20/20

Forward Vision

Celebrating 20 years of service to small business.

Administaff

2005 Annual Report

**Forward Vision** has been central to Administaff from day one. So as we celebrate the Company's first 20 years, we also are focused on our next 20 years. Our goal is to continue helping small businesses succeed by capitalizing on our opportunities with integrity and innovation.

Administaff has grown from three clients and 32 work-site employees in 1986 to more than 5,000 clients and 94,000 worksite employees at year-end 2005. In addition, the Company's revenues for 2005 totaled $1.2 billion, making Administaff the nation's leading Professional Employer Organization.

Looking back, we are proud that we have become an advocate for small businesses across America – their successes have also been ours. In the pages that follow, we highlight 20 milestones and other key developments that have been essential to our past success and helped lay the groundwork for our next 20 years...

CONTENTS

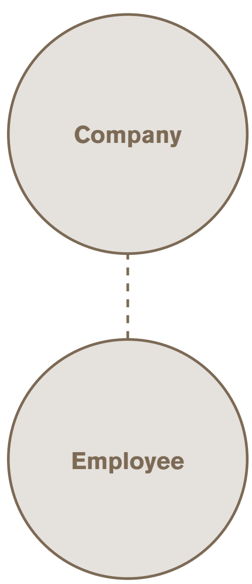
# Two men, one phone and a good idea.

# 1 Foundational values.

Operating in a tiny office with only one phone – and a really long cord – Paul Sarvadi and Jerry McIntosh founded Administaff with just three clients on April 1, 1986. Small businesses were looking for a better way – not just another way – to handle the duties of being an employer, and Administaff set out to fill that need. After 20 years of creating and delivering an expanding array of human resource services, Administaff now delivers a competitive advantage to more than 5,000 clients, and the same core values that guided our decision-making in the early days have contributed to our long-term success. These values include integrity, commitment to excellence, recognition of individual worth, teamwork to achieve goals, anticipating and managing change, community involvement and an optimistic view of what lies ahead.

# 2
# Establishing the legal framework.

New ideas require breaking new ground. Much like Federal Express had to challenge the 200-year-old postal code just to be able to deliver mail in a different way, Administaff also had to create a new way of doing business. In order to effectively deliver its comprehensive Personnel Management System[SM] to small and medium-sized businesses, Administaff pioneered a legal concept called "co-employment." This new construct replaces the traditional two-party employment relationship with a three-party arrangement between Administaff, a client and its existing employees, including the business owner. Under this arrangement, Administaff assumes or shares many of the responsibilities of being an employer, and provides clients and worksite employees with access to a wide range of human resources benefits and services not typically found at small businesses. With Administaff handling the "business of employment," clients are free to focus on the "business of business."




Traditional Employment Relationship


Co-Employment Relationship

# 3

# Helping define, build and lead an industry.

pro•fes•sion•al em•ploy´er or•gan•i•za´tion

"Administaff led the charge to help get an industry licensing law approved by the Texas Legislature during the early 1990s, and we have played an important role in helping establish similar legislation in more than 20 other states."

**– JOHN H. SPURGIN, II, SENIOR VICE PRESIDENT, LEGAL, GENERAL COUNSEL AND SECRETARY, ADMINISTAFF**

When Administaff opened for business, we not only had to build a company, we also had to help build an industry. Quite simply, there was no such thing as a Professional Employer Organization (PEO). Over the years, Administaff officers and managers have helped define and shape the PEO industry through their leadership involvement with the industry's trade organization, the National Association of Professional Employer Organizations (NAPEO). Administaff's Paul Sarvadi, Richard Rawson and Kathleen Hillegas have all served terms as NAPEO's president. In addition, Rawson created and served as chairman of NAPEO's Accounting Practices Committee, which developed key financial reporting standards and industry ratios for PEO operations. Administaff also supported the creation of the Employer Services Assurance Corporation (ESAC), the industry's nationally recognized accreditation entity, with Administaff's John Spurgin having served on its board of directors.

# 4

# A winning corporate culture.

"Perhaps the most important key to our success is establishing a culture that people want to be a part of, expand upon and develop. We hire people for their input, not just their output."

– PAUL J. SARVADI, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ADMINISTAFF

Administaff recognizes the vital role people play in the success of the Company and is proud to have been recognized at the local, state and national levels as a great place to work. Moreover, an internal survey revealed that 86 percent of Administaff's corporate employees view their position as a calling – an opportunity to do what they do best – and important to the Company. This high level of commitment is supported by a corporate culture that endorses work-life balance, family-friendly values, and an effective combination of individual and team contributions. Administaff recognizes its employees' outstanding accomplishments, both at work and in the community, with monthly, quarterly and annual achievement awards.

# 5 Community involvement.

At Administaff, community involvement is a corporate cornerstone, and we are fully committed to supporting the communities where our employees live and work. In addition to contributing funds to education, social services, the elderly and medical care, the Company encourages and supports the many volunteer efforts of its corporate employees. Toward this end, the Administaff Caring Employees program – which has been recognized with a national Points of Light Foundation Citation for Excellence in Corporate Community Service – provides employees with up to four hours per month of paid volunteer time. In 2005 alone, employees contributed more than 21,000 hours of volunteer service to their communities. They also used 100 percent of the available matching gifts fund for qualified nonprofit organizations.

## Diverse Client Base

16% Computer and Information Services
14% Finance, Insurance and Real Estate
13% Management, Administration and Consulting Services
9% Construction
9% Manufacturing
8% Medical Services
8% Wholesale Trade
7% Engineering, Accounting and Legal Services
5% Retail Trade
2% Transportation
9% Other

Identifying the ideal target market enables Administaff to develop and deliver the highest value for clients while also providing a solid foundation for the Company's business model. Administaff's long-term goal is to serve the top 10 percent of the nation's approximately 6 million small and medium-sized businesses. In identifying the "top 10 percent," the Company looks for successful, growth-minded companies with relatively low employment risks in areas such as workers' compensation and unemployment history. Clients range in size from about 10 to 2,000 employees, with the majority of clients in the 10 to 100 employee range. In addition, our clients are primarily in white collar and skilled blue collar professions covering a wide range of industries, which reduces Administaff's exposure to economic downturns and volatility in any single sector.

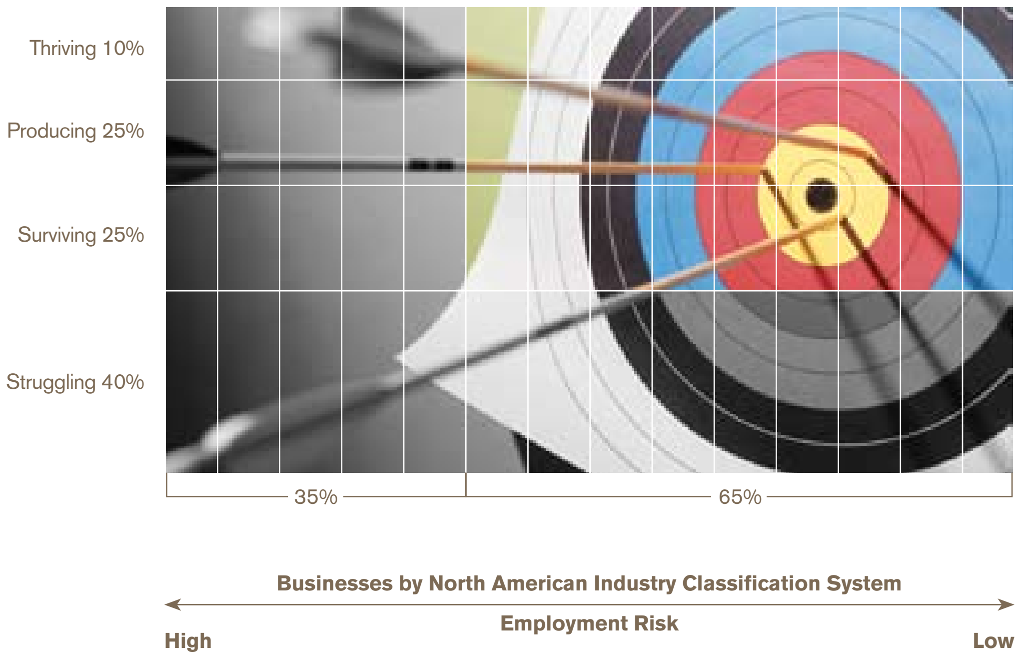
"Our target market focuses on businesses with a getting-better agenda – those that can take their operations to the next level with high-performance human resource solutions."

– JAY E. MINCKS, EXECUTIVE VICE PRESIDENT, SALES AND MARKETING, ADMINISTAFF

# 6 Target market.

### Market Segmentation

6 million small businesses




# 7

# A Personnel Management System℠ for America's best small businesses.

"We have developed a system that not only helps our clients attract and retain the best employees; it also helps train people to do the job of today and develop them to do the job of tomorrow."

– A. STEVE ARIZPE, EXECUTIVE VICE PRESIDENT, CLIENT SERVICES AND CHIEF OPERATING OFFICER, ADMINISTAFF

Administaff's Personnel Management System℠ – represented by an octagon that helps organize our services into an easy-to-understand format – includes a comprehensive range of people strategies that provides clients with administrative relief, big company benefits, reduced liabilities and a systematic way to improve productivity.

**Recruiting & Selection**
Find and hire the highest-quality employees possible.

**Performance Management**
Increase employee productivity by improving individual and group performance.

**Government Compliance**
Keep pace with changing regulations to reduce or eliminate fines and penalties.

**Benefits Management**
Gain one of the best benefits values in the marketplace for employee retention.

**Business Services**
Achieve a more secure future through forward-focused resources that help create value.

**Training & Development**
Become more productive and profitable with a professional development program for employees.

**Employer Liability Management**
Manage employer obligations more effectively with lower risk and reduced liability.

**Employment Administration**
Reduce the burden of employee-related paperwork by sharing it with Administaff.

## COMPREHENSIVE SERVICES – ALL-INCLUSIVE PRICING

### RECRUITING & SELECTION
**Find and hire the highest-quality employees possible.**

- Job Descriptions
- Resume Review & Interviewing
- Salary Planning & Administration
- Classified Advertising Coordination
- Background Checks
- Pre-Employment Testing
- Drug Testing
- Outplacement

### PERFORMANCE MANAGEMENT
**Increase employee productivity by improving individual and group performance.**

- Performance Measurement & Review
- Compensation & Incentive Plans
- Employee Relations
- Supervisor Training
- Conflict Resolution
- Job Design

### GOVERNMENT COMPLIANCE
**Keep pace with changing regulations to reduce or eliminate fines and penalties.**

- Government Reporting & Agency Interface
- Unemployment Claims Management
- Wage Claims & Audits
- OSHA, EEOC, DOL, ADA, FMLA, FLSA, Title VII & More

### BENEFITS MANAGEMENT
**Gain one of the best benefits values in the marketplace for employee retention.**

- Health Care, Dental & Vision Plans
- Employee Assistance Program
- Retirement Services
- Basic & Voluntary Disability Coverage
- Basic & Voluntary Life ce
- Basic & Voluntary Per Accident Insurance
- Adoption Assistance
- Credit Union
- Educational Assis
- Health Care Flexi Spending Accou

### BUSINESS SERVICES
**Achieve a more secure future through forward-focused resources that help create value.**

- Personnel Consulting
- Employee Communications
- Employee Service Center℠
- MarketPlace℠
- Client Network

### TRAINING & DEVELOPMENT
**Become more productive and profitable with a professional development program for emplo**

- Needs
- Curricu velopment
- Training ams
- Ce of Units
-

### EMPLOYER LIABILITY MANAGEMENT
**Manage employer obligations more effectively with lower risk and reduced liability.**

- Workers' Compensation Coverage & Claims Resolution
- Employment Practices Liability Insurance
- Safety Review & Policy Development
- Unemployment Claims Management
- Conflict Resolution
- Employee Handbooks
- Personnel Guide, Forms & Policies
- Terminations Support

### EMPLOYMENT ADMINISTRATION
**Reduce the burden of employee-related paperwork by sharing it with Administ**

- Payroll Pro
- Payroll Tax
- FICA, FUTA
- Garnishme
- Quart
- HR M
- Dire

# 8

# Innovative and effective pricing.

"Our pricing strategy includes matching price and cost for benefits and services to deliver the highest value to our customers."

– RICHARD G. RAWSON, PRESIDENT, ADMINISTAFF

Administaff's innovation extends to its fee-inclusive approach to pricing for its comprehensive Personnel Management System.℠ As part of our service fee, a wide selection of human resource services is delivered in a customized plan to meet the needs of each client. This approach to service delivery provides the best of two worlds – the benefits and services of a large corporation in the environment of a small business. Administaff's pricing system also provides clients with important insights, allowing them to view labor costs based on their business model. It also gives the Company a detailed base of information that helps us confirm effective pricing strategies, identify trends and forecast operating results.

# 9

# High-tech service delivery.

Launched in 1998, Administaff's eService platform provides clients and employees with a growing array of information and resources to help maximize the benefit of their Administaff services. By logging on to the Employee Service Center,SM clients can submit and verify payroll, generate reports, complete and submit forms, and review the Administaff Personnel Guide, all on a secure Web site. In addition, worksite employees can access online check stubs and pay history reports, locate in-network medical providers, manage their 401(k) accounts, pursue training opportunities, update their personal employment-related information and more. As a result of Administaff's development of the Employee Service Center and other technological initiatives, the Company was named to the *InformationWeek* 500 list of leading information technology innovators for five consecutive years.

# 10

## Initial public offering on the NYSE.

In January 1997, after implementing high-caliber reporting standards and building five years of profitable financial performance, Administaff completed its initial public offering and became the only Professional Employer Organization (PEO) to be listed on the New York Stock Exchange (NYSE). This milestone not only helped build credibility for Administaff; it also added increased awareness of the PEO industry. In 2005, Administaff's common stock (trading under the symbol "ASF") increased 233 percent, making it the NYSE's second-largest percentage gainer for the year.

"Being listed on the NYSE has made it easier for the investment community, our prospects and others to understand and appreciate the clear advantages of Professional Employer Organization services. That clarity is reflected in our increased market value and growth of our client base."

– RICHARD G. RAWSON, PRESIDENT, ADMINISTAFF


ASF Listed NYSE


# 11

## Growth in worksite employees.

| Administaff Growth | 1986 | 1996 | 2006 (EST) |
|---|---|---|---|
| Corporate Employees | 2 | 350 | 1,600 |
| Number of Offices | 1 | 12 | 42 |
| Square Feet of Office Space | 600 | 191,512 | 682,676 |
| Number of Clients | 3 | 1,231 | 5,000+ |
| States Served | 1 | 44 | 50 |
| Worksite Employees | 32 | 21,000 | 100,000+ |

Administaff's continuing growth is reflected by steady increases in the number of worksite employees paid – beginning with 32 in 1986 and approaching 100,000 today. Key drivers of this trend include high demand for employee benefits management, a strong need for administrative relief, increased employer liabilities and the growing burden of employment regulations. Administaff's growth also is supported by its annual Fall Campaign, which focuses the entire Company on supporting our nationwide sales effort. With business owners thinking about their business plans for the upcoming year, fall is an ideal time for them to consider joining Administaff. As a result, approximately 40 percent of the Company's sales are completed during this time of the year. Our 2005 Fall Campaign achieved record results, selling new accounts representing more than 20,000 worksite employees.


# 12

## Team-based services.

Administaff uses a team approach to deliver its comprehensive Personnel Management System[SM] to clients throughout the country. Comprised of all the functions and disciplines typically found in a *Fortune* 500-caliber human resources department, each team includes a team manager and client liaison, as well as specialists for payroll, human resources, recruiting, benefits, training and safety. Client owners and worksite employees also receive support through Administaff's national contact center and the online Employee Service Center.

# 13 Client satisfaction.

Administaff's 20-year commitment to service excellence has produced high levels of client satisfaction and helped position Administaff as the premium service provider in our industry. Our 2005 client survey yielded our highest-ever satisfaction rating – 91 percent, versus 88 percent in 2004. Other findings included: 94 percent of those surveyed would recommend Administaff to other business owners; 92 percent consider Administaff a good value for the money; and 96 percent said they plan to renew their Administaff relationship.

"Clients understand the challenges and liabilities of being an employer. They tell us they get great comfort from being with Administaff, and they wouldn't want to do it any other way."

– A. STEVE ARIZPE, EXECUTIVE VICE PRESIDENT, CLIENT SERVICES AND CHIEF OPERATING OFFICER, ADMINISTAFF

94%

of clients surveyed would recommend Administaff to other business owners.

91%

of clients surveyed are "completely or mostly satisfied" with Administaff products and services – the highest level in Company history.

92%

of clients surveyed consider Administaff a good value for the money.

96%

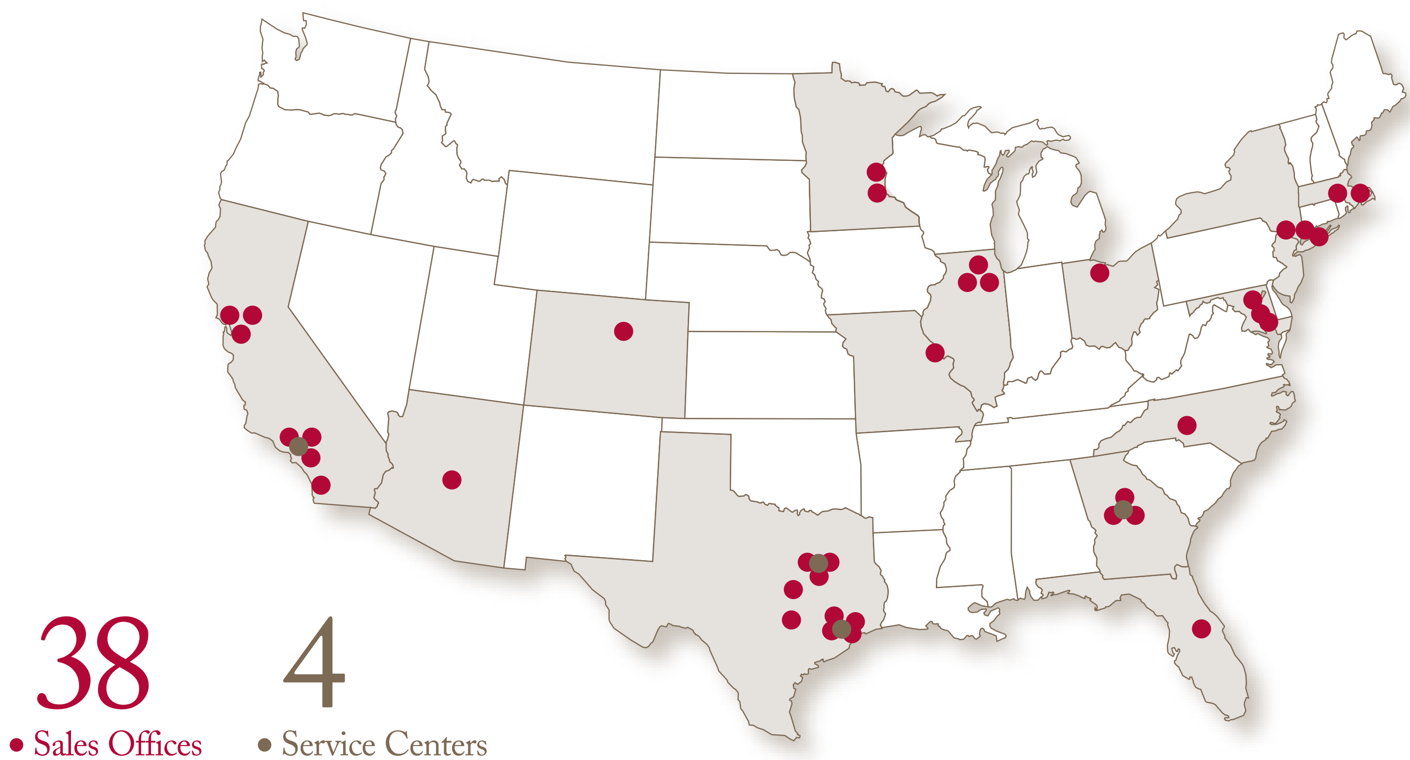
of surveyed clients said they plan to renew their Administaff relationship.

# 14 National expansion.

"Administaff's successful expansion affirms our organic growth plan and enables us to effectively serve America's best small and medium-sized businesses coast-to-coast."

– JAY E. MINCKS, EXECUTIVE VICE PRESIDENT, SALES AND MARKETING, ADMINISTAFF

Administaff is the only company that has established a national footprint for Professional Employer Organization services. Our growth is supported by the continuing rollout of a national expansion program that targets a total of 90 sales offices in 40 major markets. Toward that goal, the Company now operates 38 sales offices and four client service centers in 21 markets, and we plan to open four new sales offices in 2006. The success of our expansion program is punctuated by the increased geographical diversity of our client base. When Administaff became a public company in 1997, more than 50 percent of our revenues were derived from our initial market, Houston, and less than 20 percent came from outside Texas. In 2005, however, Houston accounted for only 20 percent of our revenues despite continued strong growth in that market, and revenues from outside of Texas totaled more than 60 percent. Furthermore, the Company's 17 expansion markets now represent 70 percent of total revenues.




# 15

# Building brand awareness.

At the core of Administaff's brand is our passion for small businesses and helping them succeed. What started as humorous radio ads – featuring Kay Reeves, owner of Walla Walla Corporation, and her assistant, Augie, as they encountered everyday human resources challenges – has grown into a national, integrated marketing and corporate communications program that strengthens the Administaff brand and positions us as an advocate for small business. In 2004, we launched a national television and radio advertising campaign featuring legendary golfer and small business owner Arnold Palmer as our Company spokesperson. This campaign was planned to coincide with our sponsorship of the Administaff Small Business Classic,® a PGA TOUR's Champions Tour golf tournament. The Company also conducts surveys to help gauge the small business community's attitudes about the economy and human resources issues. Results from these surveys have helped us garner national coverage on CNBC, FOX News, Bloomberg and numerous other news media outlets.


# 16

## Business alliances.

Throughout the last decade, Administaff has continued building and enhancing its eCommerce portal, MarketPlace,SM which serves clients and worksite employees with a best-of-class provider network. Accessible through the Employee Service Center,SM this site offers a wide range of consumer and business products and services – often at discounted pricing – from some of the nation's leading companies, including Travelers, Dell, Cingular, FTD, Continental Airlines, Pitney Bowes, Office Depot and others. Besides providing added value and convenience to our clients and worksite employees, many of these alliances represent additional revenue and lead-generation opportunities for Administaff. We believe our proven ability to partner with major companies for the benefit of our clients will continue providing us with significant business-development opportunities.

# 17

# Leveraging our expertise.

Contributing to Administaff's success is our ability to leverage the expertise and assets we have developed in serving the small business community. Our recent acquisition of HRTools.com expands our target market and further extends our service to small businesses. In addition, we have successfully created a national network of best-of-class health insurance carriers, expanded our retirement services offering, and established a new workers' compensation program that enables us to better manage risk, control costs and maximize the return on capital invested in the program. Together, these initiatives effectively support our small business service strategy, provide new revenue sources and help drive leads for our core Professional Employer Organization business.


www.HRTools.com


# 18
# Overcoming challenges.

Clients, employees and shareholders depend on Administaff to respond to challenges in positive ways. We have helped legislators, investors and others gain a better understanding of our industry, have delivered payrolls by helicopter during a major flood, and have supplied vital employee information when client workplaces were damaged or destroyed on Sept. 11, 2001. Administaff's management also overcame the financial challenges of its early years, attracted major financing and ultimately became a publicly traded company on the New York Stock Exchange. We persevered with numerous regulatory agencies to implement innovative human resource solutions for small businesses, and we won several important lawsuits, including a major case against an insurance carrier to protect our clients and our way of doing business. This ongoing ability to tackle and overcome challenges is key to our future success.

# 19
# Building shareholder value.

Administaff's proven business model has built shareholder value by effectively balancing the growth and profitability of the Company. As a result, the market value of our Company has grown from $227 million when we went public in 1997 to $1.1 billion as we enter 2006. In addition, we initiated a dividend in 2005 to return a portion of our capital to stockholders, and we have repurchased stock over the years when it made sense to do so. As a testament to our accomplishments, Administaff has been included five times on *Fortune* magazine's list of America's Most Admired Companies. These rankings were based on eight criteria: financial soundness, quality of products and services, long-term investment value, quality of management, employee talent, social responsibility, innovativeness and the use of corporate assets. Going forward, we are fully committed to further strengthening our industry-leading position and taking our Company to the next level.

## Compound Annual Growth Rates as a Public Company
(1997–2005)

| | |
|---|---|
| 16% | Worksite Employees |
| 25% | Revenue |
| 23% | Gross Profit |
| 28% | EBITDA* |
| 31% | Net Income** |

* EBITDA = Net income before taxes from continuing operations plus interest expense, depreciation and amortization

** Net income from continuing operations

"Since becoming a public company in 1997, Administaff has achieved compound annual growth rates of 31 percent in net earnings and 25 percent in revenue. Our financial strength positions the Company to continue achieving its profitability and growth objectives."

– DOUGLAS S. SHARP, VICE PRESIDENT, FINANCE, CHIEF FINANCIAL OFFICER AND TREASURER, ADMINISTAFF

# 20
# Entrepreneurial spirit.


"Administaff has come a long way and enjoyed great success in the last 20 years. Given our enormous market opportunity, however, this is still a ground-floor opportunity. We're still just getting started."

**– PAUL J. SARVADI, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ADMINISTAFF**

Administaff was founded with the same passion for small business that we celebrate today. We know that entrepreneurial spirit is the adrenaline that fuels the American dream, and we have the opportunity to see it firsthand every day because our clients are among the premier small business owners in the country. Just as these entrepreneurs embody the strength and character that help make our nation great, Administaff is proud to contribute to the success and vitality of our small business clients.

As we forge ahead into the next 20 years, we have a renewed commitment to our role as a small business advocate and have refined our mission, values and long-term goals:

## Mission

The mission of Administaff is to help the best small to medium-sized businesses succeed, making life better for clients, employees, their families and shareholders.

## Values

- Integrity as the cornerstone of personal and corporate conduct
- Respect for the worth and contribution of each individual
- Commitment to high standards and the pursuit of excellence
- Achieving goals through teamwork and servant leadership
- Anticipating and responding to change as an opportunity to innovate and learn
- Contributing to the communities where we live and work
- Perseverance through an abiding faith and optimism

## Long-term Goals

- Be the dominant player in the PEO industry
- Serve a strategically selected 10 percent of the small to medium-sized business community
- Be a delivery channel into our small business market for other goods and services
- Balance growth and profitability at every level along the way

Letter to Shareholders

# Forging ahead...

Paul J. Sarvadi
Chairman and Chief Executive Officer

## Administaff's record results in 2005 represent the most successful year in our history and provide a strong foundation for the Company's future. During our 20th year in business, we accelerated our unit growth into the double digits, maintained effective pricing and direct cost management, and achieved significant operating leverage.

Revenues for 2005 increased 20.6 percent to $1.2 billion, due to a 13.9 percent increase in the average number of worksite employees paid and a 5.9 percent increase in revenues per worksite employee per month. Gross profit increased 19.3 percent to $235.8 million, with average gross profit per worksite employee per month at $221 versus $211 in 2004 due to an increased service fee markup and a higher surplus from direct cost programs. Net income and diluted net earnings per share climbed to $30.0 million and $1.12, versus $19.2 million and $0.72 for 2004. The Company also increased operating income by 98 percent and generated more than $65.3 million in EBITDA, which contributed to an increase of $45.7 million in working capital.

These financial results demonstrate the ongoing strength of our proven business model. In addition, several of our 2005 achievements support our goal of forging ahead toward even greater success in 2006 and beyond. These accomplishments included:

- **A record fall selling season.** In 2005, our fall sales exceeded 20,500 worksite employees, 14 percent ahead of internal targets and 27 percent ahead of the 2004 season. Building on the momentum gained during this record campaign, we are positioned for another strong sales year in 2006, during which we plan to open as many as six new sales offices and increase our number of trained sales consultants from 225 to an average of 250.

"It is through the passion and forward vision we all share that we are able to put Administaff's services to work for the good of America's best small and medium-sized businesses."

- **Continuously improving client satisfaction levels.** Our 2005 satisfaction survey results yielded our highest-ever rating – 91 percent, versus 88 percent in 2004 – and attrition levels were at their lowest point in five years. Enhancing the "high-touch" aspect of our service, we rolled out our contact center nationwide and launched new customer relationship management technology designed to improve the way we manage client information and interaction.

- **Major progress on our middle-market sales front.** We increased sales to companies with 150 to 2,000 employees by 50 percent over 2004, with more than 4,800 of our worksite employee total for 2005 attributed to our middle-market effort. This increase resulted from the dedication of six sales consultants to this program, as well as the introduction of a new assessment tool that evaluates the overall HR condition at prospective client companies and provides a strategy for improvement. We also developed a new survey, to be administered beginning in 2006, for identifying products and services that will help us to continue gaining momentum in the middle-market arena.

- **The addition of new initiatives to help generate leads and revenues.** We continued to build our eBusiness portal, MarketPlace,℠ with the addition of 15 new alliance relationships, including a home and auto insurance offering through Travelers Insurance. In December, we acquired certain assets of KnowledgePoint, including HRTools.com, a leading online portal for HR products and services. The acquisition also included a wide range of business applications related to job descriptions, performance reviews, and personnel policies and procedures. In 2006, we will launch a redesign of HRTools.com and begin using it to further extend our brand, offering it as a resource to small businesses that might not be a fit for Administaff's comprehensive service model.

In closing, I would like to extend management's sincere appreciation for the dedication of our corporate staff and valuable guidance from our Board of Directors, both of which helped us to achieve superior results in 2005. It is through the passion and forward vision we all share that we are able to put Administaff's services to work for the good of America's best small and medium-sized businesses.

Sincerely,

**Paul J. Sarvadi**
Chairman and Chief Executive Officer
March 22, 2006

# Financial Highlights

| (in thousands, except per share amounts and statistical data) | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| | | | Year ended December 31, | | |
| **Income Statement Data:** | | | | | |
| Revenues[1] | $ 1,169,612 | $ 969,527 | $ 890,859 | $ 848,416 | $ 720,219 |
| Gross profit | 235,756 | 197,694 | 197,105 | 165,790 | 165,015 |
| Operating income | 43,767 | 22,131 | 24,274 | 67 | 18,539 |
| Net income (loss) from continuing operations | 29,983 | 19,210 | 14,985 | (2,921) | 10,357 |
| Net loss from discontinued operations | – | – | (2,121) | (1,160) | – |
| Net income (loss) | 29,983 | 19,210 | 12,864 | (4,081) | 10,357 |
| Diluted net income (loss) per share from continuing operations | $ 1.12 | $ 0.72 | $ 0.55 | $ (0.11) | $ 0.36 |
| **Balance Sheet Data:** | | | | | |
| Working capital | $ 93,235 | $ 47,500 | $ 56,032 | $ 41,238 | $ 36,609 |
| Total assets | 495,439 | 355,388 | 348,071 | 315,164 | 274,003 |
| Total debt | 34,890 | 36,539 | 42,362 | 44,169 | 13,500 |
| Total stockholders' equity | 182,429 | 126,529 | 122,634 | 116,349 | 122,935 |
| Cash dividends per share | 0.28 | – | – | – | – |
| **Statistical Data:** | | | | | |
| Average number of worksite employees paid per month during period | 88,780 | 77,936 | 75,036 | 77,334 | 69,480 |
| Revenues per worksite employee per month[2] | $ 1,098 | $ 1,037 | $ 989 | $ 914 | $ 864 |
| Gross profit per worksite employee per month | $ 221 | $ 211 | $ 219 | $ 179 | $ 198 |
| Operating income per worksite employee per month | $ 41 | $ 24 | $ 27 | $ – | $ 22 |

(1) Gross billings of $6.633 billion, $5.377 billion, $4.829 billion, $4.857 billion and $4.373 billion, less worksite employee payroll cost of $5.463 billion, $4.407 billion, $3.938 billion, $4.009 billion and $3.653 billion, respectively.

(2) Gross billings of $6,226, $5,749, $5,363, $5,234 and $5,245 per worksite employee per month, less payroll cost of $5,128, $4,712, $4,373, $4,320 and $4,381 per worksite employee per month, respectively.

This Annual Report includes forward-looking statements within the meaning of the federal securities laws. You can identify such forward-looking statements by the words "are confident," "expects," "intends," "plans," "projects," "believes," "estimates," "likely," "goal," "assume" and similar expressions. For information concerning important factors that could cause actual results to differ materially from those in such statements, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K.

**Company Profile**

With 2005 revenues of $1.2 billion, Administaff is the nation's leading Professional Employer Organization (PEO), serving as an off-site human resources department for small and medium-sized businesses throughout the United States. At year-end 2005, Administaff had more than 5,000 client companies, 94,000 worksite employees and 1,500 corporate employees. The Company also had four client service centers and 38 sales offices in 21 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.

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, 2005.
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<br>(State or other jurisdiction of incorporation or organization) | 76-0479645<br>(I.R.S. Employer Identification No.) |
| 19001 Crescent Springs Drive<br>Kingwood, Texas<br>(Address of principal executive offices) | 77339<br>(Zip Code) |

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

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

| (Title of class) | (Name of Exchange on Which Registered) |
|---|---|
| Common Stock, par value $0.01 per share | New York Stock Exchange |
| Rights to Purchase Series A Junior Participating Preferred Stock | New York Stock Exchange |

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ____ Accelerated filer ✓ Non-accelerated filer ____

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes____ No__✓__

As of February 9, 2006, 27,331,381 shares of the registrant's common stock, par value $0.01 per share, were outstanding. As of the end 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, 2005 closing price of the common stock as reported by the New York Stock Exchange) was approximately $521 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 3, 2006, which the registrant intends to file within 120 days of the end of the fiscal year.

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## 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 39.

## ITEM 1. BUSINESS.

### General

Administaff is a professional employer organization ("PEO") that provides a comprehensive Personnel Management System[SM] 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. In 2003, we formed Administaff Retirement Services, LP, which currently performs recordkeeping services for defined contribution plans. In December 2005, we acquired HRTools.com, an online portal for human resource products, services and information, as well as small business software applications related to job descriptions, performance reviews, and personnel policies and procedures.

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 Administaff, 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, 2005, we had 38 sales offices in 21 markets. We paid an average of 94,031 worksite employees in the fourth quarter of 2005. Our long-term strategy is to operate in approximately 90 sales offices located in 40 strategically selected markets. While there were no new sales offices opened in 2005, we intend to open four new sales offices, including one new market, in 2006.

Our national expansion strategy also includes regionalized data processing for payroll and benefits transactions and localized face-to-face human resources service. As of December 31, 2005, we have four service centers, which when fully staffed will provide the capacity to serve approximately 160,000 worksite employees. In addition, we have human resources and client service personnel located in a majority of our 21 sales markets.

## 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.

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 labor and 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. Administaff 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, 28 states have legislation containing licensing, registration, or certification requirements 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 licensed, registered or pursuing registration in all 28 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 1987 (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);
- Uniform 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 coverage:

- 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; and
- a 401(k) plan.

The group health plan includes medical, dental, vision, a worklife program and a prescription drug program. All benefit plans are provided to applicable employees based on eligibility provisions specific to those plans. We are responsible for the costs and premiums associated with 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 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 our clients, monitor changing government regulations and notify clients of the potential effect of such changes on employer liability.

*Employee Service Center*℠. 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℠ 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 ℠;
- 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 through the Administaff Talent Network;
- links to benefits providers and other key vendors; and
- frequently asked questions.

The ESC also contains MarketPlace℠, 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 Best2Best® client network, where our clients can offer their products and services to one another.

*HR Software Products*. In December 2005, we acquired HRTools.com, an online portal for human resources products, services and information from KnowledgePoint, a subsidiary of Recruitmax. 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.

## Client Service Agreement

All PEO clients enter into Administaff's Client Service Agreement ("CSA"). The CSA generally provides for an on-going relationship, subject to termination by Administaff or the client upon 30 or 60 days written notice.

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. 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 improved 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 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 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 the purposes of 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 CSA is as follows:

Administaff

- Payment of wages 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 Administaff, 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.

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. We maintain employers' practice liability insurance coverages (including coverages for our clients) to manage our exposure for these types of 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.

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

Administaff 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, who recognize the advantage in the strategic use of high-performance human resource practices. 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, 2005, Houston, our original market, accounted for approximately 20% of our revenues, with other Texas markets contributing an additional 19%. By region, our revenue growth over 2004 and revenue distribution for the year ended December 31, 2005 were as follows:

| | Revenue Growth | % of Total Revenues |
|---|---|---|
| Northeast | 32.0% | 15.1% |
| Southeast | 12.3% | 8.7% |
| Central | 13.2% | 13.3% |
| Southwest | 20.3% | 39.0% |
| West | 22.4% | 23.2% |
| Other revenue | 18.9% | 0.7% |

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, formerly known as Standard Industrial Classification 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 – 16%;
- Finance, insurance and real estate – 14%;
- Management, administration and consulting services – 13%;
- Manufacturing – 9%;
- Construction – 9%;
- Medical services – 8%;
- Wholesale trade – 8%;
- Engineering, accounting and legal services – 7%;
- Retail trade – 5%;
- Transportation – 2%; and
- Other – 9%.

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. Administaff's client retention record over the last five years reflects that approximately 72% 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 81% for clients in their fifth year with Administaff. The resulting average retention rate over the last five years was 76%. During 2005, our retention rate increased to 80% compared to 75% during 2004. Client attrition is attributable to a variety of factors, including: (i) client non-renewal due to price 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, 2005, we had 38 sales offices located in 21 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. Administaff's markets and their respective year of entry are as follows:

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

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 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 Administaff Small Business Classic professional golf tournament held in Houston, Texas. In addition, we entered into a three-year arrangement with Arnold Palmer to become our national spokesperson. 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, a predictable number of 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 Administaff'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.

## Competition

Administaff 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 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 2002 through 2004 annual NAPEO surveys of the PEO industry, we have successfully leveraged our full-service approach into significantly higher returns for Administaff on a per worksite employee per month basis. During the three-year period from 2002 through 2004, our staff support ratio averaged 51% higher than the PEO industry average, while gross profit per worksite employee and operating income per worksite employee exceeded industry averages by 134% and 70%, 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 Administaff 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 fee-for-service providers such as payroll processors and human resource consultants and face competition from large regional PEOs in certain areas of the country. As Administaff and other large PEOs expand nationally, we expect that competition may intensify.

## Vendor Relationships

Administaff provides benefits to its worksite employees under arrangements with a variety of vendors. We consider our contracts with UnitedHealthcare and American International Group to be the most significant elements of our employee benefits package. These contracts would be the most difficult to replace.

We provide health insurance coverage to our worksite employees through a national network of carriers including UnitedHealthcare ("United"), Cigna Healthcare, PacifiCare, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California and Tufts, all of which provide fully insured policies or service contracts. The policy with United provides approximately 77% of our health insurance coverage and automatically renews annually, 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 24.

Our workers' compensation coverage (the "AIG Program") is currently provided through selected member insurance companies of American International Group, Inc. ("AIG"). Under our arrangement with AIG, we bear the economic burden for the first $1 million layer of claims per occurrence. AIG bears the economic burden for all claims in excess of such first $1 million layer. The AIG Program is a fully insured policy whereby AIG 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 AIG, 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

Administaff 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.

Administaff 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 Administaff, 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. 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, sales force activity management, and customer service issue tracking.

During 2005 we completed the implementation and roll-out of a new Customer Relationship Management application intended to enhance our ability to manage the data and interactions with our customers on a day-to-day basis. The implementation provides for general access to the application for all relevant user groups and included significant integration with the AIMS application.

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 our Dallas service center. 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 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.

## 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, 28 states have passed laws that have 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) Plan (a profit-sharing plan with a cash or deferred arrangement ("CODA") under Code Section 401(k), which allows for various forms of employer contributions including an employer matching contribution feature under Code Section 401(m)) maintained consistent with the provisions of Revenue Procedure 2002-21 and 2003-86 (each of which is discussed below);
- a cafeteria plan under Code Section 125;
- a group health plan which includes medical, dental, vision 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 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 Administaff 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 Administaff 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 Administaff and its worksite employees may also arise under other federal laws, including other federal income tax laws.

*401(k) Plan.* On April 24, 2002, the Internal Revenue Service ("IRS") issued Revenue Procedure 2002-21, and on November 11, 2003, issued Revenue Procedure 2003-86, each of which provided guidance for the operation of defined contribution plans maintained by PEOs that benefit worksite employees. Each applies to plans in existence on May 12, 2002 and their operation in plan years beginning after December 31, 2003.

Consistent with the guidance for all periods beginning on or after January 1, 2004, electing clients are treated as adopting employers of the Administaff 401(k) Plan for plan qualification purposes under Code Section 413(c). On December 31, 2003, participant account balances attributable to worksite employees associated with clients who failed to: (i) agree to be treated as an adopting employer; or (ii) make another valid election in a timely manner, were transferred to the newly established Administaff Spinoff 401(k) Plan. Additionally, a small number of clients chose to transfer attributable participant account balances to other 401(k) plans separately maintained by the clients pursuant to the guidance. The Administaff Spinoff 401(k) Plan was also terminated effective December 31, 2003, subject to IRS approval received in December 2005. Accordingly, during 2006 all remaining participant account balances in such plan will be distributed pursuant to existing guidance regarding plan terminations. Ongoing compliance with Revenue Procedures 2002-21 and 2003-86 requires additional administrative compliance efforts, the cost of which is expected to be primarily born by the applicable plan and, therefore, is not expected to have a material adverse impact on the Company's financial condition or results of operations.

***Federal Employment Taxes***

As a co-employer, Administaff 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. Many states have experienced increases in unemployment claims due to depressed economic conditions over the last few years. As a result, our unemployment tax rates have increased over the last several years; however, we are not expecting unemployment tax rates on average to increase materially in 2006 due to improved employment trends in 2005. Until we receive the final tax rate notice, we estimate our expected SUI rate in those particular states.

As a result of a 2001 corporate restructuring, we filed for a transfer of our reserve account with the Employment Development Department of the State of California ("EDD"). The EDD approved our request for transfer of the reserve account in May 2002 and also notified us of our new contribution rates based upon the approved transfer. In December 2003, we received a Notice of Duplicate Accounts and Notification of Assessment from the EDD. The notice stated that the EDD was collapsing the accounts of our subsidiaries into the account of the entity with the highest unemployment tax rate. The notice also retroactively imposed the higher unemployment insurance rate on all of our California employees for 2003, resulting in an assessment of $5.6 million. In January 2004, we filed a petition with an administrative law judge of the California Unemployment Insurance Appeals Board ("ALJ") to protest the notice. Pending a resolution of our protest, in the fourth quarter of 2003 we accrued and recorded at the higher assessed rate for all of 2003.

In June 2004, we agreed to settle our dispute with the EDD for $3.3 million. Based upon receipt of written acknowledgement of this agreement, we reduced our accrued payroll tax liability and payroll tax expense by $2.3 million during the quarter ended June 30, 2004. The settlement was subject to the final approval by EDD's legal department, the California Attorney General's office and the ALJ. In October 2004, the legal department of the EDD verbally indicated they considered the previously agreed-upon settlement amount to be insufficient and suggested a settlement amount of $5.2 million. We continued discussions with the State of California, but in February 2005, we were notified that the EDD had rejected our settlement offer, and the matter will proceed with the appeals process with the ALJ. If the outcome of the appeals process is unfavorable and we are assessed additional interest and penalties, we may recognize an increase in our payroll tax expense in a future period. Conversely, if the outcome of the appeals process is favorable to us, we may recognize a decrease in our payroll tax expense in a future period. The ultimate outcome of this matter is not expected to have a material impact on our 2006 unemployment tax rate in California.

### State Regulation

While many states do not explicitly regulate PEOs, 28 states have regulations containing licensing, registration or certification requirements for 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. We hold licenses in Arkansas, Florida, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Oregon, South Carolina, Tennessee, Texas and Vermont. We are registered or certified in Colorado, Illinois, Kentucky, Louisiana, Maine, Minnesota, Nevada, New Jersey, New York, Ohio, Rhode Island, Utah, Virginia and West Virginia. We are applying for registration pursuant to recently enacted registration statutes in Arizona and Indiana. Regardless of whether a state has licensing, registration or certification requirements, we must comply with a number of other state and local regulations that could impact our operations. Administaff was instrumental in obtaining enactment of PEO legislation in various states, including Texas, where it faced a number of challenges under state law. We believe that our prior experience with Texas and other state regulatory authorities will be valuable in surmounting regulatory obstacles or challenges we may face in the future.

### Corporate Office Employees

We had approximately 1,500 corporate office and sales employees as of December 31, 2005. 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 and pending applications for registration. Although the Administaff mark is the most material trademark to our business, our trademarks as a whole are also of considerable importance to us. Additionally, we have certain copyrights and a pending patent application for our WebPayroll software program. Finally, our acquisition of certain assets from KnowledgePoint, a subsidiary of Recruitmax, in December 2005 included trademarks and other intellectual property.

## 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 39.

## 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 Headquarters

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. Our corporate headquarters secures a $33 million mortgage on the property. For more information regarding the mortgage, please read Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources" on page 36.

### Service Centers

We currently have four service centers located in Atlanta, Dallas, Houston and Los Angeles.

The Atlanta service center, which currently services approximately 26% of our worksite employee base, is located in a 40,000 square foot leased facility. This facility, which is under lease until 2014, is designed to service approximately 40,000 worksite employees at full capacity.

The Dallas service center, which currently services approximately 28% of our worksite employee base, is located in a 40,000 square foot leased facility, which also serves as our backup data processing and disaster recovery center.  This facility, which is under lease until 2008, is designed to service approximately 40,000 worksite employees at full capacity.

The Houston service center, which currently services approximately 26% of our worksite employee base, is located in a 40,000 square foot leased facility.  This facility, which is under lease until 2014, is designed to service approximately 40,000 worksite employees at full capacity.

The Los Angeles service center, which currently services approximately 20% of our worksite employee base, is located in a 45,000 square foot leased facility.  This facility, which is under lease until 2011, is designed to service approximately 40,000 worksite employees at full capacity.

### Sales Offices

As of December 31, 2005, we had sales and service personnel in 28 facilities located in 21 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, 2005, we had 38 sales offices in these 21 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.

Other than as set forth below, 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.

*Class Action Litigation*

On June 13, 2003, a class action lawsuit was filed against Administaff in the United States District Court for the Southern District of Texas on behalf of purchasers of our common stock alleging violations of the federal securities laws.  After that date, six similar class actions were filed against Administaff in that court.  Those lawsuits also named as defendants certain of our officers and directors.  Those lawsuits generally allege that Administaff and certain of its officers and directors made false and misleading statements or failed to make adequate disclosures concerning, among other things:  (i) our pricing and billing systems with respect to recalibrating pricing for clients that experienced a decline in average payroll cost per worksite employee; (ii) the matching of price and cost for health insurance on new and renewing client contracts; and (iii) our former method of reporting worksite employee payroll costs as revenue.  The complaints sought unspecified damages, among other remedies.  On March 31, 2004, the court entered an order consolidating all of the cases and appointing Carpenters Pension Trust for South California as “lead plaintiff” and Lerach Coughlin Stoia Geller Rudman & Robbins LLP as “lead counsel.”  The lead plaintiff alleges that its losses are $352,000, although the alleged damages of the purported class have not been specified.

In May 2004, the lead plaintiff filed its Consolidated Complaint, which amended and consolidated the seven previously filed cases.  In the consolidated complaint, the lead plaintiff has essentially abandoned the allegations of fraud contained in the initial seven lawsuits.  Through the consolidated complaint, the lead plaintiff now generally asserts, among other things, that Administaff and certain of its officers and directors fraudulently made false and misleading statements regarding the cost of its health plan during 2001 and 2002.  In June 2004, we filed a motion to dismiss the consolidated complaint.  We believe these claims are without merit and intend to vigorously defend this litigation.  As a result of the uncertainty regarding the outcome of this matter, no provision has been made in the accompanying consolidated financial statements.

*State Unemployment Taxes*

In December 2001, as a result of a 2001 corporate reorganization, we filed for a transfer of our reserve account with the Employment Development Department of the State of California ("EDD"). The EDD approved our request for transfer of the reserve account in May 2002 and also notified us of our new contribution rates based upon the approved transfer. In December 2003, we received a Notice of Duplicate Accounts and Notification of Assessment from the EDD. The notice stated that the EDD was collapsing the accounts of our subsidiaries into the account of the entity with the highest unemployment tax rate. The notice also retroactively imposed the higher unemployment insurance rate on all our California employees for 2003, resulting in an assessment of $5.6 million. In January 2004, we filed a petition with an administrative law judge of the California Unemployment Insurance Appeals Board ("ALJ") to protest the notice. Pending a resolution of our protest, in the fourth quarter of 2003 we accrued and recorded at the higher assessed rate for all of 2003.

In June 2004, we agreed to settle our dispute with the EDD for $3.3 million. Based upon receipt of written acknowledgement of this agreement, we reduced our accrued payroll tax liability and payroll tax expense by $2.3 million during the quarter ended June 30, 2004. The settlement was subject to the final approval by EDD's legal department, the California Attorney General's office and the ALJ. In October 2004, the legal department of the EDD verbally indicated they considered the previously agreed-upon settlement amount to be insufficient and suggested a settlement amount of $5.2 million. We continued discussions with the State of California, but in February 2005, we were notified that the EDD had rejected our settlement offer, and the matter will proceed with the appeals process with the ALJ. If the outcome of the appeals process is unfavorable and we are assessed additional interest and penalties, we may recognize an increase in our payroll tax expense in a future period. Conversely, if the outcome of the appeals process is favorable, we may recognize a decrease in our payroll tax expense in a future period. The ultimate outcome of this matter is not expected to have a material impact on our 2006 unemployment tax rate in California.

## 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, 2005.

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

The following table sets forth the names, ages (as of February 16, 2006) and positions of the Company's executive officers:

| Name | Age | Position |
|---|---|---|
| Paul J. Sarvadi | 49 | Chairman of the Board and Chief Executive Officer |
| Richard G. Rawson | 57 | President |
| A. Steve Arizpe | 48 | Executive Vice President, Client Services and Chief Operating Officer |
| Jay E. Mincks | 52 | Executive Vice President, Sales and Marketing |
| John H. Spurgin, II | 59 | Senior Vice President, Legal, General Counsel and Secretary |
| Douglas S. Sharp | 44 | Vice President, Finance, Chief Financial Officer and Treasurer |

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® for service industries.

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.

A. Steve Arizpe has served as Executive Vice President, 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, Vice President of Sales and Executive Vice President, Client Services. 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, Sales and Marketing since January 1999. Mr. Mincks served as Vice President, 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.

John H. Spurgin, II has served as Senior Vice President, Legal, General Counsel and Secretary since August 2003. He joined Administaff in January 1997 as Vice President, Legal, General Counsel and Secretary. Prior to joining Administaff, Mr. Spurgin was a partner with the Austin office of McGinnis, Lochridge & Kilgore, L.L.P., where he served as Administaff's outside counsel for nine years.

Douglas S. Sharp has served as Vice President, Finance, Chief Financial Officer and Treasurer since August 2003. He joined Administaff in January 2000 as Vice President, Finance and Controller. From July 1994 until he joined Administaff, Mr. Sharp 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 since January 2002.

# 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 9, 2006, there were 256 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 composite transactional tape.

| **2005** | **High** | **Low** |
|---|---|---|
| First Quarter | $ 16.25 | $ 11.65 |
| Second Quarter | 23.95 | 13.47 |
| Third Quarter | 39.99 | 22.56 |
| Fourth Quarter | 48.43 | 35.80 |
| **2004** | | |
| First Quarter | $ 18.45 | $ 14.06 |
| Second Quarter | 18.18 | 14.37 |
| Third Quarter | 16.59 | 9.38 |
| Fourth Quarter | 15.50 | 10.31 |

### Dividend Policy

During each quarter of 2005, the board of directors declared quarterly dividends of $0.07 per share of common stock. As of December 31, 2005 a total of $7.4 million in dividend payments has been made. No dividends were paid in 2004. 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, 2005:

| Period | Total Number of Shares Purchased [(1)] | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program [(2)] | Maximum Number of Shares that May Yet Be Purchased Under the Program [(2)] |
|---|---|---|---|---|
| 10/01/2005 – 10/31/2005 | — | $ — | — | 598,377 |
| 11/01/2005 – 11/30/2005 | — | — | — | 598,377 |
| 12/01/2005 – 12/31/2005 | — | — | — | 598,377 |
| Total | — | $ — | — | 598,377 |

(1) Our board of directors has approved the repurchase of up to an aggregate amount of 8,000,000 shares of Administaff common stock, of which 7,401,623 shares had been repurchased as of December 31, 2005. During the three months ended December 31, 2005, we did not purchase 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.

## 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 22.

| | Year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2002 | 2001 |
| | (in thousands, except per share and statistical data) | | | | |
| **Income Statement Data:** | | | | | |
| Revenues [1] | $ 1,169,612 | $ 969,527 | $ 890,859 | $ 848,416 | $ 720,219 |
| Gross profit | 235,756 | 197,694 | 197,105 | 165,790 | 165,015 |
| Operating income | 43,767 | 22,131 | 24,274 | 67 | 18,539 |
| Net income (loss) from continuing operations | 29,983 | 19,210 | 14,985 | (2,921) | 10,357 |
| Net loss from discontinued operations | — | — | (2,121) | (1,160) | — |
| Net income (loss) | 29,983 | 19,210 | 12,864 | (4,081) | 10,357 |
| Diluted net income (loss) per share from continuing operations | $ 1.12 | $ 0.72 | $ 0.55 | $ (0.11) | $ 0.36 |
| **Balance Sheet Data**: | | | | | |
| Working capital | $ 93,235 | $ 47,500 | $ 56,032 | $ 41,238 | $ 36,609 |
| Total assets | 495,439 | 355,388 | 348,071 | 315,164 | 274,003 |
| Total debt | 34,890 | 36,539 | 42,362 | 44,169 | 13,500 |
| Total stockholders' equity | 182,429 | 126,529 | 122,634 | 116,349 | 122,935 |
| Cash dividends per share | 0.28 | — | — | — | — |
| **Statistical Data:** | | | | | |
| Average number of worksite employees paid per month during period | 88,780 | 77,936 | 75,036 | 77,334 | 69,480 |
| Revenues per worksite employee per month [2] | $ 1,098 | $ 1,037 | $ 989 | $ 914 | $ 864 |
| Gross profit per worksite employee per month | $ 221 | $ 211 | $ 219 | $ 179 | $ 198 |
| Operating income per worksite employee per month | $ 41 | $ 24 | $ 27 | $ — | $ 22 |

(1) Gross billings of $6.633 billion, $5.377 billion, $4.829 billion, $4.857 billion, and $4.373 billion, less worksite employee payroll cost of $5.463 billion, $4.407 billion, $3.938 billion, $4.009 billion and $3.653 billion, respectively.

(2) Gross billings of $6,226, $5,749, $5,363, $5,234 and $5,245 per worksite employee per month, less payroll cost of $5,128, $4,712, $4,373, $4,320 and $4,381 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 39 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 number of worksite employees paid as our unit of measurement in analyzing and discussing our results of operations.

Our key objective for 2005 was to continue to accelerate the growth in the number of paid worksite employees while appropriately pricing our service offering and leveraging our existing infrastructure. We ended 2005 averaging 94,031 paid worksite employees in the fourth quarter, which represents a 16.2% increase over the fourth quarter of 2004. Our average number of worksite employees paid for the full year increased 13.9% over 2004. These increases were driven by improvements in client retention, sales and the net change in existing clients. During 2005, we experienced an 11.2% increase in the number of new worksite employees over 2004 related to new client sales and a 5.4% decline in the number of worksite employees lost due to client terminations as compared to 2004.

Our 2005 average gross profit per worksite employee per month of $221 reflected the effective execution of our pricing strategy, including a slight increase in the markup related to our HR services, while managing our direct costs to better than expected levels. Lower 2005 direct costs, particularly benefits costs and workers' compensation costs were primarily a result of the favorable trends in claims experience, complemented by lower administrative fees negotiated with our insurance carriers. Benefits costs per participant increased 3.9% over 2004, while workers' compensation costs as a percentage of non-bonus payroll declined by 18.9%.

Operating expenses increased by 9.4% in 2005 to $192.0 million on a 13.9% increase in the number of worksite employees paid, as we leveraged the existing infrastructure and operating expense levels. Accordingly, operating expenses, on a per worksite employee per month basis, declined from $188 in 2004 to $180 in 2005.

Our net income from operations increased 56.1% to $30.0 million in 2005 over 2004. We ended 2005 with working capital of $93.2 million, which is a $45.7 million increase from the end of 2004.

#### *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 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 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 amortization of deferred compensation expense of restricted stock awards and the non-cash expenses associated with the acceleration of stock option vesting in 2005.

- *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 and endorsement fees paid to Arnold Palmer.

- *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, state unemployment tax accruals 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, state unemployment taxes, 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 health insurance coverage to our worksite employees through a national network of carriers including UnitedHealthcare ("United"), Cigna Healthcare, PacifiCare, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California and Tufts, all of which provide fully insured policies or service contracts.

  The policy with United, which was first obtained in January 2002, 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 changes in the actual claims experience and other trends are incorporated into the benefits costs estimates.

Additionally, since the plan's inception in January 2002, 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 cash funded 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 cash funded 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.

We believe that 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 a decrease (or increase) in benefits costs and net income would increase (or decrease) accordingly.

The following table illustrates the sensitivity of changes in the completion rates on our estimate of total benefit costs of $455 million in 2005:

| Change in Completion Rate | Change in Benefits Costs (in thousands) | Change in Net Income (in thousands) |
|---|---|---|
| (2.5)% | $ (7,984) | $ 5,022 |
| (1.0)% | (3,193) | 2,009 |
| 1.0% | 3,193 | (2,009) |
| 2.5% | 7,984 | (5,022) |

In 2005, Administaff and United entered into a new three-year arrangement, whereby a previous contractual requirement to maintain a security deposit with United was eliminated. Accordingly, the outstanding security deposit at December 31, 2004 of $17.5 million was returned to Administaff during the quarter ended June 30, 2005. The terms of the new arrangement also require Administaff to maintain an accumulated cash surplus in the plan of $11 million, which was the balance of the accumulated surplus at December 31, 2004, and is now reported as long-term prepaid insurance. As of December 31, 2005, Plan Costs were less than the net cash funded to United by $18.1 million. As this amount is in excess of the agreed-upon $11 million surplus maintenance level, the $7.1 million balance is included in prepaid insurance, a current asset, on the Company's Consolidated Balance Sheet.

- *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. Until we receive the final tax rate notice, we estimate our expected SUI rate in those particular states. In December 2001, as a result of a 2001 corporate reorganization, we filed for a transfer of our reserve account with the Employment Development Department of the State of California ("EDD"). The EDD approved our request for transfer of our reserve account in May 2002, and notified us of our new contribution rates based upon the approved transfer. In December 2003, we received a Notice of Duplicate Accounts and Notification of Assessment ("Notice") from the EDD. The Notice stated that the EDD was collapsing the accounts of Administaff's subsidiaries into the account of the entity with the highest unemployment tax rate. The Notice also retroactively imposed the higher unemployment insurance rate on all our California employees for 2003, resulting in an assessment of $5.6 million. In January 2004, we filed a petition with an administrative law judge of the California Unemployment Insurance Appeals Board ("ALJ") to protest the Notice. Pending a resolution of our protest, in the fourth quarter of 2003 we accrued and recorded at the higher assessed rate for all of 2003.

In June 2004, we agreed to settle our dispute with the EDD for $3.3 million ("Settlement"). Based upon receipt of written acknowledgement of this agreement, we reduced our accrued payroll tax liability and payroll tax expense by $2.3 million during the quarter ended June 30, 2004. The Settlement was subject to the final approval by EDD's legal department, the California Attorney General's office and the ALJ. In October 2004, the legal department of the EDD verbally indicated they considered the previously agreed-upon settlement amount to be insufficient and suggested a settlement amount of $5.2 million. We continued discussions with the State of California, but in February 2005, we were notified that the EDD had rejected our settlement offer and that the matter will proceed with the appeals process with the ALJ. If the outcome of the appeals process is unfavorable and we are assessed additional interest and penalties, we may recognize an increase in our payroll tax expense in a future period. Conversely, if the outcome of the appeals process is favorable to us, we may recognize a decrease in our payroll tax expense in a future period. The ultimate outcome of this matter is not expected to have a material impact on our 2006 unemployment tax rate in California.

- *Workers' compensation costs* – On September 1, 2003, we obtained an annual workers' compensation policy with selected member insurance companies of American International Group, Inc. ("AIG"). This policy was subsequently renewed in September 2004 and October 2005. Under our arrangement with AIG, we bear the economic burden for the first $1 million layer of claims per occurrence. AIG bears the economic burden for all claims in excess of such first $1 million layer. The policies are fully insured whereby AIG has the responsibility to pay all claims incurred under the policies regardless of whether we satisfy our responsibilities.

  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. Our management estimates our workers' compensation costs by applying an aggregate loss development rate to worksite employee payroll levels.

  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 year ended December 31, 2005, Administaff reduced accrued workers' compensation costs by $4.6 million 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 2005 was 3.9%) 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 $54 million in 2005:

| Change in Loss Development Rate | Change in Workers' Compensation Costs (in thousands) | Change in Net Income (in thousands) |
|---|---|---|
| (5)% | $ (2,006) | $ 1,260 |
| (2.5)% | (1,003) | 630 |
| 2.5% | 1,003 | (630) |
| 5% | 2,006 | (1,260) |

At the beginning of each policy period, the insurance carrier, AIG, 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 AIG. 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.

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.

As of December 31, 2005, we had restricted cash of $27.6 million and deposits of $55.4 million. A $7.6 million security deposit related to the 2005 policy is included in deposits. We have estimated and accrued $60.3 million in incurred workers' compensation claim costs, which is net of $27.6 million in paid claims, as of December 31, 2005.

- *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. We have disclosed in our audited financial statements several issues that we believe are reasonably possible to occur, although we cannot determine the range of possible loss in all cases. See Note 13 to our consolidated financial statements. As these issues develop, we will continue to 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 analyze the estimated undiscounted future cash flows to be generated from the applicable asset. In addition, we would 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.

- *Goodwill and other intangibles* - The December 2005 acquisition of HRTools.com and associated software applications 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***

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, 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. Pro forma disclosure is no longer an alternative. We are required to adopt SFAS 123(R) in the first quarter of 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "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.

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either: (a) all prior periods presented; or (b) prior interim periods of the year of adoption.

We plan to adopt Statement 123(R) using the modified prospective method.

As permitted by Statement 123, we historically accounted for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. During the first quarter of 2005, we accelerated the vesting of all outstanding stock options, resulting in the recognition of $790,000 ($497,000, net of taxes) of stock based compensation expense. Accordingly, the adoption of SFAS 123(R) is not anticipated to have a material impact on our results of operations in 2006.

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - a Replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also redefines "restatement" as the revising of previously issued financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Administaff does not expect the adoption of SFAS 154 to have a material effect on the Company's consolidated financial position or results of operations.

### Transactions with Related and Other Certain Parties

We do not have any transactions with related parties that we consider material to our results of operations and/or financial condition.

## Results of Operations

***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004.***

The following table presents certain information related to the Company's results of operations for the years ended December 31, 2005 and 2004.

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **% change** |
| | **(in thousands, except per share and statistical data)** | | |
| Revenues (gross billings of $6.633 billion and $5.377 billion less worksite employee payroll cost of $5.463 billion and $4.407 billion, respectively) | $ 1,169,612 | $ 969,527 | 20.6% |
| Gross profit | 235,756 | 197,694 | 19.3% |
| Operating expenses | 191,989 | 175,563 | 9.4% |
| Operating income | 43,767 | 22,131 | 97.8% |
| Other income (expense) | 3,980 | 8,605 | (53.7)% |
| Net income | 29,983 | 19,210 | 56.1% |
| Diluted net income per share of common stock | 1.12 | 0.72 | 55.6% |
| **Statistical Data:** | | | |
| Average number of worksite employees paid per month | 88,780 | 77,936 | 13.9% |
| Revenues per worksite employee per month [(1)] | $ 1,098 | $ 1,037 | 5.9% |
| Gross profit per worksite employee per month | 221 | 211 | 4.7% |
| Operating expenses per worksite employee per month | 180 | 188 | (4.3)% |
| Operating income per worksite employee per month | 41 | 24 | 70.8% |
| Net income from continuing operations per worksite employee per month | 28 | 21 | 33.3% |

(1) Gross billings of $6,226 and $5,749 per worksite employee per month less payroll cost of $5,128 and $4,712 per worksite employee per month, respectively.

***Revenues***

Our revenues, which represent gross billings net of worksite employee payroll cost, increased 20.6% over 2004 due to a 13.9% increase in the average number of worksite employees paid per month and a 5.9%, or $61, increase in revenues per worksite employee per month. The 5.9% increase in revenues per worksite employee per month was due to both: (i) increases in the pricing components related to our direct costs, including payroll taxes, benefits and workers' compensation costs; and (ii) an increase in the markup related to our HR services.

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. The 13.9% increase in the average number of worksite employees paid per month during 2005 resulted from increases in all three sources of paid worksite employees.

The following table presents certain information related to the Company's revenues by region for the years ended December 31, 2005 and 2004.

| | Year ended December 31, | | | Year ended December 31, | |
|---|---|---|---|---|---|
| | 2005 | 2004 | % change | 2005 | 2004 |
| | (in thousands) | | | (% of total revenue) | |
| Northeast | $ 177,080 | $ 134,124 | 32.0% | 15.1% | 13.8% |
| Southeast | 101,851 | 90,657 | 12.3% | 8.7% | 9.4% |
| Central | 155,279 | 137,184 | 13.2% | 13.3% | 14.1% |
| Southwest | 455,741 | 378,901 | 20.3% | 39.0% | 39.1% |
| West | 271,991 | 222,209 | 22.4% | 23.2% | 22.9% |
| Other revenues | 7,670 | 6,452 | 18.9% | 0.7% | 0.7% |
| Total revenues | $1,169,612 | $ 969,527 | 20.6% | 100.0% | 100.0% |

***Gross Profit***

Gross profit increased 19.3% to $235.8 million compared to 2004. Gross profit per worksite employee increased 4.7% to $221 per month in 2005 versus $211 in 2004.

While our revenues per worksite employee per month increased 5.9%, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, increased 6.2% to $877 per worksite employee per month in 2005 versus $826 in 2004. The primary direct cost components changed as follows:

- *Payroll tax costs* – Payroll taxes increased $34 per worksite employee per month. Payroll taxes as a percentage of payroll cost were 7.46% in 2005. This compares to 7.41% in 2004 which included a $2.3 million payroll tax credit, or 0.05% as a percentage of payroll costs, related to a state unemployment matter with the state of California. Please read "Critical Accounting Policies and Estimates – State Unemployment Taxes" on page 25 for a detailed discussion of our accounting for state unemployment taxes.

- *Benefits costs* – The cost of health insurance and related employee benefits increased $23 per worksite employee per month to $427 compared to 2004. This increase is due to a 3.9% increase in the cost per covered employee and an increase in the percentage of worksite employees covered under our health insurance plan to 72.4% in 2005 versus 71.1% in 2004. Please read "—Critical Accounting Policies and Estimates – Benefits Costs" on page 24 for a discussion of our accounting for health insurance costs.

- *Workers' compensation costs* – Workers' compensation costs decreased $7 per worksite employee per month compared to 2004. As a percentage of non-bonus payroll cost, workers' compensation costs decreased to 1.09% in 2005 from 1.35% in 2004, primarily as a result of favorable trends in both the frequency and severity of workers' compensation claims. These trends resulted in reductions in estimated accrued workers' compensation costs related to prior reporting periods of $4.6 million, or 0.09% of non-bonus payroll costs, in the 2005 period. Please read "Critical Accounting Policies and Estimates – Workers' Compensation Costs" on page 26 for a discussion of our accounting for workers' compensation costs.

*Operating Expenses*

The following table presents certain information related to our operating expenses for the years ended December 31, 2005 and 2004.

| | Year ended December 31, (in thousands) | | | Year ended December 31, (per worksite employee per month) | | |
|---|---|---|---|---|---|---|
| | 2005 | 2004 | % change | 2005 | 2004 | % change |
| Salaries, wages and payroll taxes | $ 99,562 | $ 88,298 | 12.8% | $ 93 | $ 94 | (1.1)% |
| Stock-based compensation | 2,079 | — | — | 2 | — | — |
| General and administrative expenses | 52,960 | 49,283 | 7.5% | 50 | 53 | (5.7)% |
| Commissions | 10,121 | 10,447 | (3.1)% | 10 | 11 | (9.1)% |
| Advertising | 12,100 | 10,021 | 20.7% | 11 | 11 | — |
| Depreciation and amortization | 15,167 | 17,514 | (13.4)% | 14 | 19 | (26.3)% |
| Total operating expenses | $ 191,989 | $ 175,563 | 9.4% | $ 180 | $ 188 | (4.3)% |

Operating expenses increased 9.4% to $192.0 million. Operating expenses per worksite employee per month decreased 4.3% to $180 in 2005 versus $188 in 2004. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 12.8%, but declined $1 per worksite employee per month compared to 2004. During 2005, incentive compensation increased $6.1 million over 2004 due to the improved operating results. In addition, the number of corporate employees increased 3.1%, and the average pay for corporate employees increased 3.4%.

- Stock-based compensation expense of $2.1 million or $2 per worksite employee per month was a result of: (i) $790,000 related to the acceleration of stock option vesting during the first quarter of 2005; and (ii) $1,289,000 related to the amortization of deferred compensation expense associated with the February 2005 restricted stock grant. Please read Note 1 to the consolidated financial statements on page F-17 for additional information.

- General and administrative expenses increased 7.5%, but declined $3 per worksite employee per month compared to 2004. The increase in total dollars is primarily due to increases in: (i) repairs and maintenance; and (ii) professional fees such as consulting fees, accounting fees and recruiting costs.

- Commissions expense decreased 3.1% or $1 per worksite employee per month compared to 2004, as an increase in commissions paid to sales personnel was more than offset by cost savings resulting from the termination of our marketing and commission arrangement with American Express in December 2004.

- Advertising costs increased 20.7%, due primarily to increases in radio and television advertising associated with the 2005 sales campaigns. These costs remained flat on a per worksite employee basis as compared to 2004.

- Depreciation and amortization expense decreased 13.4% and $5 on a per worksite employee basis versus 2004 as the effect of certain fixed assets becoming fully amortized more than offset the incremental depreciation and amortization expense related to the 2005 capital additions.

*Other Income (Expense)*

Other income (expense) decreased to $4.0 million in 2005 compared to $8.6 million in 2004, primarily due to the $8.25 million settlement of our dispute with Aetna during the 2004 period. Interest income increased by $4.1 million, primarily as a result of an increase in cash balances, including cash held in our workers ’ compensation program and higher interest rates in 2005.

***Income Tax Expense***

During 2005, we incurred federal and state income tax expense of $17.8 million on pre-tax income of $47.7 million. Our provision for income taxes differed from the US statutory rate of 35% primarily due to state income taxes and non-deductible expenses. Our effective income tax rate was 37.2% in the 2005 period compared to 37.5% in the 2004 period.

***Net Income***

Net income for 2005 was $30.0 million, or $1.12 per diluted share, compared to $19.2 million, or $0.72 per diluted share in 2004. Net income for 2004 included $5.2 million or $0.19 per share of proceeds related to the settlement of our dispute with Aetna. On a per worksite employee per month basis, net income increased 33.3% to $28 in 2005 versus $21 in 2004.

***Year Ended December 31, 2004 Compared to Year Ended December 31, 2003.***

The following table presents certain information related to the Company's results of operations for the years ended December 31, 2004 and 2003.

| | Year ended December 31, | | |
|---|---|---|---|
| | **2004** | **2003** | **% change** |
| | **(in thousands, except per share and statistical data)** | | |
| Revenues (gross billings of $5.377 billion and $4.829 billion less worksite employee payroll cost of $4.407 billion and $3.938 billion, respectively) | $ 969,527 | $ 890,859 | 8.8% |
| Gross profit | 197,694 | 197,105 | 0.3% |
| Operating expenses | 175,563 | 172,831 | 1.6% |
| Operating income | 22,131 | 24,274 | (8.8)% |
| Other income | 8,605 | 196 | — |
| Net income from continuing operations | 19,210 | 14,985 | 28.2% |
| Diluted net income from continuing operations per share of common stock | 0.72 | 0.55 | 30.9% |
| **Statistical Data:** | | | |
| Average number of worksite employees paid per month | 77,936 | 75,036 | 3.9% |
| Revenues per worksite employee per month [1] | $ 1,037 | $ 989 | 4.9% |
| Gross profit per worksite employee per month | 211 | 219 | (3.7)% |
| Operating expenses per worksite employee per month | 188 | 192 | (2.1)% |
| Operating income per worksite employee per month | 24 | 27 | (11.1)% |
| Net income from continuing operations per worksite employee per month | 21 | 17 | 23.5% |

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[1] Gross billings of $5,749 and $5,363 per worksite employee per month less payroll cost of $4,712 and $4,373 per worksite employee per month, respectively.

***Revenues***

Our revenues, which represent gross billings net of worksite employee payroll cost, increased 8.8% over 2003 due to a 4.9% increase in revenues per worksite employee per month and a 3.9% increase in the average number of worksite employees paid per month.

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. The 3.9% increase in the average number of worksite employees paid per month during 2004 was due to an increase in worksite employees from all three sources of paid worksite employees.

The 4.9% increase in revenues per worksite employee per month was due to both: (i) increases in the pricing components related to our direct costs, including payroll taxes, benefits and workers' compensation costs; and (ii) an increase in the markup related to our HR services.

The following table presents certain information related to the Company's revenues by region for the years ended December 31, 2004 and 2003.

| | Year ended December 31, | | | Year ended December 31, | |
|---|---|---|---|---|---|
| | 2004 | 2003 | % change | 2004 | 2003 |
| | (in thousands) | | | (% of total revenue) | |
| Northeast | $ 134,124 | $ 115,872 | 15.8% | 13.8% | 13.0% |
| Southeast | 90,657 | 95,293 | (4.9)% | 9.4% | 10.7% |
| Central | 137,184 | 131,416 | 4.4% | 14.1% | 14.8% |
| Southwest | 378,901 | 355,283 | 6.6% | 39.1% | 39.8% |
| West | 222,209 | 187,996 | 18.2% | 22.9% | 21.1% |
| Other revenues | 6,452 | 4,999 | 29.1% | 0.7% | 0.6% |
| Total revenues | $ 969,527 | $ 890,859 | 8.8% | 100.0% | 100.0% |

***Gross Profit***

Gross profit increased 0.3% to $197.7 million compared to 2003. Gross profit per worksite employee decreased 3.7% to $211 per month in 2004 versus $219 in 2003. This decrease was primarily the result of moderating price increases in the health insurance component of the comprehensive service fee, relative to expected cost increases, over the last half of 2003 and first half of 2004.

While our revenues per worksite employee per month increased 4.9%, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, increased 7.3% to $826 per worksite employee per month in 2004 versus $770 in 2003. The primary direct cost components changed as follows:

- *Payroll tax costs* – Payroll taxes increased $33 per worksite employee per month. Payroll taxes as a percentage of payroll cost increased to 7.41% in 2004 from 7.23% in 2003. The increase was a result of higher weighted average state unemployment tax rates in 2004 compared to 2003, offset in part by the $2.3 million, or 0.05% of payroll cost, reduction of payroll tax expense related to the settlement discussions with the state of California in the second quarter of 2004. In addition, during 2003, we recorded a $3.9 million, or 0.10% of payroll cost, reduction in payroll taxes due to the receipt of our final 2002 and 2003 unemployment tax rates from the Texas Workforce Commission. Furthermore, we accrued $5.6 million, or 0.14% of payroll cost, in additional payroll taxes in 2003 related to an unemployment tax assessment from the Employment Development Department of the State of California. Please read "Critical Accounting Policies and Estimates – State Unemployment Taxes" on page 25 for a detailed discussion of our accounting for payroll taxes.

- *Benefits costs* – The cost of health insurance and related employee benefits increased $24 per worksite employee per month over 2003, due to a 5.7% increase in the cost per covered employee and an increase in the percentage of worksite employees covered under our health insurance plan to 71.1% in 2004 versus 70.7% in 2003. Please read "—Critical Accounting Policies and Estimates – Benefits Costs" on page 24 for a discussion of our accounting for health insurance costs.

- *Workers' compensation costs* – Workers' compensation costs decreased $5 per worksite employee per month, and decreased to 1.35% of non-bonus payroll cost in 2004 from 1.56% in 2003. In 2004, we collected and recorded a $1.1 million, or 0.03% of non-bonus payroll cost, reimbursement from an insurance carrier related to a 2003 workers' compensation settlement with the State of Texas. During 2003, we incurred: (i) a $2.5 million, or 0.07% of non-bonus payroll cost, charge related to our former workers' compensation dividend receivable due to collectibility concerns; and (ii) approximately $2.0 million, or 0.06% of non-bonus payroll cost, in workers' compensation costs related to contract termination costs associated with our former policy and state surcharges relating to policies dating back to 1999, which were assessed by various states and passed through to Administaff through our previous carrier. Please read "—Critical Accounting Policies and Estimates – Workers' Compensation Costs" on page 26 for a discussion of our accounting for workers' compensation costs.

***Operating Expenses***

The following table presents certain information related to our operating expenses for the years ended December 31, 2004 and 2003.

| | Year ended December 31, (in thousands) | | | Year ended December 31, (per worksite employee per month) | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | % change | 2004 | 2003 | % change |
| Salaries, wages and payroll taxes | $ 88,298 | $ 82,802 | 6.6% | $ 94 | $ 92 | 2.2% |
| General and administrative expenses | 49,283 | 50,033 | (1.5)% | 53 | 55 | (3.6)% |
| Commissions | 10,447 | 10,656 | (2.0)% | 11 | 12 | (8.3)% |
| Advertising | 10,021 | 8,581 | 16.8% | 11 | 10 | 10.0% |
| Depreciation and amortization | 17,514 | 20,759 | (15.6)% | 19 | 23 | (17.4)% |
| Total operating expenses | $ 175,563 | $ 172,831 | 1.6% | $ 188 | $ 192 | (2.1)% |

Operating expenses increased 1.6% to $175.6 million. Operating expenses per worksite employee per month decreased 2.1% to $188 in 2004 versus $192 in 2003. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 6.6%, or $2 per worksite employee per month compared to 2003. The increase is primarily due to a 2.7% increase in headcount and a 3.6% increase in average pay, offset by a $1.3 million decrease in incentive compensation and $1.5 million decrease in capitalized software development costs in 2004.

- General and administrative expenses decreased 1.5%, or $2 per worksite employee per month compared to 2003. The decrease is primarily due to higher legal fees in the 2003 period associated with the legal dispute with Aetna and lower consulting costs, offset by higher corporate insurance and repairs and maintenance costs in 2004.

- Commissions expense decreased 2.0% or $1 per worksite employee per month compared to 2003.

- Advertising costs increased 16.8% or $1 per worksite employee as compared to 2003, due primarily to sponsorship costs associated with the Administaff Small Business Classic professional golf tournament held in October 2004 in Houston, Texas.

- Depreciation and amortization expense decreased 15.6% and $4 on a per worksite employee basis versus 2003 as the effect of certain fixed assets becoming fully amortized more than offset the incremental depreciation and amortization expense related to the 2004 capital additions.

***Other Income (Expense)***

Other income (expense) increased to $8.6 million in 2004 compared to $196,000 in 2003, primarily due to the $8.25 million settlement of our dispute with Aetna during 2004.

*Income Tax Expense*

During 2004, we incurred federal and state income tax expense of $11.5 million on pre-tax income of $30.7 million. Our provision for income taxes differed from the US statutory rate of 35% primarily due to state income taxes and non-deductible expenses. Our effective income tax rate was 37.5% in the 2004 period compared to 38.8% in the 2003 period. During 2004, we recorded a $213,000 cumulative tax adjustment due to a change in estimate resulting from the favorable impact of our captive insurance subsidiary on state income tax rates. In 2003 we utilized previously unrecognized capital loss carryforwards on a $457,000 gain from the sale of an investment.

*Net Income From Continuing Operations*

Net income from continuing operations for 2004 was $19.2 million, or $0.72 per diluted share, compared to $15.0 million, or $0.55 per diluted share in 2003. On a per worksite employee per month basis, net income from continuing operations increased 23.5% to $21 in 2004 versus $17 in 2003.

*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.

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **% Change** |
| | **(in thousands, except per worksite employee)** | | |
| GAAP to non-GAAP reconciliation: | | | |
| Payroll cost (GAAP) | $5,463,474 | $4,407,063 | 24.0% |
| Less: bonus payroll cost | 508,170 | 392,909 | 29.3% |
| Non-Bonus payroll cost | $4,955,304 | $4,014,154 | 23.4% |
| Payroll cost per worksite employee (GAAP) | $ 5,128 | $ 4,712 | 8.8% |
| Less: Bonus payroll cost per worksite employee | 477 | 420 | 13.6% |
| Non-bonus payroll cost per worksite employee | $ 4,651 | $ 4,292 | 8.4% |

## 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 $195.4 million in cash and cash equivalents and marketable securities at December 31, 2005, of which approximately $91.3 million was payable in early January 2006 for withheld federal and state income taxes, employment taxes and other payroll deductions. At December 31, 2005, we had working capital of $93.2 million compared to $47.5 million at December 31, 2004. We currently believe that our cash on hand, marketable securities and cash flows from operations will be adequate to meet our liquidity requirements for 2006. 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 2005 increased $101.2 million from 2004 to $111.7 million. 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:

- *Operating results* – Our net income has a significant impact on our operating cash flows. Our net income increased to $30.0 million in 2005 from $19.2 million in 2004. Please read "Results of Operations – Year Ended December 31, 2005 Compared to Year Ended December 31, 2004" on page 30.

- *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 in January 2002, cash funded to United has exceeded Plan Costs resulting in an $18.1 million surplus, $7.1 of which is reflected as a current asset, and $11.0 million of which is reflected as a long-term asset on our Consolidated Balance Sheets at December 31, 2005. Additionally, the $17.5 million included in long-term deposits on the Consolidated Balance Sheet at December 31, 2004, was returned to Administaff during 2005.

- *Workers' compensation plan funding* – Under our arrangement with AIG, we make monthly payments to AIG 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 agreement with AIG, 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 arrangement with AIG can result in changes in the amount of the cash payments to AIG, which will impact our reporting of operating cash flows. Our claim funds paid to AIG, based upon anticipated worksite employee payroll levels and workers' compensation loss rates, were $50.0 million, less claims paid of $17.2 million in 2005, and $51.7 million, less claims paid of $9.8 million for the 2004 period. This compares to our estimate of workers' compensation loss costs of $36.0 million and $39.2 million in 2005 and 2004, respectively. Additionally, during year ended December 31, 2005, Administaff received $16.8 million for the return of excess funding related to the 2003-2004 policy and $6.0 million in return of buffer collateral.

- *Timing of customer 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. Therefore, the last business day of a reporting period has a substantial impact on our reporting of operating cash flows. For example, many worksite employees are paid on Fridays; therefore, operating cash flows decline in the reporting periods, which end on a Friday, such as in 2005, when client prepayments were $9.5 million and accrued worksite employee payroll was $78.4 million. However, for those reporting periods which end on a Thursday, such as in June 2005, when customer prepayments were $51.7 million and accrued worksite employee payroll was $103.2 million, our cash flows are higher due to the collection of the comprehensive service fee and client's payroll funding prior to processing the large number worksite employees' payrolls one day subsequent to the period end.

*Cash Flows From Investing Activities*

Capital expenditures totaled $28.6 million in 2005 and consisted primarily of an aircraft, computer hardware and software. Capital expenditures for computer hardware and software included costs associated with purchasing software licenses and computer hardware to enhance the performance and stability of our technology infrastructure. We expect approximately $13 million in capital expenditures in 2006.

Additionally, in 2005, we invested $30.4 million in marketable securities and $6.25 million in the acquisition of HRTools.com and associated software applications.

*Cash Flows Used In Financing Activities*

Cash flows provided by financing activities were $9.5 million during 2005, an increase of $30.8 million over 2004. Cash flows provided by financing activities primarily related to $30.1 million in proceeds from the exercise of employee stock options, offset by the repurchase of $12.2 million in treasury stock and $7.4 million in dividends paid.

On December 20, 2002, we entered into a $36 million mortgage agreement that matures in January 2008. The proceeds were used to repay our outstanding balance under our revolving credit agreement, which expired in December 2002. The mortgage bears interest at a variable rate equal to the greater of (a) 4.5%; or (b) the 30-day LIBOR rate (4.3% at December 31, 2005) plus 2.9%. The mortgage is secured by real estate and related fixtures located at Administaff's headquarters in Kingwood, Texas. Monthly principal and interest payments are approximately $296,000, with the remaining balance due upon maturity. The mortgage provides for prepayment penalties, as a percentage of the outstanding principal balance, ranging from 5% down to 1% during the first four years of the term. There is no prepayment penalty during the final year of the mortgage.

In October 2002, we entered into a $3.8 million 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.

*Contractual Obligations and Commercial Commitments*

The following table summarizes our contractual obligations and commercial commitments as of December 31, 2005 and the effect they are expected to have on our liquidity and capital resources (in thousands):

| | **Total** | **Less than 1 Year** | **1-3 Years** | **3-5 Years** | **More than 5 Years** |
|---|---|---|---|---|---|
| **Contractual obligations:** | | | | | |
| Mortgage | $ 32,599 | $ 1,158 | $ 31,441 | $ — | $ — |
| Capital lease obligations | 2,639 | 695 | 1,390 | 554 | — |
| Non-cancelable operating leases | 43,957 | 9,053 | 15,006 | 9,984 | 9,914 |
| Purchase obligations (1) | 13,155 | 6,627 | 5,808 | 720 | — |
| Other long-term liabilities | | | | | |
| Accrued workers' compensation costs (2) | 60,272 | 27,580 | 14,256 | 12,050 | 6,386 |
| Total contractual cash obligations | $152,622 | $ 45,113 | $ 67,901 | $ 23,308 | $ 16,300 |

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

(2) The current portion of these liabilities is also included. 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

### *Liability for Worksite Employee Payroll and Benefits Costs*

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; 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 and Workers' Compensation Costs*

Maintaining health and workers' compensation insurance plans that cover worksite employees is a significant part of our business. Our primary health insurance contract expires on December 31, 2006, and automatically renews each year, subject to cancellation by either party upon 180 days notice. The current workers' compensation contract expires on September 30, 2006. In the event we are unable to secure replacement contracts on competitive terms, significant disruption to our business could occur.

Health insurance premiums and workers' compensation costs 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 or workers' compensation 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.

We provide health insurance coverage to our worksite employees through a national network of carriers including UnitedHealthcare ("United"), Cigna Healthcare, PacifiCare, Kaiser Permanente, Blue Cross and Blue Shield of Georgia, Blue Shield of California and Tufts, all of which provide fully insured policies or service contracts.

The policy with United, which was first obtained in January 2002, 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; and (iii) the number of participants in the plan. Each reporting period, changes in the estimated ultimate costs resulting from changes in the actual claims experience and other trends are incorporated into the benefits costs estimates.

Additionally, since the plan's inception in January 2002, 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 cash funded 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 cash funded 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 2005, Administaff and United entered into a new three-year arrangement, whereby a previous contractual requirement to maintain a security deposit with United was eliminated. Accordingly, the outstanding security deposit at December 31, 2004 of $17.5 million was returned to Administaff during the quarter ended June 30, 2005. The terms of the new arrangement also require Administaff to maintain an accumulated cash surplus in the plan of $11 million, which was the balance of the accumulated surplus at December 31, 2004, and is now reported as long-term prepaid insurance. As of December 31, 2005, Plan Costs were less than the net cash funded to United by $18.1 million. As this amount is in excess of the agreed-upon $11 million surplus maintenance level, the $7.1 million balance is included in prepaid insurance, a current asset, on the Company's Consolidated Balance Sheet.

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 June 2005, Kemper announced further negative developments with respect to its financial status. In August 2005, Kemper announced that it had filed its audited statutory financial statements for 2004. In the event the run-off process is not successful and Kemper is forced into bankruptcy or a similar proceeding, most states have established guaranty funds to pay remaining claims. However, the guarantee 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, 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.

On September 1, 2003, we obtained an annual workers' compensation policy with selected member insurance companies of American International Group, Inc. ("AIG"). This policy was subsequently renewed in September 2004 and October 2005. Under our arrangement with AIG, we bear the economic burden for the first $1 million layer of claims per occurrence. AIG bears the economic burden for all claims in excess of such first $1 million layer. The policies are fully insured whereby AIG has the responsibility to pay all claims incurred under the policies regardless of whether we satisfy our responsibilities.

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. Our management estimates our workers' compensation costs by applying an aggregate loss development rate to worksite employee payroll levels.

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 year ended December 31, 2005, Administaff reduced accrued workers' compensation costs by $4.6 million 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 2005 was 3.9%) and is 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.

In conjunction with entering into the AIG Policy, 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.

***Increases in Unemployment Tax Rates***

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, states have the ability under law to increase unemployment tax rates to cover deficiencies in the unemployment tax fund. Many states have experienced and are experiencing significant increases in unemployment claims due to depressed economic conditions over the last few years. As a result, our unemployment tax rates have increased over the last several years; however, we are not expecting unemployment tax rates on average to increase materially in 2006 due to improving employment trends in 2005. Some states have implemented retroactive cost increases. 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.

As a result of a 2001 corporate restructuring, we filed for a transfer of our reserve account with the EDD. The EDD approved our request for transfer of our reserve account in May 2002 and also notified us of our new contribution rates based upon the approved transfer. In December 2003, we received a Notice of Duplicate Accounts and Notification of Assessment from the EDD. The notice stated that the EDD was collapsing the accounts of our subsidiaries into the account of the entity with the highest unemployment tax rate. The notice also retroactively imposed the higher unemployment insurance rate on all our California employees for 2003, resulting in an assessment of $5.6 million. In January 2004, we filed a petition with an administrative law judge of the California Unemployment Insurance Appeals Board ("ALJ") to protest the notice. Pending a resolution of our protest, in the fourth quarter of 2003 we accrued and recorded at the higher assessed rate for all of 2003.

In June 2004, we agreed to settle our dispute with the EDD for $3.3 million. Based upon receipt of written acknowledgement of this agreement, we reduced our accrued payroll tax liability and payroll tax expense by $2.3 million during the quarter ended June 30, 2004. The settlement was subject to the final approval by EDD's legal department, the California Attorney General's office and the ALJ. In October 2004, the legal department of the EDD verbally indicated they considered the previously agreed-upon settlement amount to be insufficient and suggested a settlement amount of $5.2 million. We continued discussion with the State of California, but in February 2005, we were notified that the EDD had rejected our settlement offer and the matter will proceed with the appeals process with the ALJ. If the outcome of the appeals process is unfavorable and we are assessed additional interest and penalties, we may recognize an increase in our payroll tax expense in a future period. Conversely, if the outcome of the appeals process is favorable to us, we may recognize a decrease in our payroll tax expense in a future period. The ultimate outcome of this matter is not expected to have a material impact on the Company's 2006 unemployment tax rate in California.

***Need to Renew or Replace Clients***

Our standard CSA can be cancelled by us or the client with 30 to 60 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 20% in 2005. There can be no assurance that the number of contract cancellations will continue at these levels or increase in the future.

***Competition and New Market Entrants***

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.

***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. However, because we act as a co-employer, we may be subject to liability for violations of these or other 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.

We maintain certain general insurance coverages (including coverages for our clients) to manage our exposure for these types of 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.

***Federal, State and Local Regulation***

As a major employer, our operations are affected by numerous federal, state and local laws and regulations relating to labor, tax 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 these other 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, 28 states have passed laws that have licensing 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***

While we have sales offices in 21 markets, our Houston and Texas (including Houston) markets accounted for approximately 20% and 39%, respectively, of our revenues for the year ended December 31, 2005. 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).

***Potential Client Liability for Employment Taxes***

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.

## ITEM 7A. QUALITATIVE AND QUANTITATIVE 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, our available-for-sale marketable securities, and our long-term debt. 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 marketable securities are currently managed by two professional investment management companies, each of which is guided by our investment policy. Our investment policy is designed to maximize after-tax interest income while preserving our principal investment. As a result, our marketable securities consist primarily of short and intermediate-term debt securities.

As of December 31, 2005, our available-for-sale marketable securities included an investment in a mutual fund that holds corporate debt securities with maturities up to 18 months. The amortized cost basis, fair market value and 30-day yield of this investment was $11.7 million, $11.5 million and 4.37%, respectively, at December 31, 2005. The following table presents information about our available-for-sale marketable securities, excluding the mutual fund investment, as of December 31, 2005 (dollars in thousands):

| | Principal Maturities | Average Interest Rate |
|---|---|---|
| 2006 | $ 4,700 | 3.5% |
| 2007 | 450 | 4.7% |
| 2008 | 200 | 5.0% |
| 2009 | 490 | 5.1% |
| 2010 | — | — |
| Thereafter | 40,575 [1] | 3.3% |
| Total | $ 46,415 | 3.4% |
| Fair Market Value | $ 46,492 | |

[1] Includes auction rate securities with original maturities greater than five years; however, the interest rates reset at least every 60 days based on short-term market yields.

Our mortgage loan includes variable interest rates, and as a result, our total cost of borrowing under the agreement is also subject to interest rate risk. As of December 31, 2005 we had a $32.6 million principal balance under the agreement with an interest rate of 7.2%. At December 31, 2005, the fair market value of our variable rate borrowing approximated the carrying value. The following table summarizes principal maturities of our variable interest rate mortgage as of December 31, 2005 (dollars in thousands):

| | Principal Maturities |
|---|---|
| 2006 | $ 1,158 |
| 2007 | 1,070 |
| 2008 | 30,371 |
| | $ 32,599 |

## 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, 2005.

### 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, 2005. Ernst & Young, LLP, our independent registered public accounting firm, also attested to, and reported on, management's assessment of the effectiveness of internal control over financial reporting. Management's report and the independent registered public accounting firm's attestation report are included in our 2005 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, 2005 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 AND EXECUTIVE OFFICERS OF THE REGISTRANT.

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 2009 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. 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" and "Proposal Number 2 – Approval of the 2001 Incentive Plan, as amended and restated – Equity Compensation Plan Information" in the Administaff Proxy Statement.

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

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 3: 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 AND 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 Bylaws, as amended on March 7, 2001 (incorporated by reference to Exhibit 3.2 to the Registrant's Form 10-K filed for the year ended December 31, 2000).
3.3 Certificate of Designations of Series A Junior Participating Preferred Stock of Administaff, Inc. Dated February 4, 1998 (incorporated by reference to Exhibit 2 to the Registrant's Form 8-A filed on February 4, 1998).
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 February 4, 1998, between Administaff, Inc. and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 1 to the Registrant's Form 8-A filed on February 4, 1998).
4.3 Amendment No. 1 to Rights Agreement dated as of March 9, 1998 between Administaff, Inc. and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 4.3 to the Registrant's Form 10-K for the year ended December 31, 1999).
4.4 Amendment No. 2 to Rights Agreement dated as of May 14, 1999 between Administaff, Inc. and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 2 to the Registrant's Form 8-A/A filed on May 19, 1999).
4.5 Amendment No. 3 to Rights Agreement dated as of July 22, 1999 between Administaff, Inc. and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 1 to the Registrant's Form 8-A/A filed on August 9, 1999).
4.6 Amendment No. 4 to Rights Agreement dated as of August 2, 1999 between Administaff, Inc. and Harris Trust and Savings Bank, as Rights Agent (incorporated by reference to Exhibit 2 to the Registrant's form 8-A/A filed on August 9, 1999).
4.7 Form of Rights Certificate (incorporated by reference to Exhibit 3 to the Registrant's Form 8-A filed on February 4, 1998).
4.8 Amended and Restated Rights Agreement effective as of April 19, 2003 between Administaff, Inc. and Mellon Investor Services LLC, as Rights Agent (incorporated by reference to Exhibit 1 to the Registrant's Form 8-A/A filed on May 16, 2003).
4.9 Amendment No. 1 to Amended and Restated Rights Agreement dated as of August 21, 2003 between Administaff, Inc. and Mellon Investor Services LLC, as Rights Agent (incorporated by reference to Exhibit 1 to the Registrant's Form 8A/A filed on August 22, 2003).
4.10 Amendment No. 2 to Amended and Restated Rights Agreement dated as of February 24, 2004 between Administaff, Inc. and Mellon Investor Services LLC, as Rights Agent (incorporated by reference to Exhibit 4.10 to the Registrant's Form 10-K for the year ended December 31, 2003).

| | |
|---|---|
| 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 (incorporated by reference to Exhibit 10.1 to the Registrant's Form 10-Q filed for the quarter ended March 31, 2001). |
| 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 | Administaff, 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 Administaff, 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 Administaff, 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 | Administaff, 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 Administaff, 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 Administaff, 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 | Promissory Note dated December 20, 2002 executed by Administaff Services, L.P, payable to General Electric Capital Business Asset Funding Corporation (incorporated by reference to Exhibit 10.18 to the Registrant's Form 10-K for the year ended December 31, 2002). |
| 10.21 | Guaranty dated December 20, 2002 by Administaff, Inc. in favor of General Electric Capital Business Asset Funding Corporation (incorporated by reference to Exhibit 10.19 to the Registrant's Form 10-K for the year ended December 31, 2002). |

| | |
|---|---|
| 10.22 | Commercial Deed of Trust, Security Agreement, Assignment of Leases and Rents, and Fixture Filing, dated December 20, 2002, executed by Administaff Services, L.P. in favor of General Electric Capital Business Asset Funding Corporation (incorporated by reference to Exhibit 10.20 to the Registrant's Form 10-K for the year ended December 31, 2002). |
| 10.23 | Minimum Premium Financial Agreement by and between Administaff 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). |
| 10.24 | Minimum Premium Administrative Services Agreement by and between Administaff 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). |
| 10.25 | Amended and Restated Security Deposit Agreement by and between Administaff 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). |
| 10.26 | Amendment to Various Agreements between United Healthcare Insurance Company and Administaff of Texas, Inc. |
| 10.27 | Houston Service Center Operating Lease Amendment. |
| 10.28* | Aircraft Purchase Agreement between John Wing Aviation, LLC and Administaff, Inc. dated December 30, 2005. |
| 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. |

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* Filed herewith.

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

## 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 16, 2006.

ADMINISTAFF, INC.

By: */s/ Douglas S. Sharp*
Douglas S. Sharp
*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 16, 2006:

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

** By: /s/ John H. Spurgin, II*
John H. Spurgin, II, attorney-in-fact

# ADMINISTAFF, INC.

## INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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## 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, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005. 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, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with United States generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Administaff, Inc.'s internal control over financial reporting as of December 31, 2005, 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 13, 2006 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Houston, Texas
February 13, 2006

## MANAGEMENT'S REPORT ON INTERNAL CONTROL

The Company has assessed the effectiveness of its internal control over financial reporting as of December 31, 2005 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, 2005 have issued an attestation report on management's assessment 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, 2005, 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
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 management's assessment, included in the accompanying Management's Report on Internal Control, that Administaff, Inc. maintained effective internal control over financial reporting as of December 31, 2005, 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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, management's assessment that Administaff, Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Administaff, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, 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, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2005 of Administaff, Inc. and our report dated February 13, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP

Houston, Texas
February 13, 2006

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

**ASSETS**

| | December 31, 2005 | December 31, 2004 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ 137,407 | $ 81,740 |
| Restricted cash | 27,580 | 18,511 |
| Marketable securities | 57,973 | 27,950 |
| Accounts receivable: | | |
| Trade, net | 5,225 | 610 |
| Unbilled | 91,258 | 65,149 |
| Other | 1,928 | 1,451 |
| Prepaid insurance | 9,218 | 14,428 |
| Other current assets | 4,664 | 4,731 |
| Income taxes receivable | — | 489 |
| Deferred income taxes | 3,308 | — |
| Total current assets | 338,561 | 215,059 |
| Property and equipment: | | |
| Land | 2,920 | 2,920 |
| Buildings and improvements | 58,264 | 57,005 |
| Computer hardware and software | 58,194 | 50,765 |
| Software development costs | 18,435 | 18,622 |
| Furniture and fixtures | 28,748 | 28,412 |
| Vehicles and aircraft | 22,366 | 5,725 |
| | 188,927 | 163,449 |
| Accumulated depreciation and amortization | (105,307) | (94,392) |
| Total property and equipment, net | 83,620 | 69,057 |
| Other assets: | | |
| Prepaid insurance | 11,000 | — |
| Deposits – healthcare | 954 | 18,329 |
| Deposits – workers' compensation | 55,421 | 52,264 |
| Goodwill and other intangible assets | 5,018 | — |
| Other assets | 865 | 679 |
| Total other assets | 73,258 | 71,272 |
| Total assets | $ 495,439 | $ 355,388 |

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

### LIABILITIES AND STOCKHOLDERS' EQUITY

| | December 31, 2005 | December 31, 2004 |
|---|---|---|
| Current liabilities: | | |
| Accounts payable | $ 4,979 | $ 3,130 |
| Payroll taxes and other payroll deductions payable | 101,293 | 64,471 |
| Accrued worksite employee payroll cost | 78,393 | 59,277 |
| Accrued health insurance costs | 3,495 | 1,991 |
| Accrued workers' compensation costs | 30,212 | 19,349 |
| Accrued corporate payroll and commissions | 17,801 | 11,031 |
| Other accrued liabilities | 7,453 | 6,430 |
| Deferred income taxes | — | 231 |
| Current portion of long-term debt | 1,700 | 1,649 |
| Total current liabilities | 245,326 | 167,559 |
| Noncurrent liabilities: | | |
| Long-term debt | 33,190 | 34,890 |
| Accrued workers' compensation costs | 32,692 | 22,912 |
| Deferred income taxes | 1,802 | 3,498 |
| Total noncurrent liabilities | 67,684 | 61,300 |
| 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, 2005 and 2004, respectively | 309 | 309 |
| Additional paid-in capital | 119,573 | 101,623 |
| Deferred compensation expense | (2,931) | — |
| Treasury stock, at cost – 3,547 and 5,362 shares at December 31, 2005 and 2004, respectively | (45,614) | (63,925) |
| Accumulated other comprehensive loss, net of tax | (153) | (127) |
| Retained earnings | 111,245 | 88,649 |
| Total stockholders' equity | 182,429 | 126,529 |
| Total liabilities and stockholders' equity | $ 495,439 | $ 355,388 |

See accompanying notes.

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

| | Year ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| Revenues (gross billings of $6.633 billion, $5.377 billion and $4.829 billion less worksite employee payroll cost of $5.463 billion, $4.407 billion, and $3.938 billion, respectively) | $1,169,612 | $ 969,527 | $ 890,859 |
| Direct costs: | | | |
| Payroll taxes, benefits and workers' compensation costs | 933,856 | 771,833 | 693,754 |
| Gross profit | 235,756 | 197,694 | 197,105 |
| Operating expenses: | | | |
| Salaries, wages and payroll taxes | 99,562 | 88,298 | 82,802 |
| Stock-based compensation | 2,079 | — | — |
| General and administrative expenses | 52,960 | 49,283 | 50,033 |
| Commissions | 10,121 | 10,447 | 10,656 |
| Advertising | 12,100 | 10,021 | 8,581 |
| Depreciation and amortization | 15,167 | 17,514 | 20,759 |
| | 191,989 | 175,563 | 172,831 |
| Operating income | 43,767 | 22,131 | 24,274 |
| Other income (expense): | | | |
| Interest income | 6,549 | 2,449 | 1,910 |
| Interest expense | (2,359) | (2,093) | (2,176) |
| Other, net | (210) | 8,249 | 462 |
| | 3,980 | 8,605 | 196 |
| Income before income tax expense | 47,747 | 30,736 | 24,470 |
| Income tax expense | 17,764 | 11,526 | 9,485 |
| Net income from continuing operations | $ 29,983 | $ 19,210 | $ 14,985 |
| Discontinued operations: | | | |
| Loss from discontinued operations | — | — | (3,264) |
| Income tax expense (benefit) | — | — | (1,143) |
| Net loss from discontinued operations | — | — | (2,121) |
| Net income | $ 29,983 | $ 19,210 | $ 12,864 |
| Basic net income per share of common stock: | | | |
| Income from continuing operations | $ 1.16 | $ 0.74 | $ 0.56 |
| Loss from discontinued operations | — | — | (0.08) |
| Basic net income per share of common stock | $ 1.16 | $ 0.74 | $ 0.48 |
| Diluted net income per share of common stock: | | | |
| Income from continuing operations | $ 1.12 | $ 0.72 | $ 0.55 |
| Loss from discontinued operations | — | — | (0.08) |
| Diluted net income per share of common stock | $ 1.12 | $ 0.72 | $ 0.47 |

See accompanying notes.

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

| | Common Stock Issued Shares | Common Stock Issued Amount | Additional Paid-In Capital | Deferred Compensation Expense | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2002 | 30,839 | $ 309 | $ 102,315 | $ — | $ (43,003) | $ 153 | $ 56,575 | $ 116,349 |
| Purchase of treasury stock, at cost | — | — | — | — | (8,233) | — | — | (8,233) |
| Sale of treasury stock to Administaff Employee Stock Purchase Plan | — | — | (322) | — | 848 | — | — | 526 |
| Exercise of stock options | — | — | (466) | — | 1,343 | — | — | 877 |
| Income tax benefit from exercise of stock options | — | — | 249 | — | — | — | — | 249 |
| Other | — | — | (95) | — | 250 | — | — | 155 |
| Change in unrealized gain on marketable securities, net of tax: | | | | | | | | |
| Realized gain | — | — | — | — | — | (44) | — | (44) |
| Unrealized loss | — | — | — | — | — | (109) | — | (109) |
| Net income | — | — | — | — | — | — | 12,864 | 12,864 |
| Comprehensive income | — | — | — | — | — | — | — | 12,711 |
| Balance at December 31, 2003 | 30,839 | $ 309 | $ 101,681 | $ — | $ (48,795) | $ — | $ 69,439 | $ 122,634 |
| Purchase of treasury stock, at cost | — | — | — | — | (17,153) | — | — | (17,153) |
| Sale of treasury stock to Administaff Employee Stock Purchase Plan | — | — | 80 | — | 363 | — | — | 443 |
| Exercise of stock options | — | — | (511) | — | 1,522 | — | — | 1,011 |
| Income tax benefit from exercise of stock options | — | — | 352 | — | — | — | — | 352 |
| Other | — | — | 21 | — | 138 | — | — | 159 |
| Change in unrealized gain on marketable securities, net of tax: | | | | | | | | |
| Realized gain | — | — | — | — | — | (13) | — | (13) |
| Unrealized loss | — | — | — | — | — | (114) | — | (114) |
| Net income | — | — | — | — | — | — | 19,210 | 19,210 |
| Comprehensive income | — | — | — | — | — | — | — | 19,083 |
| Balance at December 31, 2004 | 30,839 | $ 309 | $ 101,623 | $ — | $ (63,925) | $ (127) | $ 88,649 | $ 126,529 |

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

| | Common Stock Issued Shares | Common Stock Issued Amount | Additional Paid-In Capital | Deferred Compensation Expense | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2004 | 30,839 | $ 309 | $ 101,623 | $ — | $ (63,925) | $ (127) | $ 88,649 | $ 126,529 |
| Purchase of treasury stock, at cost | — | — | — | — | (12,200) | — | — | (12,200) |
| Sale of treasury stock to Administaff Employee Stock Purchase Plan | — | — | 165 | — | 249 | — | — | 414 |
| Stock option vesting acceleration | — | — | 790 | — | — | — | — | 790 |
| Exercise of stock options | — | — | 3,253 | — | 26,826 | — | — | 30,079 |
| Income tax benefit from exercise of stock options | — | — | 12,760 | — | — | — | — | 12,760 |
| Grant of restricted common shares from treasury, net of forfeitures | — | — | 886 | (4,224) | 3,338 | — | — | — |
| Amortization of deferred compensation expense | — | — | — | 1,289 | — | — | — | 1,289 |
| Other | — | — | 96 | 4 | 98 | — | — | 198 |
| Dividends paid | — | — | — | — | — | — | (7,387) | (7,387) |
| Change in unrealized gain on marketable securities, net of tax: | | | | | | | | |
| Realized loss | — | — | — | — | — | 62 | — | 62 |
| Unrealized loss | — | — | — | — | — | (88) | — | (88) |
| Net income | — | — | — | — | — | — | 29,983 | 29,983 |
| Comprehensive income | — | — | — | — | — | — | — | 29,957 |
| Balance at December 31, 2005 | 30,839 | $ 309 | $ 119,573 | $ (2,931) | $ (45,614) | $ (153) | $ 111,245 | $ 182,429 |

See accompanying notes.

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

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| Cash flows from operating activities: | | | |
| Net income | $ 29,983 | $ 19,210 | $ 12,864 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 15,482 | 17,770 | 22,185 |
| Stock-based compensation | 2,079 | — | — |
| Deferred income taxes | (5,222) | 2,168 | (3,018) |
| Bad debt expense | 460 | 463 | 494 |
| Loss (gain) on disposition of assets | 210 | 59 | (467) |
| Changes in operating assets and liabilities: | | | |
| Restricted cash | (9,069) | (13,927) | (4,584) |
| Accounts receivable | (31,661) | (5,929) | 20,237 |
| Prepaid insurance | (3,254) | 8,126 | (4,645) |
| Other current assets | 209 | 3,487 | 1,949 |
| Other assets | 14,015 | (30,637) | (17,886) |
| Accounts payable | 1,849 | (1,939) | 1,250 |
| Payroll taxes and other payroll deductions payable | 36,822 | (839) | 8,082 |
| Accrued worksite employee payroll expense | 19,116 | (6,226) | (4,173) |
| Accrued health insurance costs | (1,504) | (4,568) | 744 |
| Accrued workers' compensations costs | 20,643 | 29,355 | 12,811 |
| Accrued corporate payroll, commissions and other accrued liabilities | 8,114 | 1,563 | 2,879 |
| Income taxes payable/receivable | 13,401 | (7,657) | 7,421 |
| Total adjustments | 81,690 | (8,731) | 43,279 |
| Net cash provided by operating activities | 111,673 | 10,479 | 56,143 |
| | | | |
| Cash flows from investing activities: | | | |
| Marketable securities: | | | |
| Purchases | (55,819) | (21,644) | (25,779) |
| Proceeds from maturities | 1,379 | 453 | 6,645 |
| Proceeds from dispositions | 24,084 | 16,912 | 9,612 |
| Cash received (exchanged) for note receivable | (453) | — | 2,709 |
| Acquisition of HRTools.com | (6,250) | — | — |
| Property and equipment: | | | |
| Purchases | (28,577) | (8,114) | (8,651) |
| Proceeds from dispositions | 175 | 289 | 275 |
| Proceeds from the sale of other companies | — | — | 457 |
| Net cash used in investing activities | (65,461) | (12,104) | (14,732) |

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

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| Cash flows from financing activities: | | | |
| Purchase of treasury stock | $ (12,200) | $ (17,153) | $ (8,233) |
| Dividends paid | (7,387) | — | — |
| Proceeds from sale of common stock to the employee stock purchase plan | 414 | 443 | 526 |
| Proceeds from the exercise of stock options | 30,079 | 1,011 | 877 |
| Principal repayments on long-term debt and capital lease obligations | (1,649) | (5,823) | (1,807) |
| Other | 198 | 159 | 155 |
| Net cash provided by (used in) financing activities | 9,455 | (21,363) | (8,482) |
| Net increase (decrease) in cash and cash equivalents | 55,667 | (22,988) | 32,929 |
| Cash and cash equivalents at beginning of year | 81,740 | 104,728 | 71,799 |
| Cash and cash equivalents at end of year | $ 137,407 | $ 81,740 | $ 104,728 |
| Supplemental disclosures: | | | |
| Cash paid for income taxes | $ 10,834 | $ 19,877 | $ 5,072 |
| Cash paid for interest | $ 2,243 | $ 1,964 | $ 2,053 |

Noncash Investing and Financing Activities:

During 2005, the Company traded in its existing aircraft valued at $2.8 million and paid an additional $19.0 million to acquire a new aircraft.

See accompanying notes.

## ADMINISTAFF, INC.
## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
## December 31, 2005

### 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.

The Company provides its comprehensive service to small and medium-sized businesses in strategically selected markets throughout the United States. During 2005, 2004 and 2003, revenues from the Company's Texas markets represented 39%, 39% and 40% of the Company's total revenues, respectively.

*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 accounting principles generally accepted in the United States 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 and Cash Equivalents*

Cash and cash equivalents include bank deposits and short-term investments with original maturities of three months or less at the date of purchase.

*Marketable Securities*

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, 2005 and 2004, 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).

*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 | 2-7 years |
| Software development costs | 3-5 years |
| Furniture and fixtures | 5-7 years |
| Aircraft | 10-20 years |
| Vehicles | 5 years |

Software development costs relate primarily to the Company's proprietary professional employer information system and its Internet-based service delivery platform, the Employee Service Center, 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 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 analyze the estimated undiscounted future cash flows to be generated from the applicable asset. In addition, the Company would 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.

*Goodwill and Other Intangible Assets*

The December 2005 acquisition of HRTools.com and associated software applications included certain identifiable intangible assets and goodwill 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. 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 Company's estimated amortization expense related to purchased intangible assets other than goodwill is $420,000 per year for the next five years.

*Health Insurance Costs*

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

The policy with United, which was first obtained in January 2002, 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 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 changes in the actual claims experience and other trends are incorporated into the benefits costs estimates.

Additionally, since the plan's inception in January 2002, 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 cash funded to United, a deficit in the plan would be incurred and the Company would accrue a liability for the excess costs on its Consolidated Balance Sheet. On the other hand, if the Plan Costs for the reporting quarter are less than the cash funded to United, a surplus in the plan would be incurred and the Company would record an asset for the excess premiums on its Consolidated Balance Sheet.

In 2005, Administaff and United entered into a new three-year arrangement, whereby a previous contractual requirement to maintain a security deposit with United was eliminated. Accordingly, the outstanding security deposit at December 31, 2004 of $17.5 million was returned to Administaff during 2005. The terms of the new arrangement also require Administaff to maintain an accumulated cash surplus in the plan of $11 million, which was the balance of the accumulated surplus at December 31, 2004, and is now reported as long-term prepaid insurance. As of December 31, 2005, Plan Costs were less than the net cash funded to United by $18.1 million. As this amount is in excess of the agreed-upon $11 million surplus maintenance level, the $7.1 million balance is included in prepaid insurance, a current asset, on the Company's Consolidated Balance Sheet.

*Workers' Compensation Costs*

The Company's workers' compensation insurance policy for the two-year period ending September 30, 2003 was a guaranteed-cost policy ("2003 Policy") under which premiums were paid for full-insurance coverage of all claims incurred during the policy period. This policy also contained a dividend feature for each policy year, under which the Company was entitled to a refund of a portion of its premiums if, four years after the end of the policy year, claims paid by the insurance carrier for any policy year were less than an amount set forth in the policy. In accordance with EITF Topic D-35, *FASB Staff Views on EITF No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises,"* the Company estimated the amount of refund, if any, that had been earned under the dividend feature, based on the actual claims incurred to date and a factor used to develop those claims to an estimate of the ultimate cost of the incurred claims during that policy year. In May 2003, the Company's workers' compensation carrier's rating was downgraded by A.M. Best Co. ("Best") from a "B" or "fair" rating to a "C++" or "marginal" rating. In June 2003, Best further downgraded the carrier to a "D" or "poor" rating. Best's rating represents an opinion on the insurer's financial strength and ability to meet its ongoing obligations to its policyholders. As a result of these downgrades, the Company elected to accelerate the termination of its contract from September 30, 2003 to September 1, 2003. In addition, the Company recorded a charge of $2.5 million in 2003 to write-off its dividend receivable from its workers' compensation carrier due to the uncertainty of the carrier's ultimate ability to pay this dividend.

On September 1, 2003, the Company obtained a workers' compensation policy ("AIG Program"), which matured and was subsequently renewed in September 2004 and October 2005. The policies are with selected member insurance companies of American International Group, Inc. ("AIG"). Under its arrangement with AIG, the Company bears the economic burden for the first $1 million layer of claims per occurrence. AIG bears the economic burden for all claims in excess of such first $1 million layer. The policies are fully insured whereby AIG has the responsibility to pay all claims incurred under the policies regardless of whether the Company satisfies its responsibilities.

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 estimates its workers' compensation costs by applying an aggregate loss development rate to worksite employee payroll levels. 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. Workers' compensation cost estimates are discounted to present value at a rate based upon the US Treasury rates that correspond with the weighted average estimated claim payout period (the discount rate utilized in 2005 and 2004 averaged 3.9% and 2.8%, 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.

The following table provides the activity and balances related to incurred but not reported workers' compensation claims for the years ended December 31, 2005 and 2004 (in thousands):

| | **Year ended 2005** | **Year ended 2004** |
|---|---|---|
| Beginning balance | $ 41,423 | $ 12,000 |
| Accrued claims | 40,942 | 43,087 |
| Present value discount | (4,934) | (3,871) |
| Paid claims | (17,159) | (9,793) |
| Ending balance | $ 60,272 | $ 41,423 |
| | | |
| Current portion of accrued claims | $ 27,580 | $ 18,511 |
| Long-term portion of accrued claims | 32,692 | 22,912 |
| | $ 60,272 | $ 41,423 |

At the beginning of each policy period, the insurance carrier, AIG, 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 AIG. 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, 2005, the Company had restricted cash of $27.6 million and deposits of $55.4 million. A $7.6 million security deposit related to the current policy is included in deposits. The Company has estimated and accrued $60.3 million in incurred workers' compensation claim costs, which is net of $27.6 million in paid claims, as of December 31, 2005.

*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 long-term debt approximate fair value due to the stated interest rates approximating market rates.

*Stock-Based Compensation*

At December 31, 2005, the Company has three stock-based employee compensation plans. The Company accounts for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. During the first quarter of 2005, the Company accelerated the vesting of all outstanding stock options, resulting in the recognition of $790,000 ($497,000, net of taxes) of stock-based compensation expense. In addition, the Company issued 303,600 restricted common shares that vest over three years. During 2005, the Company recognized $1,289,000 ($810,000, net of taxes) of stock-based compensation expense associated with the restricted stock grant. The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| | (in thousands) | | |
| Net income, as reported | $ 29,983 | $ 19,210 | $ 12,864 |
| Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects | (506) | (2,530) | (5,800) |
| Pro forma net income | $ 29,477 | $ 16,680 | $ 7,064 |
| Net income per share: | | | |
| Basic – as reported | $ 1.16 | $ 0.74 | $ 0.48 |
| Basic – pro forma | $ 1.14 | $ 0.64 | $ 0.26 |
| Diluted – as reported | $ 1.12 | $ 0.72 | $ 0.47 |
| Diluted – pro forma | $ 1.10 | $ 0.62 | $ 0.26 |

The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions:

| | Year ended December 31, | | |
|---|---|---|---|
| | **2005** | **2004** | **2003** |
| Risk-free interest rate | 3.7% | 3.4% | 3.0% |
| Expected dividend yield | 2.0% | 0.0% | 0.0% |
| Expected volatility | 0.89 | 0.90 | 0.92 |
| Weighted average expected life (in years) | 5.0 | 5.0 | 5.0 |

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the Company's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

*Employee Savings Plan*

The Company matches 50% of an eligible worksite employee's eligible contributions and 100% of eligible corporate employees' contributions, both up to 6% of the employee's eligible compensation with immediate vesting. During 2005, 2004 and 2003, the Company made employer-matching contributions of $24,365,000, $13,521,000 and $10,854,000, respectively. Of these contributions, $21,391,000, $10,658,000 and $8,494,000 were made on behalf of worksite employees. The remainder represents employer contributions made 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.

*Reclassifications*

Certain prior year amounts have been reclassified to conform to the 2005 presentation.

*New Accounting Pronouncements*

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, 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. Pro forma disclosure is no longer an alternative. We are required to adopt SFAS 123R in the first quarter of 2006.

Statement 123(R) permits public companies to adopt its requirements using one of two methods:

1. A "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.

2. A "modified retrospective" method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under Statement 123 for purposes of pro forma disclosures either: (a) all prior periods presented; or (b) prior interim periods of the year of adoption.

We plan to adopt Statement 123(R) using the modified prospective method.

As permitted by Statement 123, we historically accounted for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognized no compensation cost for employee stock options. During the first quarter of 2005, we accelerated the vesting of all outstanding stock options, resulting in the recognition of $790,000 ($497,000, net of taxes) of stock based compensation expense. The primary purpose of the accelerated vesting was to eliminate future compensation expense that would otherwise be recognized in the Company's Statement of Operations subsequent to the January 1, 2006 effective date of FASB 123(R). Accordingly, the adoption of SFAS 123(R) is not anticipated to have a material impact on our results of operations in 2006.

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections - a Replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS 154"). SFAS 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also redefines "restatement" as the revising of previously issued financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Administaff does not expect the adoption of SFAS 154 to have a material effect on the Company's consolidated financial position or results of operations.

## 2. 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 $582,000 and $604,000 as of December 31, 2005 and 2004, respectively. The Company establishes an allowance for doubtful accounts based on management's assessment of the collectibility 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 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, 2005 and 2004, unbilled accounts receivable consisted of the following:

| | 2005 | 2004 |
|---|---|---|
| | (in thousands) | |
| Accrued worksite employee payroll cost | $ 78,393 | $ 59,277 |
| Unbilled revenues | 22,343 | 17,025 |
| Customer prepayments | (9,478) | (11,153) |
| Unbilled accounts receivable | $ 91,258 | $ 65,149 |

## 3. Marketable Securities

The following is a summary of the Company's available-for-sale marketable securities as of December 31, 2005 and 2004:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| | | (in thousands) | | |
| *December 31, 2005:* | | | | |
| Fixed income mutual funds | $ 11,704 | $ — | $ (223) | $ 11,481 |
| State and local government securities | 46,512 | 3 | (23) | 46,492 |
| | $ 58,216 | $ 3 | $ (246) | $ 57,973 |
| *December 31, 2004:* | | | | |
| Fixed income mutual funds | $ 11,360 | $ — | $ (166) | $ 11,194 |
| U.S. corporate debt securities | 753 | — | — | 753 |
| State and local government securities | 16,040 | 18 | (55) | 16,003 |
| | $ 28,153 | $ 18 | $ (221) | $ 27,950 |

For the years ended December 31, 2005, 2004 and 2003, the Company's realized gains and losses recognized on sales of available-for-sales marketable securities are as follows:

| | Realized Gains | Realized Losses | Net Realized Gains (Losses) |
|---|---|---|---|
| | | (in thousands) | |
| 2005 | $ 6 | $ (104) | $ (98) |
| 2004 | 64 | (43) | 21 |
| 2003 | 78 | (7) | 71 |

As of December 31, 2005, the contractual maturities of the Company's marketable securities were as follows:

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| | (in thousands) | |
| Less than one year | $ 16,419 | $ 16,181 |
| One to five years | 1,176 | 1,177 |
| Five to ten years | — | — |
| Greater than ten years | 40,621 | 40,615 |
| Total | $ 58,216 | $ 57,973 |

## 4. Deposits

The December 31, 2004 Consolidated Balance Sheet included $17.5 million as a component of deposits – healthcare. In 2005, Administaff and United entered into a new three-year arrangement, whereby a previous contractual requirement to maintain a security deposit with United was eliminated. Accordingly, the outstanding security deposit at December 31, 2004 of $17.5 million was returned to Administaff during the quarter ended June 30, 2005. The terms of the new arrangement require Administaff to maintain an accumulated cash surplus in the plan of $11 million, which was the balance of the accumulated surplus at December 31, 2004, and is now reported as long-term prepaid insurance.

As of December 31, 2005, the Company had $55.4 million of workers' compensation long-term deposits, including $7.6 million of collateral and $47.8 million of claim deposits with the Company's workers' compensation carrier, AIG. Please see Note 1 for a discussion of our accounting policies for workers' compensation costs.

## 5. HRTools.com Acquisition

In December 2005, the Company acquired certain assets of KnowledgePoint, a subsidiary of Recruitmax, for $6.25 million in cash in an effort to extend the Company's product offering. The primary assets acquired included HRTools.com, a leading portal for human resources products, services and information, as well as small business software applications related to job descriptions, performance reviews, and personnel policies and procedures.

The allocation of the purchase price is based on preliminary estimates and is subject to change based on the finalization of the purchase price allocation. The following table summarizes the allocation of the aggregate purchase price based on fair values, including acquisition costs:

| | December 31, 2005 (in thousands) | Weighted Average Amortization Period |
|---|---|---|
| Software | $ 1,440 | 5 years |
| Other intangible assets | 1,070 | 8 years |
| Goodwill | 3,948 | — |
| Total assets acquired | 6,458 | |
| Other liabilities | (93) | |
| Net assets acquired | $ 6,365 | |

## 6. Investments

During 2000, the Company purchased convertible preferred stock of Virtual Growth, Inc. ("VGI") for a total cost of approximately $3.2 million. During 2001, the Company purchased an additional $319,000 of convertible preferred stock and made loans to VGI totaling $224,000. In December 2001, VGI filed for bankruptcy protection. As a result of the filing, the Company wrote-off its investments in VGI as of that date totaling $3.8 million.

Subsequent to December 2001, the Company purchased substantially all of the assets of VGI through bankruptcy proceedings for a total cost of $1.6 million. The Company established a subsidiary, FMS, to provide outsourcing accounting and bookkeeping services using the assets acquired from VGI. During 2003, the Company ceased operations of FMS and incurred after tax asset impairment charges of $800,000 to write off the assets of FMS. FMS operating results are included in discontinued operations in the accompanying Consolidated Statements of Operations. Revenues were immaterial to the Consolidated Statements of Operations.

During 2000, the Company purchased 500,000 shares of convertible preferred stock of eProsper, Inc. ("eProsper") for $2.5 million. In 2002, the Company made an additional $500,000 investment in convertible preferred stock of eProsper. The Company has accounted for this investment using the cost method. Under the cost method, the Company periodically evaluates the realizability of this investment based on its review of the investee's financial condition, financial results, financial projections and availability of additional financing sources. In December 2002, the Company determined that the fair value of its investment in eProsper had declined below its carrying value, for reasons that were other than temporary, resulting in the Company writing-off its entire investment totaling approximately $3.1

million. During 2003, the Company collected $457,000 from the sale of its investment in eProsper, which is included as a component of other income in the accompanying Consolidated Statements of Operations.

## 7. Debt Obligations

The Company's debt obligations consist of the following:

| | December 31, | |
|---|---|---|
| | 2005 | 2004 |
| | (In thousands) | |
| Mortgage loan | $ 32,599 | $ 33,746 |
| Capital lease obligations | 2,291 | 2,793 |
| Total debt | $ 34,890 | $ 36,539 |
| Less current maturities | 1,700 | 1,649 |
| Long-term debt, net of current maturities | $ 33,190 | $ 34,890 |

Maturities of long-term debt at December 31, 2005 are summarized as follows (in thousands):

| | |
|---|---|
| 2006 | $ 1,700 |
| 2007 | 1,653 |
| 2008 | 30,999 |
| 2009 | 538 |
| | $ 34,890 |

*Mortgage Loan*

On December 20, 2002, the Company entered into a $36 million mortgage agreement ("Mortgage") that matures in January 2008. The proceeds were used to repay the Company's outstanding balance under its revolving credit agreement. The Mortgage bears interest at a variable rate equal to the greater of (a) 4.5%; or (b) the 30-day LIBOR rate (4.3% at December 31, 2005) plus 2.9%. The Mortgage is secured by the Company's real estate and related fixtures located at Administaff's headquarters in Kingwood, Texas, which has a net book value of $38.4 million at December 31, 2005. Monthly principal and interest payments are approximately $296,000, with the remaining balance due upon maturity. The Mortgage provides for prepayment penalties as a percentage of the outstanding principal balance, ranging from 5% down to 1% during the first four years of the term. There is no prepayment penalty during the final year of the Mortgage.

*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, 2005 and 2004, the capitalized cost and accumulated amortization under the capital lease arrangement were $3.8 million and $1.8 million, and $3.8 million and $1.2 million, respectively. Amortization of the capitalized lease costs is included in depreciation and amortization in the Consolidated Statements of Operations.

## 8. 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:

| | December 31, 2005 | December 31, 2004 |
|---|---|---|
| | (in thousands) | |
| Deferred tax liabilities: | | |
| Prepaid assets | $ (3,908) | $ (6,023) |
| Depreciation | (1,070) | (2,876) |
| Software development costs | (385) | (667) |
| Total deferred tax liabilities | (5,363) | (9,566) |
| Deferred tax assets: | | |
| Workers' compensation accruals | 3,479 | 3,057 |
| Long-term capital loss carry-forward | 2,133 | 2,109 |
| State unemployment tax accruals | 1,770 | 1,791 |
| Accrued rent | 633 | 554 |
| Stock-based compensation | 549 | — |
| State income taxes net operating loss carryforward | 273 | 274 |
| Uncollectible accounts receivable | 220 | 231 |
| Other | 219 | 204 |
| Total deferred tax assets | 9,276 | 8,220 |
| Valuation allowance | (2,407) | (2,383) |
| Total net deferred tax assets | 6,869 | 5,837 |
| Net deferred tax assets (liabilities) | $ 1,506 | $ (3,729) |
| Net current deferred tax assets (liabilities) | $ 3,308 | $ (231) |
| Net noncurrent deferred tax liabilities | (1,802) | (3,498) |
| | $ 1,506 | $ (3,729) |

The components of income tax expense from continuing operations are as follows:

| | Year ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| | (in thousands) | | |
| Current income tax expense: | | | |
| Federal | $21,875 | $ 9,066 | $11,115 |
| State | 1,111 | 292 | 1,388 |
| Total current income tax expense | 22,986 | 9,358 | 12,503 |
| Deferred income tax expense (benefit): | | | |
| Federal | (4,698) | 1,680 | (2,632) |
| State | (524) | 488 | (386) |
| Total deferred income tax (benefit) expense | (5,222) | 2,168 | (3,018) |
| Total income tax expense from continuing operations | $17,764 | $11,526 | $ 9,485 |

In 2005, 2004 and 2003, income tax benefits of $12.8 million, $352,000 and $249,000, 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.

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:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| | (in thousands) | | |
| Expected income tax expense at 35% | $16,711 | $10,758 | $ 8,565 |
| State income taxes, net of federal benefit | 639 | 429 | 688 |
| Nondeductible expenses | 770 | 486 | 375 |
| Tax-exempt interest income | (325) | (142) | — |
| Valuation allowance against long-term capital loss carry-forward | 34 | (32) | (160) |
| Other, net | (65) | 27 | 17 |
| Reported total income tax expense from continuing operations | $17,764 | $11,526 | $ 9,485 |

As a result of the write-off of the investments in eProsper and VGI, the Company has capital loss carryforwards totaling $5.8 million that will expire during 2006 and 2007, but can only be used to offset future capital gains. The Company has a valuation allowance of $5.8 million 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 $4.0 million ($273,000 tax effected) that expire from 2008 to 2023. The Company has recorded a valuation allowance of $273,000 at December 31, 2005, as it is uncertain if it will be able to utilize the net operating loss carryforward in these entities.

## 9. Stockholders' Equity

The Company's Board of Directors (the "Board") has authorized a program to repurchase up to 8,000,000 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 2005, 2004 and 2003, the Company repurchased 649,100, 1,411,000 and 1,373,252 shares at a cost of $12.2 million, $17.2 million and $8.2 million, respectively. As of December 31, 2005, the Company had repurchased 7,401,623 shares under this program at a total cost of approximately $95.0 million. As a result, the Company has the authorization to repurchase an additional 598,377 shares.

During each quarter of 2005, the Board declared a dividend of $0.07 per share of common stock. As of December 31, 2005 a total of $7.4 million in dividend payments were paid by the Company.

At December 31, 2005, 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 one-half of a 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 February 9, 2008.

## 10. Employee Incentive Plans

The Administaff, Inc. 1997 Incentive Plan, as amended, and the 2001 Incentive Plan (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 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 has granted limited authority to the Chief Executive Officer of the Company regarding the granting of stock options to employees who are not officers. The Company 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, 2005, 46,630 shares of common stock were available for future grants under the 2001 Incentive Plan. Prior to 2005, all awards granted to employees under the Incentive Plans had been stock options, primarily intended to qualify as "incentive stock options" within the meaning of Section 422 of the Internal Revenue Code (the "Code"). The Incentive Plans also permit 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. In February 2005, the Committee granted 303,600 restricted common shares to certain employees and officers of the Company. 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") provides for options to purchase shares of the Company's common stock that may be granted to employees who are not officers. An aggregate of 3,600,000 shares of common stock of the Company are authorized to be issued under the Nonqualified Plan. At December 31, 2005, 617,820 shares of common stock were available for future grants under the Nonqualified Plan. The purpose of the Nonqualified Plan is similar to that of the Incentive Plans. The Nonqualified Plan is administered by the Chief Executive Officer of the Company (the "CEO"). The CEO has the power to determine which eligible employees will receive stock option rights, the timing and manner of the grant of such rights, the exercise price (which may not be less than market value on the grant date), the number of shares and all of the terms of the options. 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.

*Stock Option Awards*

On February 1, 2005, the compensation committee of the board of directors approved accelerating the vesting of all unvested stock options that had an exercise price greater than the Company's January 31, 2005 closing market price of $14.59. This accelerated vesting affected approximately 733,000 common stock options with a weighted average exercise price of $18.09. In addition, the committee approved accelerating the vesting of all remaining unvested common stock options on February 18, 2005. As a result, the vesting of approximately 1,104,000 common stock options with a weighted average exercise price of $9.16 was accelerated, which resulted in the Company recognizing stock-based compensation expense of $790,000 in the first quarter of 2005. The primary purpose of the accelerated vesting was to eliminate future compensation expense the Company would otherwise recognize in its income statement with respect to these accelerated options subsequent to the January 1, 2006 effective date of FASB Statement No. 123(R).

The following summarizes stock option activity and related information:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2005 | | 2004 | | 2003 | |
| | 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 | 5,422 | $ 17.98 | 5,039 | $ 18.56 | 4,986 | $ 19.77 |
| Granted | 31 | 17.94 | 861 | 13.69 | 594 | 7.70 |
| Exercised | (2,152) | 13.98 | (127) | 7.96 | (114) | 7.73 |
| Cancelled | (127) | 27.22 | (351) | 19.38 | (427) | 20.53 |
| Outstanding – end of year | 3,174 | $ 20.32 | 5,422 | $ 17.98 | 5,039 | $ 18.56 |
| Exercisable – end of year | 3,174 | $ 20.32 | 3,567 | $ 20.66 | 3,242 | $ 21.55 |
| Weighted average fair value of options granted during year | | $ 11.27 | | $ 9.79 | | $ 5.54 |

The following summarizes information related to stock options outstanding at December 31, 2005:

| | | Options Outstanding & Exercisable | |
|---|---|---|---|
| Range of Exercise Prices | Shares | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price |
| (share amounts in thousands) | | | |
| $ 4.02 to $10.00 | 577 | 5.4 | $ 7.52 |
| $10.01 to $15.00 | 652 | 6.7 | 12.79 |
| $15.01 to $20.00 | 1,016 | 5.2 | 18.28 |
| $20.01 to $30.00 | 372 | 5.5 | 23.99 |
| $30.01 to $43.69 | 557 | 4.8 | 43.66 |
| Total | 3,174 | 5.5 | $ 20.32 |

*Restricted Stock Awards*

As of December 31, 2005, 284,200 non-vested restricted shares are outstanding from the initial restricted stock award of 303,600 shares granted on February 1, 2005. The restricted shares had a fair value of $14.86 per share on the grant date and vest over three years. 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 and the quoted price of the common stock. Such value is recognized as compensation expense over the corresponding vesting period. During 2005, the Company has recognized $1.3 million of compensation expense associated with the restricted stock awards.

## 11. 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:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2005 | 2004 | 2003 |
| | | (in thousands) | |
| Denominator: | | | |
| Basic - weighted average shares outstanding | 25,932 | 26,096 | 26,821 |
| Effect of dilutive securities: | | | |
| Common stock options - treasury stock method | 922 | 763 | 432 |
| Diluted - weighted average shares outstanding plus effect of dilutive securities | 26,854 | 26,859 | 27,253 |

Options and warrants to purchase 1,799,000, 4,148,000 and 5,866,000 shares of common stock were not included in the diluted net income per share calculation for 2005, 2004 and 2003, respectively, because their inclusion would have been anti-dilutive.

## 12. 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 $8,847,000 $9,000,000 and $8,179,000 in 2005, 2004 and 2003, respectively. At December 31, 2005, future minimum rental payments under noncancelable operating and capital leases are as follows (in thousands):

| | Operating Leases | Capital Leases |
|---|---|---|
| 2006 | $ 9,053 | $ 695 |
| 2007 | 8,363 | 695 |
| 2008 | 6,643 | 695 |
| 2009 | 5,279 | 554 |
| 2010 | 4,705 | — |
| Thereafter | 9,914 | — |
| Total minimum lease payments | $ 43,957 | $ 2,639 |
| Less amount representing interest | | 348 |
| Total present value of minimum payments | | 2,291 |
| Less current portion | | 542 |
| Long-term capital lease obligations | | $ 1,749 |

## 13. 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 software service contracts and advertising commitments. At December 31, 2005, future non-cancelable purchase and service obligations greater than $100,000 and one year were as follows (in thousands):

| | |
|---|---|
| 2006 | $ 6,627 |
| 2007 | 4,650 |
| 2008 | 1,158 |
| 2009 | 190 |
| 2010 | 530 |
| Thereafter | — |
| Total obligations | $ 13,155 |

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, except as set forth below, 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.

*Class Action Litigation*

On June 13, 2003, a class action lawsuit was filed against the Company in the United States District Court for the Southern District of Texas on behalf of purchasers of the Company's common stock alleging violations of the federal securities laws. After that date, six similar class actions were filed against the Company in that court. Those lawsuits also named as defendants certain of the Company's officers and directors. Those lawsuits generally allege that the Company and certain of its officers and directors made false and misleading statements or failed to make adequate disclosures concerning, among other things: (i) the Company's pricing and billing systems with respect to recalibrating pricing for clients that experienced a decline in average payroll cost per worksite employee; (ii) the matching of price and cost for health insurance on new and renewing client contracts; and (iii) the Company's former method of reporting worksite employee payroll costs as revenue. The complaints sought unspecified damages, among other remedies. On March 31, 2004, the court entered an order consolidating all of the cases and appointing Carpenters Pension Trust for South California as "lead plaintiff" and Lerach Coughlin Stoia Geller Rudman & Robbins LLP as "lead counsel." The lead plaintiff alleges that its losses are $352,000, although the alleged damages of the purported class have not been specified.

In May 2004, the lead plaintiff filed its Consolidated Complaint, which amended and consolidated the seven previously filed cases. In the Consolidated Complaint, the lead plaintiff has essentially abandoned the allegations of fraud contained in the initial seven lawsuits. Through the Consolidated Complaint, the lead plaintiff now generally asserts, among other things, that the Company and certain of its officers and directors fraudulently made false and misleading statements regarding the cost of its health plan during 2001 and 2002. In June 2004, the Company filed a motion to dismiss the Consolidated Complaint. The Company believes these claims are without merit and intends to vigorously defend this litigation. As a result of the uncertainty regarding the outcome of this matter, no provision has been made in the accompanying consolidated financial statements.

*State Unemployment Taxes*

The Company records its 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. Prior to the receipt of final tax rate notices, the Company estimates its expected SUI tax rate in those states for which tax rate notices have not yet been received.

In December 2001, as a result of the 2001 corporate reorganization, the Company filed for a transfer of its reserve account with the Employment Development Department of the State of California ("EDD"). The EDD approved the Company's request for transfer of its reserve account in May 2002 and also notified the Company of its new contribution rates based upon the approved transfer. In December 2003, the Company received a Notice of Duplicate Accounts and Notification of Assessment ("Notice") from the Employment Development Department of the State of California ("EDD"). The Notice stated that the EDD was collapsing the accounts of the Company's subsidiaries into the account of the entity with the highest unemployment tax rate. The Notice also retroactively imposed the higher unemployment insurance rate on all the Company's California employees for 2003, resulting in an assessment of $5.6 million. In January 2004, the Company filed a petition with an administrative law judge of the California Unemployment Insurance Appeals Board ("ALJ") to protest the Notice. Pending a resolution of its protest, in the fourth quarter of 2003 the Company accrued and recorded at the higher assessed rate for all of 2003.

In June 2004, the Company agreed to settle its dispute with the EDD for $3.3 million ("Settlement"). Based upon receipt of written acknowledgement of this agreement, the Company reduced its accrued payroll tax liability and payroll tax expense by $2.3 million during the quarter ended June 30, 2004. The Settlement was subject to the final approval by EDD's legal department, the California Attorney General's office and the ALJ. In October 2004, the legal department of the EDD verbally indicated they considered the previously agreed-upon settlement amount to be insufficient and suggested a settlement amount of $5.2 million. The Company and the State of California continued discussions, but in February 2005, the Company was notified that the EDD had rejected the Company's settlement offer and that the matter will proceed with the appeals process with the ALJ. If the outcome of the appeals process is unfavorable and the Company is assessed additional interest and penalties, the Company may recognize an increase in its payroll tax expense in a future period. Conversely, if the outcome of the appeals process is favorable to the Company; the Company may recognize a decrease in its payroll tax expense in a future period.

### 14. Quarterly Financial Data (Unaudited)

| | Quarter ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | Sept. 30 | Dec. 31 |
| | (in thousands, except per share amounts) | | | |
| *Year ended December 31, 2005:* | | | | |
| Revenues | $ 298,976 | $ 279,884 | $ 285,202 | $ 305,550 |
| Gross profit | 54,028 | 56,335 | 58,171 | 67,222 |
| Operating income | 6,880 | 10,855 | 10,605 | 15,427 |
| Net income | 4,590 | 7,284 | 7,183 | 10,926 |
| Basic net income per share | 0.18 | 0.28 | 0.28 | 0.41 |
| Diluted net income per share | 0.18 | 0.28 | 0.26 | 0.39 |
| *Year ended December 31, 2004:* | | | | |
| Revenues | $ 252,047 | $ 232,892 | $ 235,865 | $ 248,723 |
| Gross profit | 50,034 | 48,545 | 47,672 | 51,443 |
| Operating income | 7,166 | 4,499 | 5,091 | 5,375 |
| Net income | 9,238 (1) | 2,811 | 3,612 | 3,549 |
| Basic net income per share | 0.35 | 0.11 | 0.14 | 0.14 |
| Diluted net income per share | 0.33 | 0.10 | 0.14 | 0.14 |

(1) Includes $8.25 million ($5.2 million after taxes) related to the legal settlement with Aetna.



## GAAP to Non-GAAP Reconciliation

| | Year ended December 31, 2005 |
|---|---|
| Net income (GAAP) | $ 29,983 |
| Interest expense | 2,359 |
| Income tax expense | 17,764 |
| Depreciation and amortization | 15,167 |
| EBITDA | $ 65,273 |

EBITDA represents net income; which is computed in accordance with generally accepted accounting principles ("GAAP"), plus interest expense, income tax expense, depreciation and amortization expense. Administaff 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. Administaff 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 this non-GAAP financial measure used in this report to the most directly comparable GAAP financial measure as provided in the table above.

# Officers

**Paul J. Sarvadi**
Chairman and Chief Executive Officer

**Richard G. Rawson**
President

**A. Steve Arizpe**
Executive Vice President, Client Services
and Chief Operating Officer

**Jay E. Mincks**
Executive Vice President, Sales and Marketing

**John H. Spurgin, II**
Senior Vice President, Legal,
General Counsel and Secretary

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

**Gregory R. Clouse**
Vice President, Service Operations

**Betty L. Collins**
Vice President, Corporate Human Resources

**Roger L. Gaskamp**
Vice President, Client Selection and Pricing

**Samuel G. Larson**
Vice President, Enterprise and Technology Solutions

**Randall H. McCollum**
Vice President, Strategic Alliances

**Martin K. Scirratt**
Vice President, 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

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

**Legal Counsel**
Baker Botts L.L.P.
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.

**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, 2005. After the 2006 Annual Meeting of Stockholders, the Company intends to file with the New York Stock Exchange the CEO certification regarding its compliance with the NYSE's corporate governance listing standards as required by Rule 303A.12. Last year, the Company filed this CEO certification with the NYSE on May 18, 2005.

**Stock Transfer Agent**
Mellon Investor Services LLC
P.O. Box 3315
South Hackensack, New Jersey 07606

or

480 Washington Boulevard
Jersey City, New Jersey 07310-1900

866-229-4421

TDD for Hearing Impaired: 800-231-5469
Foreign Shareholders: 201-680-6578
TDD Foreign Shareholders: 201-680-6610
Web Site: www.melloninvestor.com/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 4 p.m. CDT on Wednesday, May 3, 2006, at the Company's corporate headquarters, Centre I in the Auditorium, located at 22900 Highway 59N (Eastex Freeway), Kingwood, Texas 77339.

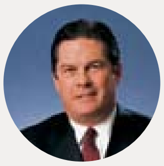
**Investor Relations**
Shareholders are encouraged to contact the Company with questions or requests for information. Copies of the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission are available without charge upon written request.

Inquiries should be directed to:

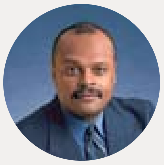
Investor Relations Specialist
Administaff, Inc.
19001 Crescent Springs Drive
Kingwood, Texas 77339-3802
281-348-3987

# Board of Directors

**Michael W. Brown | Independent Director**
Mr. Brown joined the Company as a director in November 1997, and he currently serves on the Finance, Risk Management and Audit Committee and on the Nominating and Corporate Governance Committee. A certified public accountant, he 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. He served in that capacity until his retirement in 1997. Prior to joining Microsoft, Mr. Brown spent 18 years with Deloitte & Touche LLP. Mr. Brown also is a director of EMC Corporation, 360networks, FatKat, Inc., Pipeline Financial Group, Inc., DayJet Corporation, Double LLC, and West Sound Management, and is a member of the Thomas Weisel Partners Advisory Board, the University of Washington Business School Advisory Board and the Particle Economics Research Institute.

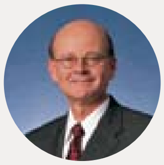


**Jack M. Fields, Jr. | Independent Director**
Mr. Fields joined the Company as a director in January 1997. He currently serves as Chairman of the Compensation Committee and also is a member of the Nominating and Corporate Governance Committee. Mr. Fields served in the United States House of Representatives for 16 years prior to his retirement. During 1995 and 1996, he 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 is Chief Executive Officer of Twenty-First Century Group in Washington, D.C., and also serves on the Board of Directors for AIM Mutual Funds and the Discovery Channel – Global Education Fund.

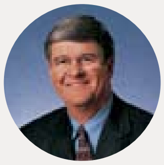


**Eli Jones | Independent Director**
Dr. Jones joined the Company as a director in April 2004, and he currently serves on the Compensation Committee and on the Nominating and Corporate Governance Committee. He has been an Associate Professor of Marketing at the University of Houston since 2002 and was an Assistant Professor at the University of Houston from 1997 until 2002. Dr. Jones currently serves as the Executive Director of the Program for Excellence in Selling and the Sales Excellence Institute at the University of Houston. He also serves on the Board of Directors of Dovarri, a CRM company based in Houston, and on the editorial review boards of the Journal of Personal Selling and Sales Management and Industrial Marketing Management. Dr. Jones has conducted research and published articles on sales and sales management topics in major journals and has co-authored two books, Selling ASAP and Strategic Sales Leadership. Before becoming a professor, Dr. Jones worked in sales and sales management for three Fortune 100 companies – Quaker Oats, Nabisco and Frito-Lay.

**Paul S. Lattanzio | Independent Director**
Mr. Lattanzio has been a director of the Company since 1995, and he currently serves on the Finance, Risk Management and Audit Committee and on the Nominating and Corporate Governance Committee. He joined Bear Stearns, Inc. in 2003 as a Senior Managing Director and head of Bear Growth Capital Partners, a private equity group. Mr. Lattanzio previously served as a Managing Director for TD Capital Communications Partners (f/k/a Toronto Dominion Capital), a venture capital investment firm from 1999 until 2002; and he was a co-founder and Senior Managing Director of NMS Capital Management, LLC, a private equity fund affiliated with NationsBanc Montgomery Securities. Mr. Lattanzio also served in several positions with various affiliates of Bankers Trust New York Corporation, lastly as a Managing Director of BT Capital Partners, Inc. He also serves on the Board of Directors of Harlem Furniture, LLC, Avid Health, Inc., New Chapter, Inc. and Dairyland Corp.



**Gregory E. Petsch | Independent Director**
Mr. Petsch joined the Company as a director in October 2002. He currently serves as Chairman of the Nominating and Corporate Governance Committee and also is a member of the Compensation Committee. He retired in 1999 from Compaq Computer Corporation, 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 at Texas Instruments. In 1992, Mr. Petsch was voted Manufacturing Executive of the Year by Upside magazine, and from 1993 to 1995 he was nominated to the Who's Who of Global Business Leaders. He is founder and President of Godsmoneyman Ministries and also is a Board member of Culture Shapers.



**Richard G. Rawson | Management Director**
Mr. Rawson is Administaff's President. Prior to his election as President in 2003, he served as Executive Vice President of Administration, Chief Financial Officer and Treasurer. He has served as a director of the Company since April 1989. Before joining the Company, Mr. Rawson served as a Senior Financial Officer and Controller for several companies in the manufacturing and seismic data processing industries. He has 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 served as Chairman of the Accounting Practices Committee of NAPEO for five years.

**Paul J. Sarvadi | Management Director**
Mr. Sarvadi is Chairman of the Board, Chief Executive Officer and co-founder of Administaff, and he has been a director and Chairman of the Board since the Company's inception in 1986. He also has served as the Chief Executive Officer of the Company since 1989, and was President of the Company from 1989 until 2003. He previously served as Vice President and Treasurer of the Company from 1986 to 1987, and then as Vice President from 1987 until 1989. Mr. Sarvadi has served as President of the National Association of Professional Employer Organizations (NAPEO) and was a member of its Board of Directors for five years. Mr. Sarvadi serves on the Board of Trustees of the DePelchin Children's Center in Houston. In 2001, he was named National Ernst & Young Entrepreneur of the Year in the Service category, and in 2004 he received the Conn Family Distinguished New Venture Leader Award from Mays Business School at Texas A&M University.

**Austin P. Young | Independent Director**
Mr. Young became a director of the Company in January 2003. He currently serves as Chairman of the Finance, Risk Management and Audit Committee and also is a member of the Nominating and Corporate Governance Committee. He is a certified public accountant and served as Senior Vice President, Chief Financial Officer and Treasurer of CellStar Corporation from 1999 until his retirement at year-end 2001. From 1996 to 1999, he served as Executive Vice President – Finance and Administration of Metamor Worldwide, Inc. Mr. Young also has served as Senior Vice President and Chief Financial Officer at American General Corporation, and he was a partner in the Houston and New York offices of KPMG Peat Marwick. He currently serves as Director and Chairman of the Audit Committees of Tower Group, Inc., Houston Zoo, Inc. and Amerisafe, Inc.

Administaff

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