paul J. Sarvadi	Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)
<u>/s/ Richard G. Rawson</u> Richard G. Rawson	President and Director
<u>/s/ Douglas S. Sharp</u> Douglas S. Sharp	Senior Vice President, Finance Chief Financial Officer and Treasurer (Principal Financial Officer)
<u>Michael W. Brown</u>	Director
* <u>Jack M. Fields, Jr.</u>	Director
* <u>Eli Jones</u>	Director
* <u>Paul S. Lattanzio</u>	Director
* <u>Gregory E. Petsch</u>	Director
<u>/s/ Austin P. Young</u> Austin P. Young	Director
* By: <u>/s/ Daniel D. Herink</u> Daniel D. Herink, attorney-in-fact	

**ADMINISTAFF, INC.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

Report of Independent Registered Public Accounting Firm.....	F-2
Management’s Report on Internal Control .....	F-3
Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting .....	F-4
Consolidated Balance Sheets as of December 31, 2008 and 2007 .....	F-6
Consolidated Statements of Operations for the years ended December 31, 2008, 2007 and 2006 .....	F-7
Consolidated Statements of Stockholders’ Equity for the years ended December 31, 2008, 2007 and 2006 .....	F-8
Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006 .....	F-10
Notes to Consolidated Financial Statements.....	F-12

THIS PAGE INTENTIONALLY LEFT BLANK



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders  
Administaff, Inc.

We have audited the accompanying Consolidated Balance Sheets of Administaff, Inc. as of December 31, 2008 and 2007, and the related Consolidated Statements of Operations, Stockholders' Equity and Cash Flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 Administaff, Inc. at December 31, 2008 and 2007, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Administaff, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission* and our report dated February 6, 2009 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Houston, Texas  
February 6, 2009

## MANAGEMENT'S REPORT ON INTERNAL CONTROL

The Company has assessed the effectiveness of its internal control over financial reporting as of December 31, 2008 based on criteria established by *Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO Framework”)*. The Company's management is responsible for establishing and maintaining adequate internal controls over financial reporting. The Company's independent registered public accountants that audited the Company's financial statements as of December 31, 2008 have issued an attestation report on management's assessment of the effectiveness of the Company's internal control over financial reporting, which appears on page F-4.

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. 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 the 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 and procedures may deteriorate.

The Company's assessment of the effectiveness of its internal control over financial reporting included testing and evaluating the design and operating effectiveness of its internal controls. In management's opinion, the Company has maintained effective internal control over financial reporting as of December 31, 2008, based on criteria established in the COSO Framework.

/s/ Paul J. Sarvadi

Paul J. Sarvadi  
Chairman of the Board and  
Chief Executive Officer

/s/ Douglas S. Sharp

Douglas S. Sharp  
Senior Vice President, Finance  
Chief Financial Officer and Treasurer

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders  
Administaff, Inc.

We have audited Administaff, Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Administaff, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, 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, Administaff, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, 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 Administaff, Inc. as of December 31, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008 of Administaff, Inc. and our report dated February 6, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP

Houston, Texas  
February 6, 2009

**ADMINISTAFF, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands)

**ASSETS**

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Current assets:</b>		
Cash and cash equivalents .....	\$ 252,190	\$ 135,793
Restricted cash .....	36,466	35,318
Marketable securities .....	225	74,880
Accounts receivable:		
Trade, net .....	4,908	3,299
Unbilled.....	116,173	125,318
Other.....	4,012	6,217
Prepaid insurance .....	28,911	22,395
Other current assets.....	6,735	6,273
Income taxes receivable.....	—	3,918
Total current assets.....	449,620	413,411
<b>Property and equipment:</b>		
Land .....	3,260	2,920
Buildings and improvements.....	63,016	61,620
Computer hardware and software .....	67,198	65,518
Software development costs.....	23,162	21,624
Furniture and fixtures .....	35,307	32,004
Aircraft.....	31,548	21,909
	223,491	205,595
Accumulated depreciation and amortization.....	(134,152)	(127,654)
Total property and equipment, net .....	89,339	77,941
<b>Other assets:</b>		
Prepaid health insurance.....	9,000	9,000
Deposits – health insurance.....	2,585	2,811
Deposits – workers’ compensation .....	56,435	51,909
Goodwill and other intangible assets, net.....	8,595	4,785
Other assets.....	1,266	794
Total other assets.....	77,881	69,299
Total assets.....	\$ 616,840	\$ 560,651

**ADMINISTAFF, INC.**  
**CONSOLIDATED BALANCE SHEETS (Continued)**  
(in thousands)

**LIABILITIES AND STOCKHOLDERS' EQUITY**

	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Current liabilities:		
Accounts payable.....	\$ 3,007	\$ 5,236
Payroll taxes and other payroll deductions payable.....	123,666	113,929
Accrued worksite employee payroll cost .....	129,954	110,406
Accrued health insurance costs .....	14,715	19,297
Accrued workers' compensation costs .....	38,028	37,150
Accrued corporate payroll and commissions .....	25,692	20,123
Other accrued liabilities.....	9,495	8,395
Current portion of capital lease obligations .....	537	629
Income tax payable .....	4,157	—
Deferred income taxes .....	<u>1,956</u>	<u>1,066</u>
Total current liabilities .....	351,207	316,231
Noncurrent liabilities:		
Capital lease obligations.....	—	537
Accrued workers' compensation costs .....	46,589	39,116
Deferred income taxes .....	<u>10,565</u>	<u>6,092</u>
Total noncurrent liabilities .....	57,154	45,745
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, par value \$0.01 per share:		
Shares authorized – 20,000		
Shares issued and outstanding - none .....	—	—
Common stock, par value \$0.01 per share:		
Shares authorized – 60,000		
Shares issued – 30,839 at December 31, 2008 and 2007, respectively .....	309	309
Additional paid-in capital.....	139,415	138,640
Treasury stock, at cost – 5,700 and 4,622 shares at December 31, 2008 and 2007, respectively.....	(147,952)	(123,600)
Accumulated other comprehensive income, net of tax.....	—	5
Retained earnings.....	<u>216,707</u>	<u>183,321</u>
Total stockholders' equity .....	<u>208,479</u>	<u>198,675</u>
Total liabilities and stockholders' equity .....	<u>\$ 616,840</u>	<u>\$ 560,651</u>

See accompanying notes.

**ADMINISTAFF, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share amounts)

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Revenues (gross billings of \$10.372 billion, \$9.437 billion and \$8.055 billion less worksite employee payroll cost of \$8.648 billion, \$7.867 billion, and \$6.666 billion, respectively)	\$1,724,434	\$1,569,977	\$1,389,464
Direct costs:			
Payroll taxes, benefits and workers' compensation costs.....	<u>1,380,695</u>	<u>1,264,055</u>	<u>1,106,735</u>
Gross profit.....	343,739	305,922	282,729
Operating expenses:			
Salaries, wages and payroll taxes.....	153,538	131,648	119,963
Stock-based compensation .....	9,970	7,513	3,411
General and administrative expenses.....	69,348	62,453	57,409
Commissions .....	12,665	11,795	10,968
Advertising .....	17,666	14,143	13,975
Depreciation and amortization .....	<u>15,570</u>	<u>16,156</u>	<u>15,438</u>
	<u>278,757</u>	<u>243,708</u>	<u>221,164</u>
Operating income.....	64,982	62,214	61,565
Other income (expense):			
Interest income .....	7,057	11,718	11,383
Interest expense .....	(66)	(111)	(1,111)
Other, net .....	<u>44</u>	<u>(382)</u>	<u>245</u>
	<u>7,035</u>	<u>11,225</u>	<u>10,517</u>
Income before income tax expense .....	72,017	73,439	72,082
Income tax expense .....	<u>26,237</u>	<u>25,947</u>	<u>25,576</u>
Net income .....	<u>\$ 45,780</u>	<u>\$ 47,492</u>	<u>\$ 46,506</u>
Basic net income per share of common stock.....	<u>\$ 1.81</u>	<u>\$ 1.78</u>	<u>\$ 1.69</u>
Diluted net income per share of common stock .....	<u>\$ 1.79</u>	<u>\$ 1.74</u>	<u>\$ 1.64</u>

See accompanying notes.

**ADMINISTAFF, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(in thousands)

	Common Stock Issued		Additional Paid-In Capital	Deferred Compensation Expense	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
	Shares	Amount						
Balance at December 31, 2005	30,839	\$ 309	\$ 119,573	\$ (2,931)	\$ (45,614)	\$ (153)	\$ 111,245	\$ 182,429
Purchase of treasury stock, at cost	—	—	—	—	(24,174)	—	—	(24,174)
Exercise of stock options	—	—	2,579	—	14,254	—	—	16,833
Income tax benefit from stock-based compensation	—	—	12,700	—	—	—	—	12,700
Cumulative effect of change in accounting principle	—	—	(684)	2,931	(2,296)	—	—	(49)
Stock-based compensation expense	—	—	1,314	—	2,146	—	—	3,460
Other	—	—	460	—	279	—	—	739
Dividends paid	—	—	—	—	—	—	(10,021)	(10,021)
Change in unrealized loss on marketable securities, net of tax:								
Unrealized gain	—	—	—	—	—	22	—	22
Net income	—	—	—	—	—	—	46,506	46,506
Comprehensive income	—	—	—	—	—	—	—	46,528
Balance at December 31, 2006	30,839	\$ 309	\$ 135,942	\$ —	\$ (55,405)	\$ (131)	\$ 147,730	\$ 228,445
Purchase of treasury stock, at cost	—	—	—	—	(80,521)	—	—	(80,521)
Exercise of stock options	—	—	(2,618)	—	6,554	—	—	3,936
Income tax benefit from stock-based compensation	—	—	2,936	—	—	—	—	2,936
Stock-based compensation expense	—	—	2,124	—	5,389	—	—	7,513
Other	—	—	256	—	383	—	—	639
Dividends paid	—	—	—	—	—	—	(11,901)	(11,901)
Change in unrealized loss on marketable securities, net of tax:								
Unrealized loss	—	—	—	—	—	(129)	—	(129)
Realized loss	—	—	—	—	—	265	—	265
Net income	—	—	—	—	—	—	47,492	47,492
Comprehensive income	—	—	—	—	—	—	—	47,628
Balance at December 31, 2007	<u>30,839</u>	<u>\$ 309</u>	<u>\$ 138,640</u>	<u>\$ —</u>	<u>\$(123,600)</u>	<u>\$ 5</u>	<u>\$ 183,321</u>	<u>\$ 198,675</u>

**ADMINISTAFF, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Continued)**  
(in thousands)

	Common Stock Issued		Additional Paid-In Capital	Deferred Compensation Expense	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total
	Shares	Amount						
Balance at December 31, 2007	30,839	\$ 309	\$ 138,640	\$ —	\$(123,600)	\$ 5	\$ 183,321	\$ 198,675
Purchase of treasury stock, at cost	—	—	—	—	(38,082)	—	—	(38,082)
Exercise of stock options	—	—	(2,415)	—	5,606	—	—	3,191
Income tax benefit from stock-based compensation, net	—	—	821	—	—	—	—	821
Stock-based compensation expense	—	—	2,352	—	7,601	—	17	9,970
Other	—	—	17	—	523	—	—	540
Dividends paid	—	—	—	—	—	—	(12,411)	(12,411)
Change in unrealized loss on marketable securities, net of tax:								
Unrealized loss	—	—	—	—	—	(5)	—	(5)
Net income	—	—	—	—	—	—	45,780	<u>45,780</u>
Comprehensive income	—	—	—	—	—	—	—	<u>45,775</u>
Balance at December 31, 2008	<u>30,839</u>	<u>\$ 309</u>	<u>\$ 139,415</u>	<u>\$ —</u>	<u>\$(147,952)</u>	<u>\$ —</u>	<u>\$ 216,707</u>	<u>\$ 208,479</u>

See accompanying notes.



**ADMINISTAFF, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash flows from operating activities:			
Net income .....	\$ 45,780	\$ 47,492	\$ 46,506
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization .....	15,541	16,548	15,531
Stock-based compensation.....	9,970	7,513	3,411
Deferred income taxes .....	5,363	4,370	4,204
Changes in operating assets and liabilities, net of effect of acquisition:			
Restricted cash .....	(1,148)	2,087	(9,825)
Accounts receivable.....	9,741	(12,111)	(24,312)
Prepaid insurance.....	(6,516)	657	(646)
Other current assets .....	(462)	(1,873)	91
Other assets .....	(4,722)	(4,120)	7,686
Accounts payable.....	(2,229)	1,434	(1,177)
Payroll taxes and other payroll deductions payable .....	9,737	(2,997)	15,633
Accrued worksite employee payroll expense.....	19,548	15,588	16,425
Accrued health insurance costs.....	(4,582)	4,081	(1,468)
Accrued workers' compensations costs .....	8,351	(2,788)	16,149
Accrued corporate payroll, commissions and other accrued liabilities.....	6,249	(172)	3,438
Income taxes payable/receivable .....	7,169	(725)	(3,193)
Total adjustments.....	<u>72,010</u>	<u>27,492</u>	<u>41,947</u>
Net cash provided by operating activities .....	117,790	74,984	88,453
Cash flows from investing activities:			
Marketable securities:			
Purchases .....	—	(87,643)	(70,786)
Proceeds from maturities .....	3,895	86,877	43,126
Proceeds from dispositions .....	70,746	11,296	50
Cash received (exchanged) for note receivable .....	—	173	—
Acquisition of USDatalink .....	(3,780)	—	—
Property and equipment:			
Purchases .....	(26,714)	(12,868)	(12,931)
Proceeds from dispositions .....	<u>124</u>	<u>52</u>	<u>161</u>
Net cash provided by (used in) investing activities ...	44,271	(2,113)	(40,380)

**ADMINISTAFF, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
(in thousands)

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Cash flows from financing activities:			
Purchase of treasury stock .....	\$ (38,082)	\$ (80,521)	\$ (24,174)
Dividends paid .....	(12,411)	(11,901)	(10,021)
Proceeds from the exercise of stock options .....	3,191	3,936	16,833
Principal repayments on long-term debt and capital lease obligations .....	(629)	(583)	(33,141)
Income tax benefit from stock-based compensation .....	1,727	2,936	12,700
Other .....	<u>540</u>	<u>639</u>	<u>739</u>
Net cash used in financing activities .....	<u>(45,664)</u>	<u>(85,494)</u>	<u>(37,064)</u>
Net increase (decrease) in cash and cash equivalents .....	116,397	(12,623)	11,009
Cash and cash equivalents at beginning of year .....	<u>135,793</u>	<u>148,416</u>	<u>137,407</u>
Cash and cash equivalents at end of year .....	<u>\$ 252,190</u>	<u>\$ 135,793</u>	<u>\$ 148,416</u>
Supplemental disclosures:			
Cash paid for income taxes .....	\$ 11,978	\$ 22,501	\$ 12,482
Cash paid for interest .....	\$ 66	\$ 111	\$ 1,066

See accompanying notes.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008**

**1. Accounting Policies**

*Description of Business*

Administaff, Inc. (the “Company”) is a professional employer organization (“PEO”). As a PEO, the Company provides a bundled comprehensive service for its clients in the area of personnel management. The Company provides its comprehensive service through its Personnel Management System, which encompasses a broad range of human resource functions, including payroll and benefits administration, health and workers’ compensation insurance programs, personnel records management, employer liability management, employee recruiting and selection, employee performance management, and employee training and development.

The Company provides its comprehensive service by entering into a co-employment relationship with its clients, under which the Company and its clients each take responsibility for certain portions of the employer-employee relationship. The Company and its clients designate each party’s responsibilities through its Client Services Agreement (“CSA”), under which the Company becomes the employer of its worksite employees for most administrative and regulatory purposes.

As a co-employer of its worksite employees, the Company assumes most of the rights and obligations associated with being an employer. The Company enters into an employment agreement with each worksite employee, thereby maintaining a variety of employer rights, including the right to hire or terminate employees, the right to evaluate employee qualifications or performance, and the right to establish employee compensation levels. Typically, the Company only exercises these rights in consultation with its clients or when necessary to ensure regulatory compliance. The responsibilities associated with the Company’s role as employer include the following obligations with regard to its worksite employees: (i) to compensate its worksite employees through wages and salaries; (ii) to pay the employer portion of payroll-related taxes; (iii) to withhold and remit (where applicable) the employee portion of payroll-related taxes; (iv) to provide employee benefit programs; and (v) to provide workers’ compensation insurance coverage.

In addition to its assumption of employer status for its worksite employees, the Company’s comprehensive service also includes other human resource functions for its clients to support the effective and efficient use of personnel in their business operations. To provide these functions, the Company maintains a significant staff of professionals trained in a wide variety of human resource functions, including employee training, employee recruiting, employee performance management, employee compensation, and employer liability management. These professionals interact and consult with clients on a daily basis to help identify each client’s service requirements and to ensure that the Company is providing appropriate and timely personnel management services.

In April 2008, the Company purchased certain assets and operations of USDataLink, Ltd., an employee screening services company, for \$4.2 million, including \$420,000 to be paid in April 2009. An additional \$300,000 is payable in 2009 upon the satisfaction of certain conditions, as specified in the purchase agreement.

The Company provides its comprehensive service to small and medium-sized businesses in strategically selected markets throughout the United States. During 2008, 2007 and 2006, revenues from the Company’s Texas markets represented 31%, 32% and 32% of the Company’s total revenues, respectively.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Revenue and Direct Cost Recognition*

The Company accounts for its revenues in accordance with EITF 99-19, *Reporting Revenues Gross as a Principal Versus Net as an Agent*. The Company's revenues are derived from its gross billings, which are based on (i) the payroll cost of its worksite employees; and (ii) a markup computed as a percentage of the payroll cost. The gross billings are invoiced concurrently with each periodic payroll of its worksite employees. Revenues are recognized ratably over the payroll period as worksite employees perform their service at the client worksite. Revenues that have been recognized but not invoiced are included in unbilled accounts receivable on the Company's Consolidated Balance Sheets.

In determining the pricing of the markup component of the gross billings, the Company takes into consideration its estimates of the costs directly associated with its worksite employees, including payroll taxes, benefits and workers' compensation costs, plus an acceptable gross profit margin. As a result, the Company's operating results are significantly impacted by the Company's ability to accurately estimate, control and manage its direct costs relative to the revenues derived from the markup component of the Company's gross billings.

Consistent with its revenue recognition policy, the Company's direct costs do not include the payroll cost of its worksite employees. The Company's direct costs associated with its revenue generating activities are comprised of all other costs related to its worksite employees, such as the employer portion of payroll-related taxes, employee benefit plan premiums and workers' compensation insurance costs.

*Segment Reporting*

The Company operates in one reportable segment under the Statement of Financial Accounting Standards ("SFAS") No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

*Principles of Consolidation*

The Consolidated Financial Statements include the accounts of Administaff, Inc. and its wholly owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

*Use of Estimates*

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

*Concentrations of Credit Risk*

Financial instruments that could potentially subject the Company to concentration of credit risk include accounts receivable.

*Cash, Cash Equivalents and Marketable Securities*

The Company invests its excess cash in federal government and municipal-based money market funds and debt instruments of U.S. municipalities. Administaff's investments do not include any asset-backed securities with underlying collateral of sub-prime mortgages or home equity loans, nor do they include any collateralized debt obligations or collateralized loan obligations. All highly liquid investments with stated maturities of three months or less from date of purchase are classified as cash equivalents. Liquid investments with stated maturities of greater than three months are classified as marketable securities in current assets.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company accounts for marketable securities in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The Company determines the appropriate classification of all marketable securities as held-to-maturity, available-for-sale or trading at the time of purchase, and re-evaluates such classification as of each balance sheet date. At December 31, 2008 and 2007, all of the Company's investments in marketable securities were classified as available-for-sale, and as a result, were reported at fair value. Unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss) in stockholders' equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts from the date of purchase to maturity. Such amortization is included in interest income as an addition to or deduction from the coupon interest earned on the investments. The Company follows its investment managers' methods of determining the cost basis in computing realized gains and losses on the sale of its available-for-sale securities, which includes both the specific identification and average cost methods. Realized gains and losses are included in other income (expense).

*Fair Value of Financial Instruments*

The carrying amounts of cash, cash equivalents, accounts receivable and accounts payable approximate their fair values due to the short-term maturities of these instruments. The carrying amount of the Company's marketable securities and capital leases approximate fair value due to the stated interest rates approximating market rates.

*Property and Equipment*

Property and equipment are recorded at cost and are depreciated over the estimated useful lives of the related assets using the straight-line method. The estimated useful lives of property and equipment for purposes of computing depreciation are as follows:

Buildings and improvements .....	5-30 years
Computer hardware and software .....	1-5 years
Software development costs.....	3-5 years
Furniture and fixtures .....	5-7 years
Aircraft .....	20 years

Software development costs relate primarily to the Company's proprietary professional employer information system and are accounted for in accordance with Statement of Position ("SOP") 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

The Company accounts for software acquired in connection with the 2005 acquisition of HRTools.com in accordance with SFAS No. 86, *Accounting for Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. This Statement establishes standards of financial accounting and reporting for the costs of computer software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process, whether internally developed and produced or purchased.

The Company periodically evaluates its long-lived assets for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 requires that an impairment loss be recognized for assets to be disposed of or held-for-use when the carrying amount of an asset is deemed to not be recoverable. If events or circumstances were to indicate that any of the Company's long-lived assets might be impaired, the Company would assess recoverability based on the estimated undiscounted future cash flows to be generated from the applicable asset. In addition, the Company may record an impairment loss to the extent that the carrying value of the asset exceeded the fair value of the asset. Fair value is generally determined using an estimate of discounted future net cash flows from operating activities or upon disposal of the asset.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During 2007, the Company embarked on a strategy to redevelop the technological platform for the HRTools.com software products; as a result, the unamortized software costs were written down to the net realizable value, resulting in an impairment charge of \$1.2 million, which is included in amortization expense in the Consolidated Statement of Operations.

*Goodwill and Other Intangible Assets*

The purchase prices associated with the December 2005 acquisition of HRTools.com and the 2008 acquisition of USDataLink, contained certain identifiable intangible assets and goodwill. The goodwill and intangible assets are subject to the provisions of SFAS No. 142, “*Goodwill and Other Intangible Assets*” (“SFAS 142”). In accordance with SFAS 142, goodwill and other intangible assets are tested for impairment on an annual basis or when indicators of impairment exist, and written down when impaired. As of December 31, 2008, no impairment write downs were necessary. Furthermore, SFAS 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. Administaff’s purchased intangible assets are carried at cost less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets, five to ten years.

The following table provides the gross carrying amount and accumulated depreciation as of December 31, 2008 and 2007, for each class of intangible assets and goodwill (in thousands):

	<u>2008</u>		<u>2007</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortizable intangible assets:				
Trademarks	\$ 1,613	\$ (233)	\$ 500	\$ (100)
Customer relationships	2,190	(380)	610	(173)
Goodwill	<u>5,405</u>	<u>—</u>	<u>3,948</u>	<u>—</u>
Total goodwill and intangible assets	<u>\$ 9,208</u>	<u>\$ (613)</u>	<u>\$ 5,058</u>	<u>\$ (273)</u>
HRTools.com	\$ 5,058	\$ (410)	\$ 5,058	\$ (273)
USDataLink	<u>4,150</u>	<u>(203)</u>	<u>—</u>	<u>—</u>
	<u>\$ 9,208</u>	<u>\$ (613)</u>	<u>\$ 5,058</u>	<u>\$ (273)</u>

The Company’s amortization expense related to purchased intangible assets other than goodwill was \$340,000 in 2008, \$137,000 in both 2007 and 2006, and is estimated to be \$400,000 per year from 2009 through 2012 and \$318,000 in 2013.

*Health Insurance Costs*

The Company provides group health insurance coverage to its worksite employees through a national network of carriers including UnitedHealthcare (“United”), PacifiCare, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California, Hawaii Medical Service Association and Tufts, all of which provide fully insured policies or service contracts.

The policy with United provides the majority of the Company’s health insurance coverage. As a result of certain contractual terms, the Company has accounted for this plan since its inception using a partially self-funded insurance accounting model. Accordingly, Administaff records the costs of the United Plan, including an estimate of the incurred claims, taxes and administrative fees (collectively the “Plan Costs”) as benefits expense in the

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Consolidated Statements of Operations. The estimated incurred claims are based upon: (i) the level of claims processed during the quarter; (ii) recent claim development patterns under the plan, to estimate a completion rate; and (iii) the number of participants in the plan. Each reporting period, changes in the estimated ultimate costs resulting from claim trends, plan design and migration, participant demographics and other factors are incorporated into the benefits costs.

Additionally, since the plan's inception, under the terms of the contract, United establishes cash funding rates 90 days in advance of the beginning of a reporting quarter. If the Plan Costs for a reporting quarter are greater than the premiums paid and owed to United, a deficit in the plan would be incurred and we would accrue a liability for the excess costs on our Consolidated Balance Sheet. On the other hand, if the Plan Costs for the reporting quarter are less than the premiums paid and owed to United, a surplus in the plan would be incurred and we would record an asset for the excess premiums on our Consolidated Balance Sheet. The terms of the arrangement require us to maintain an accumulated cash surplus in the plan of \$9.0 million, which is reported as long-term prepaid insurance. In April 2007, Administaff and United entered into a new three-year arrangement, which reduced the required accumulated cash surplus in the plan from \$11.0 million to \$9.0 million and included a \$3.3 million administrative fee credit, which was recorded as a reduction of benefits costs in the second quarter of 2007. As of December 31, 2008, Plan Costs were less than the net premiums paid and owed to United by \$30.8 million. As this amount is in excess of the agreed-upon \$9.0 million surplus maintenance level, the \$21.8 million balance is included in prepaid insurance, a current asset, on our Consolidated Balance Sheet. The premiums owed to United at December 31, 2008, were \$11.4 million, which is included in accrued health insurance costs, a current liability on our Consolidated Balance Sheet.

*Workers' Compensation Costs*

Since October 1, 2007, our workers' compensation coverage has been provided through our arrangement with ACE Group of Companies ("ACE"). Under our arrangement with ACE (the "ACE Program"), we bear the economic burden for the first \$1 million layer of claims per occurrence. ACE bears the economic burden for all claims in excess of such first \$1 million layer. The ACE Program is a fully insured policy whereby ACE has the responsibility to pay all claims incurred under the policy regardless of whether we satisfy our responsibilities. Prior to our current relationship with ACE, our coverage from September 1, 2003 through September 30, 2007 was provided through selected member insurance companies of American International Group, Inc. (the "AIG Program"). The AIG Program coverage and structure was consistent with the ACE Program.

Because the Company bears the economic burden of the first \$1 million layer of claims per occurrence, such claims, which are the primary component of the Company's workers' compensation costs, are recorded in the period incurred. Workers compensation insurance includes ongoing healthcare and indemnity coverage whereby claims are paid over numerous years following the date of injury. Accordingly, the accrual of related incurred costs in each reporting period includes estimates, which take into account the ongoing development of claims and therefore requires a significant level of judgment.

The Company employs a third party actuary to estimate its loss development rate, which is primarily based upon the nature of worksite employees' job responsibilities, the location of worksite employees, the historical frequency and severity of workers compensation claims, and an estimate of future cost trends. Each reporting period, changes in the actuarial assumptions resulting from changes in actual claims experience and other trends are incorporated into the Company's workers' compensation claims cost estimates. During the year ended December 31, Administaff reduced accrued workers' compensation costs by \$9.8 million in 2008 and \$19.6 million in 2007, for changes in estimated losses and tax surcharges related to prior reporting periods. Workers' compensation cost estimates are discounted to present value at a rate based upon the U.S. Treasury rates that correspond with the weighted average estimated claim payout period (the average discount rate utilized in 2008 and 2007 was 2.6% and 4.5%, respectively) and are accreted over the estimated claim payment period and included as a component of direct costs in the Company's Consolidated Statements of Operations.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table provides the activity and balances related to incurred but not reported workers' compensation claims for the years ended December 31, 2008 and 2007 (in thousands):

	<u>Year ended</u>	
	<u>2008</u>	<u>2007</u>
Beginning balance	\$ 74,433	\$ 77,424
Accrued claims	38,159	23,237
Present value discount	(3,466)	(3,370)
Paid claims	<u>(26,071)</u>	<u>(22,858)</u>
Ending balance	<u>\$ 83,055</u>	<u>\$ 74,433</u>
Current portion of accrued claims	36,466	\$ 35,317
Long-term portion of accrued claims	<u>46,589</u>	<u>39,116</u>
	<u>\$ 83,055</u>	<u>\$ 74,433</u>

As of December 31, the undiscounted accrued workers' compensation costs were \$98.5 million in 2008 and \$88.5 million in 2007.

At the beginning of each policy period, the insurance carrier establishes monthly funding requirements comprised of premium costs and funds to be set aside for payment of future claims ("claim funds"). The level of claim funds is primarily based upon anticipated worksite employee payroll levels and expected workers compensation loss rates, as determined by the insurance carrier. Monies funded into the program for incurred claims expected to be paid within one year are recorded as restricted cash, a short-term asset, while the remainder of claim funds are included in deposits, a long-term asset in the Company's Consolidated Balance Sheets.

The Company's estimate of incurred claim costs expected to be paid within one year are recorded as accrued workers' compensation costs and included in short-term liabilities, while its estimate of incurred claim costs expected to be paid beyond one year are included in long-term liabilities on the Company's Consolidated Balance Sheets.

As of December 31, 2008, the Company had restricted cash of \$36.5 million and deposits of \$56.4 million.

*Stock-Based Compensation*

At December 31, 2008, the Company has three stock-based employee compensation plans. Effective January 1, 2006, the Company began accounting for these plans under the recognition and measurement principles of Financial Accounting Standards Board ("FASB") Statement No. 123 (revised 2004), *Share-Based Payment* ("Statement 123(R)"). Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. The Company adopted Statement 123(R) using the "modified prospective" method in which compensation cost is recognized beginning with the effective date: (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date; and (b) based on the requirements of Statement 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain unvested on the effective date.

The Company generally makes annual grants of restricted and unrestricted stock under its stock-based incentive compensation plans to its directors, officers and other management. Restricted stock grants to officers and other management vest over three to five years from the date of grant. Annual stock grants issued to directors are



**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

100% vested on the grant date. Shares of restricted stock are based on fair value on date of grant and the associated expense net of estimated forfeitures is recognized over the vesting period.

*Company-Sponsored 401(k) Plans*

Under the Company's 401(k) plan for corporate employees (the "Corporate Plan"), the Company matches 100% of eligible corporate employees' contributions, up to 6% of the employee's eligible compensation. Under the Company's separate 401(k) plan for worksite employees (the "Worksite Employee Plan"), the match percentage for worksite employees ranges from 0% to 6%, as determined by each client company. Matching contributions under the Corporate Plan and the Worksite Employee Plan are immediately vested. During 2008, 2007 and 2006, the Company made matching contributions to the Corporate and Worksite Employee Plans of \$52.0 million, \$44.0 million and \$32.8 million, respectively. Of these contributions, \$47.3 million, \$39.8 million and \$29.2 million were made under the Worksite Employee Plan on behalf of worksite employees. The remainder represents matching contributions made under the Corporate Plan on behalf of corporate employees.

*Advertising*

The Company expenses all advertising costs as incurred.

*Income Taxes*

The Company uses the liability method in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and income tax carrying amounts of assets and liabilities and are measured using the enacted tax rates and laws in effect when the differences are expected to reverse.

*New Accounting Pronouncements*

In September 2006, FASB Statement 157, "*Fair Value Measurements*" ("SFAS 157") was issued. SFAS 157 establishes a framework for measuring fair value by providing a standard definition of fair value as it applies to assets and liabilities. SFAS 157, which does not require any new fair value measurements, clarifies the application of other accounting pronouncements that require or permit fair value measurements. Our effective date was initially January 1, 2008. However, the FASB has released FASB Staff Position No. *FAS 157-b, Effective Date of FASB Statement No. 157*, which delayed the effective date of Statement 157 for all non-financial assets and non-financial liabilities until fiscal years beginning after November 15, 2008. Accordingly, we adopted SFAS on January 1, 2008 for our financial assets and liabilities only. The adoption of SFAS 157 for our financial assets and liabilities did not have a material impact on our consolidated financial statements and we do not anticipate a material impact when applied to our non-financial assets and liabilities.

In December 2007, the FASB Statement 141R, "*Business Combinations*" ("SFAS 141R") was issued. SFAS 141R replaces SFAS 141. SFAS 141R requires the acquirer of a business to recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at fair value. SFAS 141R also requires transactions costs related to the business combination to be expensed as incurred. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Our effective date was January 1, 2009. We have not yet determined the impact of SFAS 141R, if any, on our consolidated financial statements, because the impact of SFAS 141R is fact-specific and will not be invoked until we acquire a business after the effective date.

In June 2008, the FASB issued Emerging Issue Task Force ("EITF") EITF 03-6-1, "*Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*." ("EITF 03-6-1") was issued. EITF 03-6-1 concludes that unvested restricted share awards that pay nonforfeitable cash dividends are

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

participating securities and are subject to the two-class method of computing earnings per share. Our effective date for EITF 03-6-1 was January 1, 2009. We do not anticipate the adoption of EITF 03-6-1 will have a material impact on our Consolidated Financial Statements.

In October 2008, the FASB Staff Position No. FAS 157-3, “*Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active*” (“FAS 157-3”). FAS 157-3 clarifies the methods employed in determining the fair value for financial assets when a market for such assets is not active. FSP No. FAS 157-3 was effective immediately. The adoption of FAS 157-3 did not have a significant impact on our Consolidated Financial Statements.

**2. Cash, Cash Equivalents and Marketable Securities**

The following table summarizes the Company’s investments in cash equivalents and marketable securities held by investment managers and overnight investments:

	<b>December 31, 2008</b>	<b>December 31, 2007</b>
	<b>(in thousands)</b>	
<u>Overnight Holdings</u>		
Money market funds (cash equivalents) .....	\$ 181,594	\$ 130,435
<u>Investment Holdings</u>		
Money market funds (cash equivalents) .....	85,127	9,824
Marketable securities .....	225	74,880
Total	\$ 266,946	\$ 215,139

The Company’s overnight holdings fluctuate based on the timing of the client’s payroll processing cycle. Included in the overnight holdings balance as of December 31, 2008, are \$108.8 million in withholdings associated with federal and state income taxes, employment taxes and other payroll deductions; as well as \$49.3 million in client prepayments. Please read “*Cash Flows from Operating Activities – Timing of Client Payments/Payrolls*,” on page 37 for additional information.

On January 1, 2008, the Company adopted SFAS No. 157 “Fair Value Measurements” (“SFAS 157”), for financial assets and liabilities. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The fair value measurement disclosures are grouped into three levels based on valuation factors:

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

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the levels of fair value measurements of the Company's financial assets:

	<b>Fair Value Measurements</b>			
	<b>(in thousands)</b>			
<b>December 31,</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>2008</b>				
Money market funds.....	\$ 266,721	\$ 266,721	\$ —	\$ —
Municipal bonds .....	<u>225</u>	<u>225</u>	<u>—</u>	<u>—</u>
Total	\$ 266,946	\$ 266,946	\$ —	\$ —

The following is a summary of the Company's available-for-sale marketable securities as of December 31, 2008 and 2007:

	<b>Amortized</b>	<b>Gross</b>	<b>Gross</b>	<b>Estimated</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Fair Value</b>
		<b>Gains</b>	<b>Losses</b>	
		<b>(in thousands)</b>		
<i>December 31, 2008:</i>				
State and local government securities .....	<u>\$ 225</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 225</u>
	<u>\$ 225</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 225</u>
<i>December 31, 2007:</i>				
State and local government securities .....	<u>\$ 74,875</u>	<u>\$ 5</u>	<u>\$ —</u>	<u>\$ 74,880</u>
	<u>\$ 74,875</u>	<u>\$ 5</u>	<u>\$ —</u>	<u>\$ 74,880</u>

For the years ended December 31, 2008, 2007 and 2006, the Company's realized gains and losses recognized on sales of available-for-sales marketable securities are as follows:

	<b>Realized</b>	<b>Realized</b>	<b>Net</b>
	<b>Gains</b>	<b>Losses</b>	<b>Realized</b>
			<b>Gains</b>
			<b>(Losses)</b>
	<b>(in thousands)</b>		
2008 .....	\$ —	\$ —	\$ —
2007 .....	1	(407)	(406)
2006 .....	1	—	1

### 3. Accounts Receivable

The Company's accounts receivable is primarily composed of trade receivables and unbilled receivables. The Company's trade receivables, which represent outstanding gross billings to clients, are reported net of allowance for doubtful accounts of \$977,000 and \$809,000 as of December 31, 2008 and 2007, respectively. The Company establishes an allowance for doubtful accounts based on management's assessment of the collectability of specific accounts and by making a general provision for other potentially uncollectible amounts.

The Company makes an accrual at the end of each accounting period for its obligations associated with the earned but unpaid wages of its worksite employees and for the accrued gross billings associated with such wages. These accruals are included in accrued worksite employee payroll cost and unbilled accounts receivable; however, these amounts are presented net in the Consolidated Statements of Operations. The Company generally requires that

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

clients pay invoices for service fees no later than one day prior to the applicable payroll date. As such, the Company generally does not require collateral. Customer prepayments directly attributable to unbilled accounts receivable have been netted against such receivables as the gross billings have been earned and the payroll cost has been incurred, thus the Company has the legal right of offset for these amounts. As of December 31, 2008 and 2007, unbilled accounts receivable consisted of the following:

	<b>2008</b>	<b>2007</b>
	<b>(in thousands)</b>	
Accrued worksite employee payroll cost .....	\$ 129,954	\$ 110,406
Unbilled revenues .....	35,551	30,370
Customer prepayments .....	<u>(49,332)</u>	<u>(15,458)</u>
Unbilled accounts receivable .....	<u>\$ 116,173</u>	<u>\$ 125,318</u>

**4. Deposits**

The contractual arrangement with United for health insurance coverage requires Administaff to maintain an accumulated cash surplus in the plan of \$9.0 million, which is reported as long-term prepaid health insurance. Please see Note 1 for a discussion of our accounting policies for health insurance costs.

As of December 31, 2008, the Company had \$56.4 million of workers' compensation long-term deposits. Please see Note 1 for a discussion of our accounting policies for workers' compensation costs.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**5. Income Taxes**

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities used for financial reporting purposes and the amounts used for income tax purposes. Significant components of the net deferred tax assets and net deferred tax liabilities as reflected on the balance sheet are as follows:

	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
	(in thousands)	
Deferred tax liabilities:		
Prepaid assets .....	\$(10,968)	\$ (9,114)
Depreciation .....	(8,160)	(3,858)
Software development costs.....	(706)	(855)
Other .....	<u>(142)</u>	<u>(52)</u>
Total deferred tax liabilities.....	(19,976)	(13,879)
Deferred tax assets:		
Workers' compensation accruals .....	2,778	3,092
Long-term capital loss carry-forward .....	184	1,142
State unemployment tax accruals.....	164	526
Accrued rent .....	1,340	651
Stock-based compensation .....	2,807	2,147
Uncollectible accounts receivable.....	<u>366</u>	<u>305</u>
Total deferred tax assets.....	7,639	7,863
Valuation allowance .....	<u>(184)</u>	<u>(1,142)</u>
Total net deferred tax assets .....	<u>7,455</u>	<u>6,721</u>
Net deferred tax liabilities .....	<u>\$(12,521)</u>	<u>\$ (7,158)</u>
Net current deferred tax liabilities .....	\$ (1,956)	\$ (1,066)
Net noncurrent deferred tax liabilities .....	<u>(10,565)</u>	<u>(6,092)</u>
	<u>\$(12,521)</u>	<u>\$ (7,158)</u>

The components of income tax expense are as follows:

	<u>Year ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(in thousands)		
Current income tax expense:			
Federal .....	\$19,171	\$20,328	\$19,778
State .....	<u>1,703</u>	<u>1,248</u>	<u>1,594</u>
Total current income tax expense.....	20,874	21,576	21,372
Deferred income tax expense:			
Federal .....	5,111	4,091	3,900
State .....	<u>252</u>	<u>280</u>	<u>304</u>
Total deferred income tax expense.....	<u>5,363</u>	<u>4,371</u>	<u>4,204</u>
Total income tax expense .....	<u>\$26,237</u>	<u>\$25,947</u>	<u>\$25,576</u>

In 2008, 2007 and 2006, net income tax benefits of \$821,000, \$2.9 million and \$12.7 million, respectively, resulting from deductions relating to nonqualified stock option exercises and disqualifying dispositions of certain employee incentive stock options were recorded as increases in stockholders' equity.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The reconciliation of income tax expense computed at U.S. federal statutory tax rates to the reported income tax expense from continuing operations is as follows:

	<b>Year ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>		
Expected income tax expense at 35% .....	\$25,206	\$25,704	\$25,229
State income taxes, net of federal benefit.....	1,372	1,152	1,233
Nondeductible expenses .....	906	754	503
Tax-exempt interest income .....	(1,098)	(1,814)	(1,394)
Valuation allowance against long-term capital loss carry-forward .....	—	142	—
Other, net .....	(149)	9	5
Reported total income tax expense .....	<u>\$26,237</u>	<u>\$25,947</u>	<u>\$25,576</u>

The Company has capital loss carryforwards totaling approximately \$500,000 that will expire during 2012, but can only be used to offset future capital gains. The Company has a valuation allowance of \$500,000 against these related deferred tax assets as it is uncertain that the Company will be able to utilize the capital loss carryforwards prior to their expiration. In addition, the Company has incurred net operating losses at the subsidiary level for state income tax purposes totaling \$1.9 million (\$134,000 tax effected) that expire from 2009 to 2027.

The Company adopted the provisions of FASB Interpretation No. 48 “*Accounting for Uncertainty in Income Taxes*” (“FIN 48”) an interpretation of FASB Statement No. 109 *Accounting for Income Taxes*, on January 1, 2007. The adoption of FIN 48 resulted in no impact to the Company’s consolidated financial statements.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of December 31, 2008, the Company made no provisions for interest or penalties related to uncertain tax positions. The tax years 2005 through 2008 remain open to examination by the Internal Revenue Service of the United States.

The Company’s provision for income taxes differed from the U.S. statutory rate of 35% primarily due to state income taxes and non-deductible expenses, offset by tax exempt interest income. The income tax rate for the year ended December 31, 2008 was 36.4%.

## **6. Stockholders’ Equity**

The Company’s Board of Directors (the “Board”) has authorized a program to repurchase up to 12,500,000 shares of the Company’s outstanding common stock. The purchases are to be made from time to time in the open market or directly from stockholders at prevailing market prices based on market conditions or other factors. During 2008, 2007 and 2006, the Company repurchased 1,731,025, 2,342,094, and 614,126 shares at a cost of \$38.1 million, \$80.5 million and \$24.2 million, respectively. As of December 31, 2008, the Company had repurchased 12,088,868 shares under this program at a total cost of approximately \$237.7 million. As a result, the Company has the authorization to repurchase an additional 411,132 shares.

During the third and fourth quarters of 2008 the Board declared a dividend of \$0.13 per share of common stock. During the first and second quarter of 2008 and each quarter of 2007, the Board declared a dividend of \$0.11 per share of common stock, resulting in a total of \$12.4 million and \$11.9 million in dividend payments paid by the Company, respectively.

At December 31, 2008, 20 million shares of preferred stock were authorized and were designated as Series A Junior Participating Preferred Stock that is reserved for issuance on exercise of preferred stock purchase rights under Administaff’s Share Purchase Rights Plan (the “Rights Plan”). Each issued share of the Company’s common stock has

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

one preferred stock purchase right attached to it. No preferred shares have been issued and the rights are not currently exercisable. The Rights Plan expires on November 13, 2017.

**7. Incentive Plans**

The Administaff, Inc. 1997 Incentive Plan, as amended, and the 2001 Incentive Plan, as amended, (collectively, the “Incentive Plans”) provide for options and other stock-based awards that may be granted to eligible employees and non-employee directors of the Company or its subsidiaries. The 2001 Incentive Plan is currently the only Administaff plan under which stock-based awards may be granted. No new stock-based awards may be made under any other plan. The Incentive Plans are administered by the Compensation Committee of the Board of Directors (the “Committee”). The Committee has the power to determine which eligible employees will receive awards, the timing and manner of the grant of such awards, the exercise price of stock options (which may not be less than market value on the date of grant), the number of shares and all of the terms of the awards. The Board may at any time amend or terminate the Incentive Plans. However, no amendment that would impair the rights of any participant, with respect to outstanding grants, can be made without the participant’s prior consent. Stockholder approval of amendments to the Incentive Plans is necessary only when required by applicable law or stock exchange rules. The 1997 Incentive Plan expired on April 24, 2005; therefore no new grants may be made under the Plan. At December 31, 2008, 625,986 shares of common stock were available for future grants under the 2001 Incentive Plan. The Incentive Plans permit stock options, including nonqualified stock options and options intended to qualify as “incentive stock options” within the meaning of Section 422 of the Internal Revenue Code (the “Code”), stock awards, phantom stock awards, stock appreciation rights, performance units, and other stock-based awards and cash awards, all of which may or may not be subject to the achievement of one or more performance objectives. The purposes of the Incentive Plans generally are to retain and attract persons of training, experience and ability to serve as employees of the Company and its subsidiaries and to serve as non-employee directors of the Company, to encourage the sense of proprietorship of such persons and to stimulate the active interest of such persons in the development and financial success of the Company and its subsidiaries.

The Administaff Nonqualified Stock Option Plan (the “Nonqualified Plan”) provided for options to purchase shares of the Company’s common stock that were granted to employees who are not officers. An aggregate of 3,600,000 shares of common stock of the Company were authorized to be issued under the Nonqualified Plan. Although there are approximately 640,000 unissued shares remaining, no new awards may be granted under the Nonqualified Plan. The Committee may at any time terminate or amend the Nonqualified Plan, provided that no such amendment may adversely affect the rights of optionees with regard to outstanding options.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Stock Option Awards*

The following summarizes stock option activity and related information:

	Year ended December 31,					
	2008		2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
	(in thousands, except per share amounts)					
Outstanding – beginning of year	1,823	\$ 23.48	2,127	\$ 22.02	3,174	\$ 20.32
Granted	13	28.69	—	—	—	—
Exercised	(223)	14.27	(301)	13.10	(1,028)	16.37
Cancelled	(3)	43.69	(3)	32.98	(19)	43.36
Outstanding – end of year	<u>1,610</u>	\$ 24.76	<u>1,823</u>	\$ 23.48	<u>2,127</u>	\$ 22.02
Exercisable – end of year	<u>1,610</u>	\$ 24.76	<u>1,823</u>	\$ 23.48	<u>2,127</u>	\$ 22.02
Weighted average fair value of options granted during year		\$ 28.69		\$ —		\$ —
Intrinsic value of options outstanding at year end		\$ 5,289		\$ 15,519		\$ 44,321

The following summarizes information related to stock options outstanding at December 31, 2008:

<b>Options Outstanding &amp; Exercisable</b>			
<u>Range of Exercise Prices</u>	<u>Shares</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Weighted Average Exercise Price</u>
(share amounts in thousands)			
\$ 4.02 to \$10.00	146	2.7	\$ 7.48
\$10.01 to \$15.00	153	4.6	12.92
\$15.01 to \$20.00	611	2.6	18.61
\$20.01 to \$30.00	263	3.0	24.16
\$30.01 to \$43.69	<u>437</u>	1.7	43.66
Total	<u>1,610</u>	2.6	\$ 24.76

*Restricted Stock Awards*

Restricted common shares, under fixed plan accounting, are generally measured at fair value on the date of grant based on the number of shares granted, estimated forfeitures and the quoted price of the common stock. Such value is recognized as compensation expense over the corresponding vesting period, three to five years for the Company's shares currently outstanding. The Company has recognized \$10.0 million, \$7.5 million and \$3.4 million of compensation expense associated with the restricted stock awards in 2008, 2007 and 2006, respectively. As of December 31, 2008, unrecognized compensation expense associated with the non-vested shares outstanding was \$11.6 million and is expected to be recognized over a weighted average period of 20 months.



**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following summarizes restricted stock awards as of December 31, 2008, 2007 and 2006:

	<b>Year ended December 31,</b>					
	<b>2008</b>		<b>2007</b>		<b>2006</b>	
	<b>Shares</b>	<b>Market Value at Grant Date</b>	<b>Shares</b>	<b>Market Value at Grant Date</b>	<b>Shares</b>	<b>Market Value at Grant Date</b>
Non-vested – beginning of year	528,049	\$ 34.09	404,793	\$ 30.33	284,200	\$ 14.86
Granted	414,948	24.61	296,302	35.53	230,354	43.17
Vested	(267,227)	26.21	(171,345)	39.28	(101,060)	43.10
Cancelled/Forfeited	(6,302)	26.22	(1,701)	27.04	(8,701)	23.25
Non-vested – end of year	<u>669,468</u>	\$ 29.77	<u>528,049</u>	34.09	<u>404,793</u>	30.33

**8. Earnings Per Share**

The numerator used in the calculations of both basic and diluted net income per share for all periods presented was net income. The denominator for each period presented was determined as follows:

	<b>Year ended December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>		
Denominator:			
Basic - weighted average shares outstanding.....	25,233	26,660	27,470
Effect of dilutive securities – treasury stock method:			
Common stock options .....	247	537	790
Restricted stock awards.....	<u>97</u>	<u>67</u>	<u>101</u>
Diluted - weighted average shares outstanding plus effect of dilutive securities.....	<u>25,577</u>	<u>27,264</u>	<u>28,361</u>

Options and/or restricted stock awards to purchase 692,000, 808,000 and 326,000 shares of common stock were not included in the diluted net income per share calculation for 2008, 2007 and 2006, respectively, because their inclusion would have been anti-dilutive.

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**9. Leases**

The Company leases various office facilities, furniture, equipment and vehicles under capital and operating lease arrangements, some of which contain rent escalation clauses. Most of the leases contain purchase and/or renewal options at fair market and fair rental value, respectively. Rental expense relating to all operating leases was \$12,145,000, \$10,460,000 and \$9,586,000 in 2008, 2007 and 2006, respectively. At December 31, 2008, future minimum rental payments under noncancelable operating and capital leases are as follows (in thousands):

	<b><u>Operating Leases</u></b>	<b><u>Capital Leases</u></b>
2009.....	\$ 13,662	\$ 555
2010.....	13,007	—
2011.....	11,643	—
2012.....	9,841	—
2013.....	8,102	—
Thereafter.....	<u>9,400</u>	<u>—</u>
Total minimum lease payments.....	<u>\$ 65,655</u>	<u>\$ 555</u>
Less amount representing interest.....		<u>(18)</u>
Total present value of minimum payments .....		537
Less current portion.....		<u>537</u>
Long-term capital lease obligations .....		<u>\$ —</u>

*Capital Lease Obligations*

In October 2002, the Company entered into a capital lease arrangement to finance the purchase of office furniture. The assets under capital lease were capitalized using an effective interest rate of 7.5%. The current monthly lease payments are \$58,000 per month over the seven-year lease term. As of December 31, 2008 and 2007, the capitalized cost and accumulated amortization under the capital lease arrangement were \$3.8 million and \$3.4 million, and \$3.8 million and \$2.8 million, respectively. Amortization of the capitalized lease costs is included in depreciation and amortization in the Consolidated Statements of Operations.

**10. Commitments and Contingencies**

The Company enters into non-cancelable fixed purchase and service obligations in the ordinary course of business. These arrangements primarily consist of advertising commitments and service contracts. At December 31, 2008 future non-cancelable purchase and service obligations greater than \$100,000 and one year were as follows (in thousands):

2009.....	\$ 8,240	
2010.....	3,300	
2011.....	790	
2012.....	190	
2013.....	150	
Thereafter.....	<u>150</u>	
Total obligations .....	<u>\$ 12,820</u>	

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

**ADMINISTAFF, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*State Unemployment Taxes*

During the second quarter 2008, the State of Colorado Department of Labor and Employment, Unemployment Insurance Division (the “Division”) notified the Company of its identification of discrepancies, originating in 2002, regarding the application of the provisions of the Colorado Employment Security Act. The Division indicated that it is reviewing Administaff’s prior corporate reorganizations to determine whether the state unemployment accounts of certain Administaff subsidiaries should be combined into a single account, which could result in higher rates for certain prior and prospective periods. The Division has not issued a formal assessment of any additional taxes owed. The Company does not believe there is any valid basis for an assessment of additional taxes.

**11. Quarterly Financial Data (Unaudited)**

	<b>Quarter ended</b>			
	<b>March 31</b>	<b>June 30</b>	<b>Sept. 30</b>	<b>Dec. 31</b>
	(in thousands, except per share amounts)			
<i>Year ended December 31, 2008:</i>				
Revenues .....	\$ 456,066	\$ 420,469	\$ 421,914	\$ 425,985
Gross profit .....	86,607	84,061	85,499	87,572
Operating income .....	17,986	15,572	16,923	14,501
Net income .....	13,156	10,987	11,929	9,708
Basic net income per share .....	0.52	0.43	0.47	0.39
Diluted net income per share .....	0.51	0.43	0.46	0.39
 <i>Year ended December 31, 2007:</i>				
Revenues .....	\$ 407,758	\$ 376,758	\$ 383,380	\$ 402,081
Gross profit .....	68,067	78,467	75,042	84,346
Operating income .....	10,027	18,314	15,802	18,071 <sup>(1)</sup>
Net income .....	8,393	13,645	12,154	13,300
Basic net income per share .....	0.31	0.51	0.46	0.51
Diluted net income per share .....	0.30	0.50	0.45	0.50

(1) In December 2007, the Company incurred an impairment charge of \$1.2 million related to software acquired in the HRTools.com acquisition. Please read Footnote 1, “Accounting Policies – Property and Equipment” on page F-14.

## GAAP to Non-GAAP Reconciliation

**Year ended Dec. 31, 2008**

**(in thousands)**

Net income (GAAP)	\$ 45,780
Interest expense	66
Income tax expense	26,237
Depreciation and amortization	<u>15,570</u>
EBITDA	<u>\$ 87,653</u>

EBITDA represents net income computed in accordance with generally accepted accounting principles (“GAAP”), plus interest expense, income tax expense, depreciation and amortization expense. Administration management believes EBITDA is often a useful measure of the Company’s operating performance, as it allows for additional analysis of the Company’s operating results separate from the impact of taxes and capital and financing transactions on earnings.

EBITDA is not a financial measure prepared in accordance with GAAP and may be different from similar measures used by other companies. EBITDA should not be considered as a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP. Administration includes EBITDA in this report because the Company believes it is useful to investors in allowing for greater transparency related to the Company’s operating performance during the periods presented. Investors are encouraged to review the reconciliation of the non-GAAP financial measures used in this report to the most directly comparable GAAP financial measure as provided in the tables above.

THIS PAGE INTENTIONALLY LEFT BLANK

# Officers

## Paul J. Sarvadi

Chairman and Chief Executive Officer

## Richard G. Rawson

President

## A. Steve Arizpe

Executive Vice President of Client Services  
and Chief Operating Officer

## Jay E. Mincks

Executive Vice President of Sales and Marketing

## Daniel D. Herink

Senior Vice President of Legal, General Counsel  
and Secretary

## Douglas S. Sharp

Senior Vice President of Finance, Chief Financial Officer  
and Treasurer

## Mark W. Allen

Senior Vice President of Strategic Planning

## Gregory R. Clouse

Senior Vice President of Service Operations

## Betty L. Collins

Senior Vice President of Corporate Human Resources

## Roger L. Gaskamp

Senior Vice President of Client Selection and Pricing

## Samuel G. Larson

Senior Vice President of Enterprise and Technology Solutions

## Randall H. McCollum

Senior Vice President of Strategic Alliances

## Ronald M. McGee

Senior Vice President of Property and Casualty Products  
and Services

## Martin K. Scirratt

Senior Vice President of Sales

# Corporate Information

## Corporate Headquarters

19001 Crescent Springs Drive  
Kingwood, Texas 77339-3802  
281-358-8986

## Sales Department

800-465-3800

## Web Site

[www.administaff.com](http://www.administaff.com)

## Independent Auditors

Ernst & Young LLP  
5 Houston Center  
1401 McKinney, Suite 1200  
Houston, Texas 77010

## Legal Counsel

Baker Botts LLP  
One Shell Plaza  
910 Louisiana  
Houston, Texas 77002-4995

## Board of Directors

Members of the Board of Directors can be contacted  
at [directors@administaff.com](mailto:directors@administaff.com).

## Certifications

The Company has filed the required certifications under Section 302 of the Sarbanes-Oxley Act of 2002 as Exhibits 31.1 and 31.2 to our Annual Report on Form 10-K for the year ended December 31, 2008. After the 2009 Annual Meeting of Stockholders, the Company intends to file with the New York Stock Exchange (NYSE) the CEO certification regarding its compliance with the NYSE's corporate governance listing standards as required by Rule 303A.12. In 2008, the Company filed this CEO certification with the NYSE on May 29.

## Transfer Agent and Registrar

BNY Mellon Shareowner Services  
480 Washington Boulevard  
Jersey City, New Jersey 07313-1900  
866-229-4421

TDD for Hearing Impaired: 800-231-5469

Foreign Shareholders: 201-680-6578

TDD Foreign Shareholders: 201-680-6610

Web Site: [www.bnymellon.com/shareowner/isd](http://www.bnymellon.com/shareowner/isd)

## Common Stock

Administaff, Inc.'s common stock is traded on the  
New York Stock Exchange under the symbol "ASF."

## Annual Meeting

Administaff, Inc.'s Annual Meeting of Shareholders  
will be held at 3 p.m. CDT on Tuesday, May 5, 2009,  
at the Company's corporate headquarters, Centre I,  
in the Auditorium, located at 22900 Highway 59N  
(Eastex Freeway), Kingwood, Texas 77339.

## Investor Relations

Shareholders are encouraged to contact the Company  
with questions or requests for information. Copies of  
the Company's Annual Report on Form 10-K as filed  
with the Securities and Exchange Commission are  
available without charge upon written request.

Inquiries should be directed to:

Investor Relations Administrator  
Administaff, Inc.  
19001 Crescent Springs Drive  
Kingwood, Texas 77339-3802  
281-348-3987

# Board of Directors



## Michael W. Brown | Independent Director

Mr. Brown, age 63, joined the Company as a Class I director in November 1997. He is a member of the Company's Finance, Risk Management and Audit Committee and the Nominating and Corporate Governance Committee. Mr. Brown is the past Chairman of the Nasdaq Stock Market Board of Directors and a past governor of the National Association of Securities Dealers.

Mr. Brown joined Microsoft Corporation in 1989 as its Treasurer and became its Chief Financial Officer in 1993, in which capacity he served until his retirement in July 1997. Prior to joining Microsoft, Mr. Brown spent 18 years with Deloitte & Touche LLP. Mr. Brown is also a director of EMC Corporation, VMware, Inc., 360networks, FatKat, Inc., Pipeline Financial Group, Inc., and Thomas Weisel Partners and serves on the audit committees of EMC Corporation, Thomas Weisel Partners and VMware, Inc. He is a member of the Particle Economics Research Institute. Mr. Brown holds a Bachelor of Science in Economics from the University of Washington in Seattle.



## Jack M. Fields, Jr. | Independent Director

Mr. Fields, age 57, joined the Company as a Class III director in January 1997 following his retirement from the United States House of Representatives, where he served for 16 years. Mr. Fields is a member of the Company's Compensation Committee and the Nominating and Corporate Governance Committee. During 1995 and 1996, Mr. Fields served as Chairman of the House

Telecommunications and Finance Subcommittee, which has jurisdiction and oversight of the Federal Communications Commission and the Securities and Exchange Commission. Mr. Fields has been Chief Executive Officer of the Twenty-First Century Group in Washington, D.C. since January 1997. Mr. Fields also serves on the Board of Directors for AIM Management Group, Inc., the Discovery Channel – Global Education Fund, and the Advisory Council of the Honors College at Baylor University. Mr. Fields earned a Bachelor of Arts in 1974 from Baylor University, and graduated from Baylor Law School in 1977.



## Dr. Eli Jones | Independent Director

Dr. Jones, age 47, joined the Company as a Class I director in April 2004. He is Chairman of the Company's Compensation Committee and a member of the Nominating and Corporate Governance Committee. Dr. Jones is Dean of the E. J. Ourso College of Business and Ourso Distinguished Professor of Business at Louisiana State University. Prior to joining the faculty at Louisiana State University, he was

Professor of Marketing and Associate Dean at the C.T. Bauer College of Business at the University of Houston from 2007 to 2008; an Associate Professor of Marketing from 2002 to 2007; and an Assistant Professor from 1997 until 2002. He taught at Texas A&M University for several years before joining the faculty of the University of Houston. He served as the Executive Director of the Program for Excellence in Selling and the Sales Excellence Institute at the University of Houston from 1997 until 2007. Dr. Jones also serves on the editorial review boards of the Journal of the Academy of Marketing Sciences, Journal of Personal Selling and Sales Management, Journal of Business and Industrial Marketing, and Industrial Marketing Management. He has conducted research and published articles on sales and sales management topics in major journals and is the co-author of a sales textbook, *Selling ASAP*, and a professional book: *Strategic Sales Leadership*. Dr. Jones is also an ad hoc reviewer for the Journal of Marketing, Journal of Business Research, American Marketing Association, and the National Conference in Sales Management. Before becoming a professor, Dr. Jones worked in sales and sales management for three Fortune 100 companies: Quaker Oats, Nabisco and Frito-Lay. He received his Bachelor of Science degree in Journalism in 1982, his MBA in 1986 and his Ph.D. in 1997 from Texas A&M University.



## Paul S. Lattanzio | Independent Director

Mr. Lattanzio, age 45, has been a Class III director of the Company since 1995. He is a member of the Company's Finance, Risk Management and Audit Committee and the Nominating and Corporate Governance Committee. Mr. Lattanzio served as a Senior Managing Director and head of Bear Growth Capital Partners, a private equity group, from July 2003 to February 2009. He previously

served as a Managing Director for TD Capital Communications Partners (f/k/a Toronto Dominion Capital), a venture capital investment firm, from July 1999 until July 2002. From February 1998 to March 1999, he was a co-founder and Senior Managing Director of NMS Capital Management, LLC, a \$600 million private equity fund affiliated with NationsBanc Montgomery Securities. Prior to NMS Capital, Mr. Lattanzio served in several positions with various affiliates of Bankers Trust New York Corporation for over 13 years, most recently as a Managing Director of BT Capital Partners, Inc. Mr. Lattanzio has experience in a variety of investment banking disciplines, including mergers and acquisitions, private placements and restructuring. Mr. Lattanzio received his Bachelor of Science in Economics with honors from the University of Pennsylvania's Wharton School of Business in 1984.



## Gregory E. Petsch | Independent Director

Mr. Petsch, age 58, joined the Company as a Class I director in October 2002. He is Chairman of the Company's Nominating and Corporate Governance Committee and a member of the Compensation Committee. Mr. Petsch retired from Compaq Computer Corporation in 1999 where he had held various positions since 1983, most recently as Senior Vice President of Worldwide

Manufacturing and Quality since 1991. Prior to joining Compaq, he worked for 10 years for Texas Instruments. In 1992, Mr. Petsch was voted Manufacturing Executive of the Year by Upside Magazine, and in 1993 – 1995 he was nominated Who's Who of Global Business Leaders. He is founder and President of Petsch Foundation, Inc. He earned a Bachelor of Business Technology degree from the University of Houston in 1978.



## Richard G. Rawson | Management Director

Mr. Rawson, age 60, President of the Company and its subsidiaries, is a Class III director and has been a director of the Company since 1989. He has been President since August 2003. Before being elected President, he served as Executive Vice President of Administration, Chief Financial Officer and Treasurer of the Company from February 1997 until August 2003. Prior to that, he served as

Senior Vice President, Chief Financial Officer and Treasurer of the Company since 1989. Prior to joining the Company in 1989, Mr. Rawson served as a Senior Financial Officer and Controller for several companies in the manufacturing and seismic data processing industries. Mr. Rawson also serves on the University of Houston's C.T. Bauer College of Business Dean's Executive Advisory Board and on the Board of Directors of the YMCA of Greater Houston. He previously served the National Association of Professional Employer Organizations (NAPEO) as President (1999-2000), First Vice President, Second Vice President and Treasurer. In addition, he previously served as Chairman of the Accounting Practices Committee of NAPEO for five years. Mr. Rawson has a Bachelor of Business Administration in finance from the University of Houston.



## Paul J. Sarvadi | Management Director

Mr. Sarvadi, age 52, Chairman of the Board and Chief Executive Officer and co-founder of the Company and its subsidiaries, is a Class II director and has been a director and Chairman of the Board since the Company's inception in 1986. He has also served as the Chief Executive Officer of the Company since 1989. He also served as President of the Company from 1989 until August 21, 2003.

He attended Rice University and the University of Houston prior to starting and operating several small companies. Mr. Sarvadi has served as President of NAPEO and was a member of its Board of Directors for five years. He also served as President of the Texas Chapter of the NAPEO for three of the first four years of its existence. Mr. Sarvadi serves on the Board of Trustees of the DePelchin Children's Center in Houston. In 1995, Mr. Sarvadi was selected as Houston's Ernst & Young Entrepreneur of the Year for service industries and in 2001, he was selected as the 2001 National Ernst & Young Entrepreneur of the Year for service industries. In 2004, he received the Conn Family Distinguished New Venture Leader Award from Mays Business School at Texas A&M University. In 2007, he was inducted into the Texas Business Hall of Fame.



## Austin P. Young | Independent Director

Mr. Young, age 68, joined the Company as a Class II director in January 2003. He is Chairman of the Company's Finance, Risk Management and Audit Committee and a member of the Nominating and Corporate Governance Committee. Mr. Young served as Senior Vice President, Chief Financial Officer and Treasurer of CellStar Corporation from 1999 to December 2001, when he retired. From

1996 to 1999, he served as Executive Vice President - Finance and Administration of Metamor Worldwide, Inc. Mr. Young also held the position of Senior Vice President and Chief Financial Officer of American General Corporation for over eight years and was a partner in the Houston and New York offices of KPMG before joining American General. Mr. Young currently serves as a Director and Chairman of the Audit Committees of Tower Group, Inc. and Amerisafe, Inc. He is a member of the Houston and State Chapters of the Texas Society of CPAs, the American Institute of CPAs, and the Financial Executives Institute. He holds an accounting degree from the University of Texas.



19001 Crescent Springs Drive  
Kingwood, TX 77339-3802  
[www.administaff.com](http://www.administaff.com)