

INSPERITY, INC.
Form 10-Q
November 01, 2012

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2012.

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

Insperty, Inc.
(Exact name of registrant as specified in its charter)

Delaware 76-0479645
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)
organization)

19001 Crescent Springs Drive
Kingwood, Texas 77339
(Address of principal executive offices) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

Edgar Filing: INSPERITY, INC. - Form 10-Q

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 October 25, 2012, 25,654,217 shares of the registrant's common stock, par value \$0.01 per share, were outstanding.

TABLE OF CONTENTS

Part I

| | | |
|---------|--|----|
| Item 1. | <u>Financial Statements</u> | 3 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 20 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 31 |
| Item 4. | <u>Controls and Procedures</u> | 31 |

Part II

| | | |
|----------|--|----|
| Item 1. | <u>Legal Proceedings</u> | 32 |
| Item 1a. | <u>Risk Factors</u> | 32 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 34 |
| Item 6. | <u>Exhibits</u> | 35 |

Table of Contents

PART I

ITEM 1. FINANCIAL STATEMENTS

INSPERITY, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

ASSETS

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|---|---|-------------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 202,218 | \$ 211,208 |
| Restricted cash | 46,069 | 44,737 |
| Marketable securities | 51,702 | 56,987 |
| Accounts receivable, net: | | |
| Trade | 2,255 | 7,893 |
| Unbilled | 198,197 | 158,508 |
| Other | 2,656 | 4,532 |
| Prepaid insurance | 23,739 | 21,300 |
| Other current assets | 8,133 | 11,488 |
| Income taxes receivable | — | 2,902 |
| Deferred income taxes | 940 | 3,233 |
| Total current assets | 535,909 | 522,788 |
| Property and equipment: | | |
| Land | 3,653 | 3,653 |
| Buildings and improvements | 69,868 | 67,496 |
| Computer hardware and software | 78,836 | 76,105 |
| Software development costs | 35,431 | 32,699 |
| Furniture and fixtures | 36,595 | 36,133 |
| Aircraft | 35,879 | 35,866 |
| | 260,262 | 251,952 |
| Accumulated depreciation and amortization | (167,335) | (159,008) |
| Total property and equipment, net | 92,927 | 92,944 |
| Other assets: | | |
| Prepaid health insurance | 9,000 | 9,000 |
| Deposits – health insurance | 3,000 | 2,640 |
| Deposits – workers’ compensation | 57,588 | 52,320 |
| Goodwill and other intangible assets, net | 27,131 | 28,433 |
| Other assets | 4,879 | 4,134 |
| Total other assets | 101,598 | 96,527 |
| Total assets | \$ 730,434 | \$ 712,259 |

Table of Contents

INSPERITY, INC.
CONSOLIDATED BALANCE SHEETS (Continued)
(in thousands)

LIABILITIES AND STOCKHOLDERS' EQUITY

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|--|---|-------------------------|
| Current liabilities: | | |
| Accounts payable | \$3,088 | \$5,085 |
| Payroll taxes and other payroll deductions payable | 107,932 | 168,652 |
| Accrued worksite employee payroll cost | 174,264 | 130,317 |
| Accrued health insurance costs | 22,522 | 9,427 |
| Accrued workers' compensation costs | 48,369 | 46,548 |
| Accrued corporate payroll and commissions | 21,819 | 22,383 |
| Other accrued liabilities | 13,975 | 13,814 |
| Income taxes payable | 3,987 | — |
| Total current liabilities | 395,956 | 396,226 |
| Noncurrent liabilities: | | |
| Accrued workers' compensation costs | 63,463 | 60,054 |
| Deferred income taxes | 10,768 | 10,772 |
| Total noncurrent liabilities | 74,231 | 70,826 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock | 309 | 309 |
| Additional paid-in capital | 136,688 | 135,871 |
| Treasury stock, at cost | (138,784) | (134,647) |
| Accumulated other comprehensive income, net of tax | 70 | 24 |
| Retained earnings | 261,964 | 243,650 |
| Total stockholders' equity | 260,247 | 245,207 |
| Total liabilities and stockholders' equity | \$730,434 | \$712,259 |

See accompanying notes.

Table of Contents

INSPERITY, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|--------------|
| | 2012 | 2011 | 2012 | 2011 |
| Revenues (gross billings of \$3.068 billion, \$2.835 billion, \$9.339 billion and \$8.454 billion, less worksite employee payroll cost of \$2.556 billion, \$2.363 billion, \$7.712 billion and \$6.973 billion, respectively) | \$ 511,953 | \$ 471,821 | \$ 1,626,386 | \$ 1,481,105 |
| Direct costs: | | | | |
| Payroll taxes, benefits and workers' compensation costs | 413,533 | 384,792 | 1,337,668 | 1,219,276 |
| Gross profit | 98,420 | 87,029 | 288,718 | 261,829 |
| Operating expenses: | | | | |
| Salaries, wages and payroll taxes | 44,032 | 39,494 | 127,402 | 117,558 |
| Stock-based compensation | 2,429 | 2,109 | 7,385 | 6,455 |
| Commissions | 3,358 | 3,399 | 10,299 | 9,750 |
| Advertising | 3,680 | 5,235 | 17,001 | 18,280 |
| General and administrative expenses | 21,122 | 18,912 | 61,694 | 57,828 |
| Depreciation and amortization | 4,659 | 3,786 | 13,336 | 11,335 |
| | 79,280 | 72,935 | 237,117 | 221,206 |
| Operating income | 19,140 | 14,094 | 51,601 | 40,623 |
| Other income (expense): | | | | |
| Interest, net | 142 | 245 | 462 | 829 |
| Other, net | (3) | (7,501) | 141 | (7,497) |
| | 139 | (7,256) | 603 | (6,668) |
| Income before income tax expense | 19,279 | 6,838 | 52,204 | 33,955 |
| Income tax expense | 7,827 | 2,739 | 21,247 | 14,329 |
| Net income | \$11,452 | \$4,099 | \$30,957 | \$19,626 |
| Less net income allocated to participating securities | (334) | (120) | (898) | (582) |
| Net income allocated to common shares | \$11,118 | \$3,979 | \$30,059 | \$19,044 |
| Basic net income per share of common stock | \$0.45 | \$0.16 | \$1.20 | \$0.75 |
| Diluted net income per share of common stock | \$0.45 | \$0.16 | \$1.20 | \$0.74 |

See accompanying notes.

Table of Contents

INSPERITY, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income | \$11,452 | \$4,099 | \$30,957 | \$19,626 |
| Other comprehensive income: | | | | |
| Unrealized gain (loss) on available-for-sale securities, net of tax | 12 | (7) | 46 | 31 |
| Comprehensive income | \$11,464 | \$4,092 | \$31,003 | \$19,657 |

See accompanying notes.

Table of Contents

INSPERITY, INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
NINE MONTHS ENDED SEPTEMBER 30, 2012
(in thousands)
(Unaudited)

| | Common Stock Issued | | Additional Paid-In Capital | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
|---|------------------------|--------|----------------------------------|-------------------|---|----------------------|------------|
| | Shares | Amount | Capital | Stock | (Loss) | Earnings | Total |
| Balance at December 31, 2011 | 30,839 | \$ 309 | \$ 135,871 | \$ (134,647) | \$ 24 | \$ 243,650 | \$ 245,207 |
| Purchase of treasury stock, at cost | | | | (13,770) | — | | (13,770) |
| Exercise of stock options | | | (558) | 1,620 | — | | 1,062 |
| Income tax benefit from stock-based compensation, net | | | 1,097 | — | — | | 1,097 |
| Stock-based compensation expense | — | — | 199 | 7,186 | — | — | 7,385 |
| Other | | | 79 | 827 | — | | 906 |
| Dividends paid | — | — | — | — | — | (12,643) | (12,643) |
| Unrealized gain on marketable securities, net of tax | — | — | — | — | 46 | — | 46 |
| Net income | — | — | — | — | — | 30,957 | 30,957 |
| Balance at September 30, 2012 | 30,839 | \$ 309 | \$ 136,688 | \$ (138,784) | \$ 70 | \$ 261,964 | \$ 260,247 |

See accompanying notes.

Table of Contents

INSPERITY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net income | \$30,957 | \$19,626 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 13,336 | 11,335 |
| Loss on exchange of assets | (21) | 4,396 |
| Amortization of marketable securities | 1,827 | 1,535 |
| Stock-based compensation | 7,385 | 6,455 |
| Deferred income taxes | 2,259 | (96) |
| Changes in operating assets and liabilities, net of effects from acquisitions: | | |
| Restricted cash | (1,332) | (1,608) |
| Accounts receivable | (32,175) | (20,231) |
| Prepaid insurance | (2,439) | 9,796 |
| Other current assets | 3,355 | (2,339) |
| Other assets | (6,373) | 4,876 |
| Accounts payable | (1,997) | (650) |
| Payroll taxes and other payroll deductions payable | (60,704) | (40,892) |
| Accrued worksite employee payroll expense | 43,947 | 21,091 |
| Accrued health insurance costs | 13,095 | (10,210) |
| Accrued workers' compensation costs | 5,231 | 6,013 |
| Accrued corporate payroll, commissions and other accrued liabilities | 2,155 | 3,656 |
| Income taxes payable/receivable | 6,529 | 479 |
| Total adjustments | (5,922) | (6,394) |
| Net cash provided by operating activities | 25,035 | 13,232 |
| Cash flows from investing activities: | | |
| Marketable securities purchases | (23,585) | (43,607) |
| Marketable securities proceeds from dispositions | — | 3,907 |
| Marketable securities proceeds from maturities | 27,119 | 26,194 |
| Cash exchanged for acquisitions | (1,200) | (13,125) |
| Property and equipment | (11,996) | (23,404) |
| Net cash used in investing activities | (9,662) | (50,035) |

Table of Contents

INSPERITY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(in thousands)
(Unaudited)

| | Nine Months Ended September 30, | |
|--|------------------------------------|-------------|
| | 2012 | 2011 |
| Cash flows from financing activities: | | |
| Purchase of treasury stock | \$(13,770) | \$(22,459) |
| Dividends paid | (12,643) | (11,871) |
| Proceeds from the exercise of stock options | 1,062 | 3,881 |
| Income tax benefit from stock-based compensation | 1,457 | 2,049 |
| Other | (469) | 284 |
| Net cash used in financing activities | (24,363) | (28,116) |
| Net decrease in cash and cash equivalents | (8,990) | (64,919) |
| Cash and cash equivalents at beginning of period | 211,208 | 234,829 |
| Cash and cash equivalents at end of period | \$202,218 | \$169,910 |

Supplemental Cash Flow Information:

In September 2011, the Company exchanged an existing aircraft with a fair value of \$4.0 million and paid an additional \$10.0 million to acquire a replacement aircraft, resulting in a non-cash loss of \$4.4 million, which is included in other income (expense).

See accompanying notes.

Table of Contents

INSPERITY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2012
(Unaudited)

1. Basis of Presentation

Insperty, Inc., a Delaware corporation (“Insperty,” “we,” “our,” and “us”), provides an array of human resources (“HR”) and business solutions designed to help improve business performance. Our most comprehensive HR business offering is provided through our professional employer organization (“PEO”) services, known as Workforce Optimization™, which encompasses a broad range of HR functions, including payroll and employment administration, employee benefits, workers’ compensation, government compliance, performance management, and training and development services.

In addition to Workforce Optimization, we offer Human Capital Management, Payroll Services, Time and Attendance, Performance Management, Organizational Planning, Recruiting Services, Employment Screening, Financial Services, Expense Management, Retirement Services and Insurance Services (collectively “Adjacent Businesses”), many of which are offered via desktop applications and software as a service (“SaaS”) delivery models. These other products or services are offered separately, as a bundle, or along with Workforce Optimization (“Bundle Plus”).

We provide our Workforce Optimization solution to small and medium-sized businesses in strategically selected markets throughout the United States. For the nine months ended September 30, 2012 and 2011, Workforce Optimization revenues from Insperty’s Texas markets represented 26% and 27%, while Workforce Optimization revenues from Insperty’s California markets represented 17% and 16%, of Insperty’s total Workforce Optimization revenues, respectively.

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

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

The accompanying Consolidated Financial Statements should be read in conjunction with our audited Consolidated Financial Statements as of and for the year ended December 31, 2011. Our Consolidated Balance Sheet at December 31, 2011 has been derived from the audited financial statements at that date, but does not include all of the information or footnotes required by GAAP for complete financial statements. Our Consolidated Balance Sheet at September 30, 2012 and the Consolidated Statements of Operations and Comprehensive Income for the three and nine month periods ended September 30, 2012 and 2011, the Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2012 and 2011, and Consolidated Statement of Stockholders’ Equity for the nine month period ended September 30, 2012, have been prepared by us without audit. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows, have been made.

Table of Contents

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

2. Accounting Policies

Health Insurance Costs

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

The policy with United provides the majority of our health insurance coverage. As a result of certain contractual terms, Insuperity has accounted for this plan since its inception using a partially self-funded insurance accounting model. Accordingly, Insuperity 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) estimated completion rates based upon recent claim development patterns under the plan; and (iii) the number of participants in the plan, including both active and COBRA enrollees. Each reporting period, changes in the estimated ultimate costs resulting from claim trends, plan design and migration, participant demographics and other factors are incorporated into the benefits costs.

Additionally, since the plan’s inception, under the terms of the contract, United establishes cash funding rates 90 days in advance of the beginning of a reporting quarter. If the Plan Costs for a reporting quarter are greater than the premiums paid and owed to United, a deficit in the plan would be incurred and a liability for the excess costs would be accrued in our Consolidated Balance Sheets. On the other hand, if the Plan Costs for the reporting quarter are less than the premiums paid and owed to United, a surplus in the plan would be incurred and we would record an asset for the excess premiums in our Consolidated Balance Sheets. The terms of the arrangement require Insuperity to maintain an accumulated cash surplus in the plan of \$9.0 million, which is reported as long-term prepaid insurance. In addition, United requires a deposit equal to approximately one day of claims funding activity, which was \$2.8 million as of September 30, 2012, and is reported as a long-term asset. As of September 30, 2012, Plan Costs were less than the net premiums paid and owed to United by \$30.2 million. As this amount is in excess of the agreed-upon \$9.0 million surplus maintenance level, the \$21.2 million balance is included in prepaid insurance, a current asset, in our Consolidated Balance Sheets. The premiums owed to United at September 30, 2012 were \$19.2 million, which is included in accrued health insurance costs, a current liability in our Consolidated Balance Sheets.

Table of Contents

Workers' Compensation Costs

Insperty's workers' compensation coverage has been provided through an arrangement with the ACE Group of Companies ("the ACE Program") since 2007. The ACE Program is fully insured in that ACE has the responsibility to pay all claims incurred regardless of whether Insperty satisfies its responsibilities. Through September 30, 2010, Insperty bore the economic burden for the first \$1 million layer of claims per occurrence and the insurance carrier was and remains responsible for the economic burden for all claims in excess of such first \$1 million layer.

Effective October 1, 2010, in addition to our bearing the economic burden for the first \$1 million layer of claims per occurrence, we also bear the economic burden for those claims exceeding \$1 million, up to a maximum aggregate amount of \$5 million per policy year.

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

Insperty employs a third party actuary to estimate its loss development rate, which is primarily based upon the nature of worksite employees' job responsibilities, the location of worksite employees, the historical frequency and severity of workers' compensation claims, and an estimate of future cost trends. Each reporting period, changes in the actuarial assumptions resulting from changes in actual claims experience and other trends are incorporated into our workers' compensation claims cost estimates. During the nine months ended September 30, 2012 and 2011, Insperty reduced accrued workers' compensation costs by \$10.4 million and \$8.6 million, respectively, for changes in estimated losses related to prior reporting periods. Workers' compensation cost estimates are discounted to present value at a rate based upon the U.S. Treasury rates that correspond with the weighted average estimated claim payout period (the average discount rates utilized in 2012 and 2011 were 0.7% and 1.2%, respectively) and are accreted over the estimated claim payment period and included as a component of direct costs in our Consolidated Statements of Operations.

Table of Contents

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

| | Nine Months Ended September 30, | |
|-------------------------------------|---------------------------------|------------|
| | 2012 | 2011 |
| | (in thousands) | |
| Beginning balance, January 1, | \$ 104,791 | \$ 96,934 |
| Accrued claims | 28,586 | 26,668 |
| Present value discount | (712) | (1,159) |
| Paid claims | (23,133) | (21,123) |
| Ending balance | \$ 109,532 | \$ 101,320 |
| | | |
| Current portion of accrued claims | \$ 46,069 | \$ 42,812 |
| Long-term portion of accrued claims | 63,463 | 58,508 |
| | \$ 109,532 | \$ 101,320 |

The current portion of accrued workers' compensation costs on the Consolidated Balance Sheets at September 30, 2012 includes \$2.3 million of workers' compensation administrative fees.

As of September 30, 2012 and 2011, the undiscounted accrued workers' compensation costs were \$121.7 million and \$115.1 million, respectively.

At the beginning of each policy period, the insurance carrier establishes monthly funding requirements comprised of premium costs and funds to be set aside for payment of future claims ("claim funds"). The level of claim funds is primarily based upon anticipated worksite employee payroll levels and expected workers' compensation loss rates, as determined by the insurance carrier. Monies funded into the program for incurred claims expected to be paid within one year are recorded as restricted cash, a short-term asset, while the remainder of claim funds are included in deposits, a long-term asset in our Consolidated Balance Sheets. In the first nine months of 2012 and 2011, we received \$2.5 million and \$10.0 million, respectively, for the return of excess claim funds related to the ACE Program, which reduced deposits. As of September 30, 2012, we had restricted cash of \$46.1 million and deposits of \$57.6 million.

Insperty'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 our Consolidated Balance Sheets.

Table of Contents

3. Cash, Cash Equivalents and Marketable Securities

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

| | September 30, 2012 (in thousands) | December 31, 2011 |
|--|--|----------------------|
| Overnight Holdings | | |
| Money market funds (cash equivalents) | \$46,079 | \$ 71,350 |
| Investment Holdings | | |
| Money market funds (cash equivalents) | 67,395 | 59,587 |
| Marketable securities | 51,702 | 56,987 |
| | 165,176 | 187,924 |
| Cash held in demand accounts | 102,761 | 113,968 |
| Outstanding checks | (14,017) | (33,697) |
| Total cash, cash equivalents and marketable securities | \$253,920 | \$ 268,195 |
| | | |
| Cash and cash equivalents | \$202,218 | \$ 211,208 |
| Marketable securities | 51,702 | 56,987 |
| | \$253,920 | \$ 268,195 |

Our cash and overnight holdings fluctuate based on the timing of the client's payroll processing cycle. Included in the cash balance as of September 30, 2012 and December 31, 2011, are \$96.5 million and \$150.8 million, respectively, in funds associated with federal and state income tax withholdings, employment taxes and other payroll deductions, as well as \$12.4 million and \$10.4 million in client prepayments, respectively.

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

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

Table of Contents

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

| | Fair Value Measurements (in thousands) September 30, 2012 | | | |
|--------------------|---|------------|-----------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Money market funds | \$ 113,474 | \$ 113,474 | \$ — | \$ — |
| Municipal bonds | 51,702 | — | 51,702 | — |
| Total | \$ 165,176 | \$ 113,474 | \$ 51,702 | \$ — |

| | Fair Value Measurements (in thousands) December 31, 2011 | | | |
|--------------------|--|-----------|----------|---------|
| | | Level 1 | Level 2 | Level 3 |
| Money market funds | \$130,937 | \$130,937 | \$— | \$— |
| Municipal bonds | 56,987 | — | 56,987 | — |
| Total | \$187,924 | \$130,937 | \$56,987 | \$— |

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

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

| | Amortized Cost | Gross Unrealized Gains (in thousands) | Gross Unrealized Losses | Estimated Fair Value |
|---------------------|-------------------|--|-------------------------------|-------------------------|
| September 30, 2012: | | | | |
| Municipal bonds | \$51,584 | \$133 | \$(15) | \$51,702 |
| December 31, 2011: | | | | |
| Municipal bonds | \$56,945 | \$90 | \$(48) | \$56,987 |

During the periods ended September 30, 2012 and 2011, we had no realized gains or losses recognized on sales of marketable securities.

Table of Contents

As of September 30, 2012, the contractual maturities of our marketable securities were as follows:

| | Amortized Cost (in thousands) | Estimated Fair Value |
|--------------------|-------------------------------------|-------------------------|
| Less than one year | \$ 23,513 | \$ 23,552 |
| One to five years | 28,071 | 28,150 |
| Total | \$ 51,584 | \$ 51,702 |

4. Revolving Credit Facility

On September 15, 2011, we entered into a four-year, \$100 million revolving credit facility (the “Facility”), which may be increased to \$150 million based on the terms and subject to the conditions set forth in the agreement relating to the Facility (the “Credit Agreement”). The Facility is available for working capital and general corporate purposes, including acquisitions, and issuances of letters of credit. Insperty’s obligations under the Facility are secured by 65% of the stock of our captive insurance subsidiary and are guaranteed by all of our domestic subsidiaries. In January 2012, we issued an irrevocable standby letter of credit for \$285,000 under the Facility to a state workers’ compensation agency. At September 30, 2012, we had not drawn on the Facility.

The Facility matures on September 15, 2015. Borrowings under the Facility bear interest at an alternate base rate or LIBOR, at our option, plus an applicable margin. Depending on our leverage ratio, the applicable margin varies (i) in the case of LIBOR loans, from 2.00% to 2.75%; and (ii) in the case of alternate base rate loans, from 0.00% to 0.75%. The alternate base rate is the highest of (i) the prime rate most recently published in The Wall Street Journal; (ii) the federal funds rate plus 0.50%; and (iii) the 30-day LIBOR rate plus 2.00%. We also pay an unused commitment fee on the average daily unused portion of the Facility at a rate of 0.25%. Interest expense and unused commitment fees are recorded in other income (expense).

The Facility contains both affirmative and negative covenants, which we believe are customary for arrangements of this nature. Covenants include, but are not limited to, limitations on our ability to incur additional indebtedness, sell material assets, retire, redeem or otherwise reacquire our capital stock, acquire the capital stock or assets of another business, make investments and pay dividends. In addition, the Credit Agreement requires us to comply with financial covenants limiting our total funded debt, minimum interest coverage ratio and maximum leverage ratio. We were in compliance with all financial covenants under the Credit Agreement at September 30, 2012.

5. Stockholders’ Equity

Our Board of Directors (the “Board”) has authorized a program to repurchase shares of our outstanding common stock (“Repurchase Program”). The purchases are to be made from time to time in the open market or directly from stockholders at prevailing market prices based on market conditions and other factors. During the nine months ended September 30, 2012, 407,400 shares were repurchased under the Repurchase Program and 107,228 shares not subject to the Repurchase Program were withheld to satisfy tax withholding obligations for the vesting of restricted stock awards. As of September 30, 2012, we were authorized to repurchase an additional 829,472 shares under the program.

Table of Contents

The Board declared quarterly dividends of \$0.17 per share of common stock in the second and third quarter of 2012 and \$0.15 per share of common stock in the first quarter of 2012 and each quarter of 2011, resulting in a total of \$12.6 million and \$11.9 million, respectively, in dividend payments made by Insperty during the first nine months of each year.

6. Net Income per Share

We utilize the two-class method to compute net income per share. The two-class method allocates a portion of net income to participating securities, which include unvested awards of share-based payments with non-forfeitable rights to receive dividends. Net income allocated to unvested share-based payments is excluded from net income allocated to common shares. Basic net income per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income allocated to common shares by the weighted average number of common shares outstanding during the period, plus the dilutive effect of outstanding stock options.

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

| | Three Months Ended September 30, 2012 | | Nine Months Ended September 30, 2012 | |
|--|---|---------|--|----------|
| | 2011 | 2011 | 2011 | 2011 |
| | (in thousands) | | | |
| Net income | \$11,452 | \$4,099 | \$30,957 | \$19,626 |
| Less income allocated to participating securities | (334) | (120) | (898) | (582) |
| Net income allocated to common shares | \$11,118 | \$3,979 | \$30,059 | \$19,044 |
| Weighted average common shares outstanding | 24,923 | 25,425 | 25,034 | 25,546 |
| Incremental shares from assumed conversions of common stock options | 57 | 74 | 63 | 98 |
| Adjusted weighted average common shares outstanding | 24,980 | 25,499 | 25,097 | 25,644 |
| Potentially dilutive securities not included in weighted average share calculation due to anti-dilutive effect | 41 | 54 | 33 | 21 |

Table of Contents

7. Commitments and Contingencies

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

Pennsylvania Sales Taxes

Pennsylvania imposes a sales tax on “help supply services.” The Pennsylvania Department of Revenue (“Department”) had maintained that PEO services constitute help supply services and are subject to the tax. On February 21, 2012, the Pennsylvania Supreme Court affirmed the Appeals Court decision in the matter titled All Staffing vs. Commonwealth of Pennsylvania, which ruled that PEO services are not subject to the Pennsylvania sales tax.

In 2010, we filed refund claims totaling \$2.9 million with the Department for the sales taxes paid in error for the period April 1, 2007 through December 31, 2009. In the second quarter of 2012, the Pennsylvania Board of Finance and Revenue approved our refund claims, and we recognized a \$2.9 million receivable and a corresponding reduction to payroll tax expense, a component of direct costs. During the third quarter of 2012, we received the \$2.9 million refund.

Kemper Insurance Companies

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 ended September 2003, Lumbermens Mutual Casualty Company, formerly known as Kemper, (“Lumbermens Mutual”) made the decision to substantially cease underwriting operations and voluntarily entered into “run-off.” In July 2012, Lumbermens Mutual announced that an agreed order of rehabilitation had been entered against it in Cook County, Illinois. Under the order, the Director of the Illinois Department of Insurance was vested with control over Lumbermens Mutual property and decision-making. The Director has publicly announced that while claims will continue to be paid during the rehabilitation process, he intends to use the rehabilitation period to work with state guaranty associations to prepare for the orderly transition of claim handling responsibilities to such funds once an Order of Liquidation is entered. After this transition process has been completed, the Director has stated that he intends to file a verified complaint for liquidation.

Guaranty associations are non-profit organizations created by statute for the purpose of protecting policyholders from severe financial losses and preventing delays in claim payment due to the insolvency of an insurer. They do this by assuming responsibility for the payment of claims that would otherwise have been paid by the insurer had it not become insolvent. Each state has one or more guaranty association(s), with each association handling certain types of insurance. Insurance companies are required to be members of the state guaranty association as a condition of being licensed to do business in the state.

Table of Contents

The guaranty associations in some states, including Texas, may assert that state law allows them to recover the amount of benefits paid by the guaranty association along with associated administration and defense costs from an insured with a net worth exceeding certain specified levels. If an Order of Liquidation is entered and if one or more guaranty associations were to seek recovery from us for open claims with Lumbermens Mutual, we may be required to repay those amounts. While we are not certain when or if Lumbermens Mutual will be placed into liquidation or whether any state guaranty association will ultimately assert a claim against us, we intend to vigorously assert any and all available defenses to any such claim. We estimate the outstanding claims that may be subject to such contentions from state guaranty associations to range from \$2.9 million to \$5.0 million as of September 30, 2012. In the event state guaranty associations attempt to seek recovery from the Company and are successful, the Company would be required to pay such claims, which would reduce net income and could have a material adverse effect on net income in the reported period.

Table of Contents

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

You should read the following discussion in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011, as well as our Consolidated Financial Statements and notes thereto included in this quarterly report on Form 10-Q.

New Accounting Pronouncements

We believe we have implemented the accounting pronouncements with a material impact on our financial statements.

Results of Operations

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011.

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

| | Three Months Ended September 30, | | | |
|--|---|------------|----------|----|
| | 2012 | 2011 | % Change | |
| | (in thousands, except per share and statistical data) | | | |
| Revenues (gross billings of \$3.068 billion and \$2.835 billion, less worksite employee payroll cost of \$2.556 billion and \$2.363 billion, respectively) | \$ 511,953 | \$ 471,821 | 8.5 | % |
| Gross profit | 98,420 | 87,029 | 13.1 | % |
| Operating expenses | 79,280 | 72,935 | 8.7 | % |
| Operating income | 19,140 | 14,094 | 35.8 | % |
| Other income (expense) | 139 | (7,256) | (101.9) |)% |
| Net income | 11,452 | 4,099 | 179.4 | % |
| Diluted net income per share of common stock | 0.45 | 0.16 | 181.3 | % |

Statistical Data:

| | | | | |
|---|----------|----------|-------|---|
| Average number of worksite employees paid per month | 127,096 | 118,226 | 7.5 | % |
| Revenues per worksite employee per month(1) | \$ 1,343 | \$ 1,330 | 1.0 | % |
| Gross profit per worksite employee per month | 258 | 245 | 5.3 | % |
| Operating expenses per worksite employee per month | 208 | 206 | 1.0 | % |
| Operating income per worksite employee per month | 50 | 40 | 25.0 | % |
| Net income per worksite employee per month | 30 | 12 | 150.0 | % |

(1)Gross billings of \$8,047 and \$7,992 per worksite employee per month, less payroll cost of \$6,704 and \$6,662 per worksite employee per month, respectively.

Revenues

Our revenues for the third quarter of 2012 increased 8.5% over the 2011 period, primarily due to a 7.5% increase in the average number of worksite employees paid per month and a 1.0%, or \$13 increase in revenues per worksite employee per month.

Table of Contents

By region, our Workforce Optimization revenue change from the third quarter of 2011 and distribution for the quarters ended September 30, 2012 and 2011 were as follows:

| | Three Months Ended September 30, | | | Three Months Ended September 30, | | | |
|---------------|----------------------------------|-----------|----------|----------------------------------|------|---------|--|
| | 2012 | 2011 | % Change | 2012 | 2011 | | |
| | (in thousands) | | | (% of total revenues) | | | |
| Northeast | \$131,759 | \$120,994 | 8.9 % | 26.1 % | | 26.1 % | |
| Southeast | 47,670 | 46,271 | 3.0 % | 9.5 % | | 10.0 % | |
| Central | 73,875 | 66,314 | 11.4 % | 14.7 % | | 14.3 % | |
| Southwest | 140,843 | 134,295 | 4.9 % | 27.9 % | | 28.9 % | |
| West | 110,110 | 96,122 | 14.6 % | 21.8 % | | 20.7 % | |
| | 504,257 | 463,996 | 8.7 % | 100.0 % | | 100.0 % | |
| Other revenue | 7,696 | 7,825 | (1.6)% | | | | |
| Total revenue | \$511,953 | \$471,821 | 8.5 % | | | | |

Other revenue is comprised primarily of revenues generated by our Adjacent Businesses.

Our Workforce Optimization growth rate is affected by three primary sources – worksite employees paid from new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During the third quarter of 2012, the net change in existing clients declined, while worksite employees paid from new client sales and client retention remained consistent with the third quarter of 2011.

Gross Profit

Gross profit for the third quarter of 2012 increased 13.1% over the third quarter of 2011 to \$98.4 million. The average gross profit per worksite employee increased 5.3% to \$258 per month in the 2012 period from \$245 per month in the 2011 period.

Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by increasing revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses. While our revenues increased 1.0% per worksite employee per month, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, remained flat on a per worksite employee per month basis compared to the third quarter of 2011.

- **Benefits costs** – The cost of group health insurance and related employee benefits decreased \$13 per worksite employee per month, or 0.5% on a cost per covered employee basis compared to the third quarter of 2011. The percentage of worksite employees covered under our health insurance plans was 71.9% in the 2012 period compared to 73.0% in the 2011 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Health Insurance Costs,” for a discussion of our accounting for health insurance costs.
- **Workers' compensation costs** – Workers' compensation costs increased 46.9%, or \$10 per worksite employee per month compared to the third quarter of 2011. As a percentage of non-bonus payroll cost, workers' compensation costs were 0.57% in the 2012 period compared to 0.43% in the 2011 period. During the 2012 period, we recorded reductions in workers' compensation costs of \$3.9 million, or 0.16% of non-bonus payroll costs, for changes in estimated losses related to prior reporting periods, compared to \$4.9 million, or 0.22% of non-bonus payroll costs, in the 2011 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Workers' Compensation Costs,” for a discussion of our accounting for workers' compensation costs.

Table of Contents

- Payroll tax costs – Payroll taxes increased 8.5%, or \$4 per worksite employee per month compared to the third quarter of 2011, primarily due to the 8.2% increase in payroll costs. Payroll taxes as a percentage of payroll cost were 6.4% in both the 2012 period and the 2011 period.

Operating Expenses

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

| | Three Months Ended September 30, 2012 | | | Three Months Ended September 30, 2011 | | | Three Months Ended September 30, 2011 | | |
|-------------------------------------|--|----------|----------|--|-------|----------|--|--|----------|
| | (in thousands) | | % Change | (in thousands) | | % Change | (per worksite employee per month) | | % Change |
| Salaries, wages and payroll taxes | \$44,032 | \$39,494 | 11.5 % | \$115 | \$111 | 3.6 % | | | |
| Stock-based compensation | 2,429 | 2,109 | 15.2 % | 6 | 6 | — | | | |
| Commissions | 3,358 | 3,399 | (1.2)% | 9 | 10 | (10.0)% | | | |
| Advertising | 3,680 | 5,235 | (29.7)% | 10 | 15 | (33.3)% | | | |
| General and administrative expenses | 21,122 | 18,912 | 11.7 % | 56 | 53 | 5.7 % | | | |
| Depreciation and amortization | 4,659 | 3,786 | 23.1 % | 12 | 11 | 9.1 % | | | |
| Total operating expenses | \$79,280 | \$72,935 | 8.7 % | \$208 | \$206 | 1.0 % | | | |

Operating expenses increased 8.7% to \$79.3 million compared to \$72.9 million in the third quarter of 2011. Operating expenses in the third quarter of 2011 included \$1.8 million in costs associated with the launch of our new brand. Operating expenses per worksite employee per month increased to \$208 in the 2012 period from \$206 in the 2011 period. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 11.5%, or \$4 per worksite employee per month compared to the 2011 period. This increase was primarily due to a 4.6% rise in headcount and higher incentive compensation accruals resulting from improved operating results.
- Stock-based compensation increased 15.2%, but remained flat on a per worksite employee per month basis compared to the 2011 period, due primarily to an increase in the weighted average market value on the date of grant associated with restricted stock awards. The stock-based compensation expense represents amortization of restricted stock awards granted to employees.

Table of Contents

- Commissions expense decreased 1.2%, or \$1 per worksite employee per month compared to the 2011 period.
- Advertising costs decreased 29.7%, or \$5 per worksite employee per month compared to the 2011 period, primarily due to the non-recurrence of expenses related to our 2011 rebranding initiative. Advertising costs in the 2011 period included \$1.7 million associated with the launch of our new brand.
- General and administrative expenses increased 11.7%, or \$3 per worksite employee per month compared to the 2011 period, primarily due to higher travel and training expenses.
- Depreciation and amortization expense increased 23.1%, or \$1 per worksite employee per month compared to the 2011 period, primarily due to investments in our technology infrastructure made in the second half of 2011.

Other Income (Expense)

Other income was \$139,000 for the third quarter of 2012 compared to other expense of \$7.3 million in the third quarter of 2011, primarily due to a \$4.4 million loss in the 2011 period related to the exchange of an aircraft and a \$3.1 million loss in the 2011 period related to a settlement with the State of California.

Income Tax Expense

Our effective income tax rate was 40.6% in the 2012 period compared to 40.1% in the 2011 period. Our provision for income taxes differed from the U.S. statutory rate of 35% primarily due to state income taxes and non-deductible expenses.

Operating and Net Income

Operating and net income per worksite employee per month was \$50 and \$30 in the 2012 period, versus \$40 and \$12 in the 2011 period.

Table of Contents

Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011.

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

| | Nine Months Ended September 30, | | | % Change |
|--|---|--------------|---------|----------|
| | 2012 | 2011 | | |
| | (in thousands, except per share and statistical data) | | | |
| Revenues (gross billings of \$9.339 billion and \$8.454 billion, less worksite employee payroll cost of \$7.712 billion and \$6.973 billion, respectively) | \$1,626,386 | \$ 1,481,105 | 9.8 | % |
| Gross profit | 288,718 | 261,829 | 10.3 | % |
| Operating expenses | 237,117 | 221,206 | 7.2 | % |
| Operating income | 51,601 | 40,623 | 27.0 | % |
| Other income (expense) | 603 | (6,668) | (109.0) |)% |
| Net income | 30,957 | 19,626 | 57.7 | % |
| Diluted net income per share of common stock | 1.20 | 0.74 | 62.2 | % |
| Statistical Data: | | | | |
| Average number of worksite employees paid per month | 124,418 | 115,097 | 8.1 | % |
| Revenues per worksite employee per month(1) | \$1,452 | \$ 1,430 | 1.5 | % |
| Gross profit per worksite employee per month | 258 | 253 | 2.0 | % |
| Operating expenses per worksite employee per month | 212 | 214 | (0.9) |)% |
| Operating income per worksite employee per month | 46 | 39 | 17.9 | % |
| Net income per worksite employee per month | 28 | 19 | 47.4 | % |

(1)Gross billings of \$8,340 and \$8,161 per worksite employee per month, less payroll cost of \$6,888 and \$6,731 per worksite employee per month, respectively.

Revenues

Our revenues for the nine months ended September 30, 2012, increased 9.8% over the 2011 period, primarily due to an 8.1% increase in the average number of worksite employees paid per month and a 1.5%, or \$22 increase in revenues per worksite employee per month.

Table of Contents

By region, our Workforce Optimization revenue change from the first nine months of 2011 and distribution for the nine months ended September 30, 2012 and 2011 were as follows:

| | Nine Months Ended September 30, | | | Nine Months Ended September 30, | | | |
|---------------|---------------------------------|-------------|----------|---------------------------------|---------|--|--|
| | 2012 | 2011 | % Change | 2012 | 2011 | | |
| | (in thousands) | | | (% of total revenues) | | | |
| Northeast | \$425,295 | \$383,938 | 10.8 % | 26.5 % | 26.3 % | | |
| Southeast | 148,552 | 144,120 | 3.1 % | 9.3 % | 9.8 % | | |
| Central | 235,464 | 212,910 | 10.6 % | 14.7 % | 14.6 % | | |
| Southwest | 447,617 | 423,139 | 5.8 % | 27.9 % | 29.0 % | | |
| West | 346,387 | 295,678 | 17.2 % | 21.6 % | 20.3 % | | |
| | 1,603,315 | 1,459,785 | 9.8 % | 100.0 % | 100.0 % | | |
| Other revenue | 23,071 | 21,320 | 8.2 % | | | | |
| Total revenue | \$1,626,386 | \$1,481,105 | 9.8 % | | | | |

Other revenue is comprised primarily of revenues generated by our Adjacent Businesses.

Our Workforce Optimization growth rate is affected by three primary sources – worksite employees paid from new client sales, client retention and the net change in existing clients through worksite employee new hires and layoffs. During the first nine months of 2012, the net change in existing clients and client retention remained consistent with the first nine months of 2011, while worksite employees paid from new client sales declined.

Gross Profit

Gross profit for the first nine months of 2012 increased 10.3% over the 2011 period to \$288.7 million. The average gross profit per worksite employee increased 2.0% to \$258 per month in the 2012 period from \$253 per month in the 2011 period.

Our pricing objectives attempt to maintain or improve the gross profit per worksite employee by increasing revenue per worksite employee to match or exceed changes in primary direct costs and operating expenses. While our revenues increased 1.5% per worksite employee per month, our direct costs, which primarily include payroll taxes, benefits and workers' compensation expenses, increased 1.4% to \$1,194 per worksite employee per month in the first nine months of 2012 versus \$1,177 in the 2011 period.

- **Benefits costs** – The cost of group health insurance and related employee benefits increased \$7 per worksite employee per month, or 3.1% on a cost per covered employee basis compared to the 2011 period. The percentage of worksite employees covered under our health insurance plans was 72.3% in the 2012 period compared to 73.7% in the 2011 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Health Insurance Costs,” for a discussion of our accounting for health insurance costs.
- **Workers' compensation costs** – Workers' compensation costs increased 13.5%, or \$2 per worksite employee per month compared to the first nine months of 2011. As a percentage of non-bonus payroll cost, workers' compensation costs were 0.56% in the 2012 period compared to 0.54% in the 2011 period. During the 2012 period, we recorded reductions in workers' compensation costs of \$10.4 million, or 0.15% of non-bonus payroll costs, for changes in estimated losses related to prior reporting periods, compared to \$8.6 million, or 0.14% of non-bonus payroll costs, in the 2011 period. Please read Note 2 to the Consolidated Financial Statements, “Accounting Policies – Workers' Compensation Costs,” for a discussion of our accounting for workers' compensation costs.

Table of Contents

- Payroll tax costs – Payroll taxes increased 9.9%, or \$9 per worksite employee per month compared to the first nine months of 2011, primarily due to the 10.6% increase in payroll costs, partially offset by a \$2.9 million (or \$3 per worksite employee per month) credit related to the Pennsylvania sales tax matter. Please read Note 7 to the Consolidated Financial Statements, “Commitments and Contingencies” for further information. Payroll taxes as a percentage of payroll cost were 7.7% in both the 2012 and the 2011 periods.

Operating Expenses

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

| | Nine Months Ended September 30, | | | Nine Months Ended September 30, | | | | |
|-------------------------------------|---------------------------------|-----------|----------|-----------------------------------|-------|----------|--------|----|
| | 2012 | 2011 | % Change | 2012 | 2011 | % Change | | |
| | (in thousands) | | | (per worksite employee per month) | | | | |
| Salaries, wages and payroll taxes | \$127,402 | \$117,558 | 8.4 | % | \$114 | \$113 | 0.9 | % |
| Stock-based compensation | 7,385 | 6,455 | 14.4 | % | 7 | 6 | 16.7 | % |
| Commissions | 10,299 | 9,750 | 5.6 | % | 9 | 10 | (10.0) |)% |
| Advertising | 17,001 | 18,280 | (7.0) |)% | 15 | 18 | (16.7) |)% |
| General and administrative expenses | 61,694 | 57,828 | 6.7 | % | 55 | 56 | (1.8) |)% |
| Depreciation and amortization | 13,336 | 11,335 | 17.7 | % | 12 | 11 | 9.1 | % |
| Total operating expenses | \$237,117 | \$221,206 | 7.2 | % | \$212 | \$214 | (0.9) |)% |

Operating expenses increased 7.2% to \$237.1 million compared to \$221.2 million in the first nine months of 2011. Operating expenses in the 2011 period included \$9.7 million in costs associated with the launch of our new brand. Operating expenses per worksite employee per month decreased to \$212 in the 2012 period from \$214 in the 2011 period. The components of operating expenses changed as follows:

- Salaries, wages and payroll taxes of corporate and sales staff increased 8.4%, or \$1 per worksite employee per month compared to the 2011 period. This increase was primarily due to a 6.8% rise in headcount.
- Stock-based compensation increased 14.4%, or \$1 per worksite employee per month compared to the 2011 period, due primarily to an increase in the weighted average market value on the date of grant associated with restricted stock awards. The stock-based compensation expense represents amortization of restricted stock awards granted to employees.

Table of Contents

- Commissions expense increased 5.6% in the 2012 period, but decreased \$1 per worksite employee per month compared to the 2011 period.
- Advertising costs decreased 7.0%, or \$3 per worksite employee per month compared to the 2011 period, primarily due to the non-recurrence of \$6.1 million in expenses related to our 2011 rebranding initiative, partially offset by the timing of business promotion expenses related to our Insperty Championship™ professional golf tournament, which moved into the first nine months of the year during 2012.
- General and administrative expenses increased 6.7%, but decreased \$1 per worksite employee per month compared to the first nine months of 2011, primarily due to increased travel, training, repairs and maintenance, partially offset by the non-recurrence of expenses related to our 2011 rebranding initiative. General and administrative expenses in the 2011 period included \$3.6 million associated with the launch of our new brand.
- Depreciation and amortization expense increased 17.7%, or \$1 per worksite employee per month compared to the 2011 period, primarily due to investments in our technology infrastructure made in the second half of 2011.

Other Income (Expense)

Other income was \$603,000 in the 2012 period compared to other expense of \$6.7 million in the 2011 period, primarily due to a \$4.4 million loss in the 2011 period related to the exchange of an aircraft and a \$3.1 million loss in the 2011 period related to a settlement with the State of California.

Income Tax Expense

Our effective income tax rate was 40.7% in the 2012 period compared to 42.2% in the 2011 period. Our provision for income taxes differed from the U.S. statutory rate of 35% primarily due to state income taxes and non-deductible expenses.

Operating and Net Income

Operating and net income per worksite employee per month was \$46 and \$28 in the 2012 period, versus \$39 and \$19 in the 2011 period.

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 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.

Table of Contents

| | Three Months Ended | | | Nine Months Ended | | | | |
|---|---|-------------|-------------|-----------------------|-------------|-------------|------|---|
| | September 30, 2012 | 2011 | % Change | September 30, 2012 | 2011 | % Change | | |
| | (in thousands, except per worksite employee data) | | | | | | | |
| Payroll cost (GAAP) | \$2,556,114 | \$2,362,941 | 8.2 | % | \$7,712,302 | \$6,972,806 | 10.6 | % |
| Less: Bonus payroll cost | 156,723 | 174,668 | (10.3 |)% | 728,589 | 644,129 | 13.1 | % |
| Non-bonus payroll cost | \$2,399,391 | \$2,188,273 | 9.6 | % | \$6,983,713 | \$6,328,677 | 10.4 | % |
| Payroll cost per worksite employee per month (GAAP) | \$6,704 | \$6,662 | 0.6 | % | \$6,888 | \$6,731 | 2.3 | % |
| Less: Bonus payroll cost per worksite employee per month | 411 | 492 | (16.5 |)% | 651 | 621 | 4.8 | % |
| Non-bonus payroll cost per worksite employee per month | \$6,293 | \$6,170 | 2.0 | % | \$6,237 | \$6,110 | 2.1 | % |

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, acquisition plans 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 \$253.9 million in cash, cash equivalents and marketable securities at September 30, 2012, of which approximately \$96.5 million was payable in early October 2012 for withheld federal and state income taxes, employment taxes and other payroll deductions, and approximately \$12.4 million of client prepayments that were payable in October 2012. At September 30, 2012, we had working capital of \$140.0 million compared to \$126.6 million at December 31, 2011. We currently believe that our cash on hand and cash flows from operations will be adequate to meet our liquidity requirements for the remainder of 2012. 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.

Table of Contents

In September 2011, we completed the financing for a new four-year, \$100 million revolving credit facility (“Facility”), with a syndicate of financial institutions. The Facility is available for working capital and general corporate purposes, including acquisitions, and was undrawn at September 30, 2012. Please read Note 4 to our Consolidated Financial Statements, “Revolving Credit Facility,” for additional information.

Cash Flows from Operating Activities

Net cash provided by operating activities in 2012 was \$25.0 million. Our primary source of cash from operations is the comprehensive service fee and payroll funding we collect from our clients. Our cash and cash equivalents, and thus our reported cash flows from operating activities are significantly impacted by various external and internal factors, which are reflected in part by the changes in our balance sheet accounts. These include the following:

- Timing of client payments / payrolls – We typically collect our comprehensive service fee, along with the client’s payroll funding, from clients at least one day prior to the payment of worksite employee payrolls and associated payroll taxes. Therefore, the last business day of a reporting period has a substantial impact on our reporting of operating cash flows. For example, many worksite employees are paid on Fridays; therefore, operating cash flows decrease in the reporting periods that end on a Friday. In the period ended September 30, 2012, the last business day of the reporting period was a Friday and client prepayments were \$12.4 million and accrued worksite employee payroll was \$174.3 million. In the period ended September 30, 2011, the last business day of the reporting period was also a Friday and client prepayments were \$3.9 million and accrued worksite employee payroll was \$130.8 million.
- Workers’ compensation plan funding – Under our workers’ compensation insurance arrangements, we make monthly payments to the carriers comprised of premium costs and funds to be set aside for payment of future claims (“claim funds”). These pre-determined amounts are stipulated in our agreements with the carriers, and are based primarily on anticipated worksite employee payroll levels and workers’ compensation loss rates during the policy year. Changes in payroll levels from those that were anticipated in the arrangements can result in changes in the amount of cash payments, which will impact our reporting of operating cash flows. Our claim funds paid, based upon anticipated worksite employee payroll levels and workers’ compensation loss rates, were \$32.1 million in the first nine months of 2012 and \$27.3 million in the first nine months of 2011. However, our estimate of workers’ compensation loss costs was \$27.9 million in 2012 and \$25.5 million in 2011, respectively. During 2012 and 2011, we received \$2.5 million and \$10.0 million, respectively, for the return of excess claim funds related to the workers’ compensation program, which resulted in an increase to working capital.
- Medical plan funding – Our health care contract with United establishes participant cash funding rates 90 days in advance of the beginning of a reporting quarter. Therefore, changes in the participation level of the United plan have a direct impact on our operating cash flows. In addition, changes to the funding rates, which are solely determined by United based primarily upon recent claim history and anticipated cost trends, also have a significant impact on our operating cash flows. At September 30, 2012, premiums owed and cash funded to United have exceeded Plan Costs, resulting in a \$30.2 million surplus, \$21.2 million of which is reflected as a current asset, and \$9.0 million of which is reflected as a long-term asset on our Consolidated Balance Sheets. The premiums owed to United at September 30, 2012, were \$19.2 million, which is included in accrued health insurance costs, a current liability, on our Consolidated Balance Sheets.

Table of Contents

- Operating results – Our net income has a significant impact on our operating cash flows. Our net income increased 57.7% to \$31.0 million in the nine months ended September 30, 2012, compared to \$19.6 million in the nine months ended September 30, 2011. Please read “Results of Operations – Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011.”

Cash Flows from Investing Activities

Net cash flows used in investing activities were \$9.7 million for the nine months ended September 30, 2012, primarily due to \$12.0 million in capital expenditures primarily related to our technology infrastructure.

Cash Flows from Financing Activities

Net cash flows used in financing activities were \$24.4 million for the nine months ended September 30, 2012, including \$13.8 million in stock repurchases and \$12.6 million in dividends paid.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We are primarily exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on the market values of our cash equivalent short-term investments. In addition, borrowings under our Facility bear interest at a variable market rate. As of September 30, 2012, we had not drawn on the Facility. Please read Note 4 to the Consolidated Financial Statements, "Revolving Credit Facility," for additional information. Our cash equivalent short-term investments consist primarily of overnight investments and money market funds, which are not significantly exposed to interest rate risk, except to the extent that changes in interest rates will ultimately affect the amount of interest income earned on these investments. The available-for-sale marketable securities are subject to interest rate risk because these securities generally include a fixed interest rate. As a result, the market values of these securities are affected by changes in prevailing interest rates.

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

ITEM 4. CONTROLS AND PROCEDURES.

In accordance with the Securities Exchange Act of 1934 Rules 13a-15 and 15d-15, we carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2012.

There has been no change in our internal controls over financial reporting that occurred during the three months ended September 30, 2012, that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

Table of Contents

PART II

ITEM 1. LEGAL PROCEEDINGS.

Please read Note 7 to our Consolidated Financial Statements, “Commitments and Contingencies,” which is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Forward-Looking Statements

The statements contained herein that are not historical facts are forward-looking statements within the meaning of the federal securities laws (Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934). You can identify such forward-looking statements by the words “expects,” “intends,” “plans,” “projects,” “believes,” “estimates,” “likely,” “possibly,” “probably,” “goal,” “opportunity,” “objective,” “target,” “assume,” “outlook,” “guidance,” “indicator” and similar expressions. Forward-looking statements involve a number of risks and uncertainties. In the normal course of business, Insperty, Inc., in an effort to help keep our stockholders and the public informed about our operations, may from time to time issue such forward-looking statements, either orally or in writing. Generally, these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of such plans or strategies, or projections involving anticipated revenues, earnings, unit growth, profit per worksite employee, pricing, operating expenses or other aspects of operating results. We base the forward-looking statements on our expectations, estimates and projections at the time such statements are made. These statements are not guarantees of future performance and involve risks and uncertainties that we cannot predict. In addition, we have based many of these forward-looking statements on assumptions about future events that may prove to be inaccurate. Therefore, the actual results of the future events described in such forward-looking statements could differ materially from those stated in such forward-looking statements. Among the factors that could cause actual results to differ materially are: (i) continued effects of the economic recession and general economic conditions; (ii) regulatory and tax developments and possible adverse application of various federal, state and local regulations; (iii) the ability to secure competitive replacement contracts for health insurance and workers’ compensation contracts at expiration of current contracts; (iv) increases in health insurance costs and workers’ compensation rates and underlying claims trends, health care reform, financial solvency of workers’ compensation carriers and other insurers, state unemployment tax rates, liabilities for employee and client actions or payroll-related claims; (v) failure to manage growth of our operations and the effectiveness of our sales and marketing efforts; (vi) changes in the competitive environment in the PEO industry, including the entrance of new competitors and our ability to renew or replace client companies; (vii) our liability for worksite employee payroll, payroll taxes and benefits costs; (viii) our liability for disclosure of sensitive or private information; (ix) our ability to integrate or realize expected return on our adjacent business strategy, including acquisitions; and (x) an adverse final judgment or settlement of claims against Insperty. These factors are discussed in further detail in our 2011 Annual Report on Form 10-K under “Factors That May Affect Future Results and the Market Price of Common Stock” on page 19, and elsewhere in this report. Any of these factors, or a combination of such factors, could materially affect the results of our operations and whether forward-looking statements we make ultimately prove to be accurate.

Table of Contents

There have been no material changes in the risk factors disclosed pursuant to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2011, except for the item noted below.

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 ended September 2003, Lumbermens Mutual Casualty Company, formerly known as Kemper, ("Lumbermens Mutual") made the decision to substantially cease underwriting operations and voluntarily entered into "run-off." In July 2012, Lumbermens Mutual announced that an agreed order of rehabilitation had been entered against it in Cook County, Illinois. Under the order, the Director of the Illinois Department of Insurance was vested with control over Lumbermens Mutual property and decision-making. The Director has publicly announced that while claims will continue to be paid during the rehabilitation process, he intends to use the rehabilitation period to work with state guaranty associations to prepare for the orderly transition of claim handling responsibilities to such funds once an Order of Liquidation is entered. After this transition process has been completed, the Director has stated that he intends to file a verified complaint for liquidation.

Guaranty associations are non-profit organizations created by statute for the purpose of protecting policyholders from severe financial losses and preventing delays in claim payment due to the insolvency of an insurer. They do this by assuming responsibility for the payment of claims that would otherwise have been paid by the insurer had it not become insolvent. Each state has one or more guaranty association(s), with each association handling certain types of insurance. Insurance companies are required to be members of the state guaranty association as a condition of being licensed to do business in the state.

The guaranty associations in some states, including Texas, may assert that state law allows them to recover the amount of benefits paid by the guaranty association along with associated administration and defense costs from an insured with a net worth exceeding certain specified levels. If an Order of Liquidation is entered and if one or more guaranty associations were to seek recovery from us for open claims with Lumbermens Mutual, we may be required to repay those amounts. While we are not certain when or if Lumbermens Mutual will be placed into liquidation or whether any state guaranty association will ultimately assert a claim against us, we intend to vigorously assert any and all available defenses to any such claim. We estimate the outstanding claims that may be subject to such contentions from state guaranty associations to range from \$2.9 million to \$5.0 million as of September 30, 2012. In the event state guaranty associations attempt to seek recovery from the Company and are successful, the Company would be required to pay such claims, which would reduce net income and could have a material adverse effect on net income in the reported period.

Table of Contents

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

The following table provides information about purchases by Insperty during the three months ended September 30, 2012, of equity securities that are registered by Insperty pursuant to Section 12 of the Exchange Act:

| Period | Total Number of Shares Purchased(1)(2) | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program(1) | Maximum Number of Shares that may yet be Purchased under the Program(1) |
|-------------------------|--|---------------------------------|--|--|
| 07/01/2012 – 07/31/2012 | 187 (2) | \$ 27.44 | - | 910,902 |
| 08/01/2012 – 08/31/2012 | 80,000 | 24.88 | 80,000 | 830,902 |
| 09/01/2012 – 09/30/2012 | 1,430 | 24.02 | 1,430 | 829,472 |
| Total | 81,617 | \$ 24.87 | 81,430 | 829,472 |

(1) The Board has approved a repurchase program of Insperty common stock. During the three months ended September 30, 2012, 81,430 shares were repurchased under the program and 187 shares were withheld to satisfy tax withholding obligations for the vesting of restricted stock awards. As of September 30, 2012, we were authorized to repurchase an additional 829,472 shares under the program. Unless terminated earlier by resolution of the Board, the repurchase program will expire when we have repurchased all shares authorized for repurchase under the repurchase program.

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

Table of Contents

ITEM 6.EXHIBITS

(a) List of exhibits.

| | | |
|----------------|----|---|
| <u>10.1</u> † | * | Form of Restricted Stock Agreement. |
| <u>10.2</u> † | * | Form of Director Stock Option Agreement. |
| <u>10.3</u> † | * | Form of Director Restricted Stock Award Agreement. |
| <u>10.4</u> † | * | Directors Compensation Plan. |
| <u>31.1</u> | * | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| <u>31.2</u> | * | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| <u>32.1</u> | ** | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| <u>32.2</u> | ** | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| <u>101.INS</u> | * | XBRL Instance Document.(1) |
| <u>101.SCH</u> | * | XBRL Taxonomy Extension Schema Document. |
| <u>101.CAL</u> | * | XBRL Taxonomy Extension Calculation Linkbase Document. |
| <u>101.DEF</u> | * | XBRL Extension Definition Linkbase Document. |
| <u>101.LAB</u> | * | XBRL Taxonomy Extension Label Linkbase Document. |
| <u>101.PRE</u> | * | XBRL Taxonomy Extension Presentation Linkbase Document. |

* Filed with this report.

**Furnished with this report.

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

- (1) Attached as exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Operations for the three and nine month periods ended September 30, 2012 and 2011; (ii) the Consolidated Statements of Comprehensive Income for the three and nine month periods ended September 30, 2012 and 2011; (iii) the Consolidated Balance Sheets at September 30, 2012 and December 31, 2011; (iv) the Consolidated Statement of Stockholders' Equity for the nine month period ended September 30, 2012; (v) the Consolidated Statements of Cash Flows for the nine month periods ended September 30, 2012 and 2011; and (vi) Notes to the Consolidated Financial Statements.

Table of Contents

SIGNATURES

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

Insperty, Inc.

Date: November 1, 2012

By: /s/ Douglas S. Sharp
Douglas S. Sharp
Senior Vice President of Finance,
Chief Financial Officer and Treasurer
(Principal Financial and Duly Authorized Officer)