

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with, and is qualified in its entirety by, the Company's Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report. Historical results are not necessarily indicative of trends in operating results for any future period.

This document 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," "goal," "assume" and similar expressions. In the normal course of business, Administaff, Inc. ("Administaff" or the "Company"), in an effort to help keep its stockholders and the public informed about the Company's 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 or other aspects of operating results. Administaff bases the forward-looking statements on its current expectations, estimates and projections. Administaff cautions you that these statements are not guarantees of future performance and involve risks, uncertainties and assumptions that Administaff cannot predict. In addition, Administaff has 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 under the caption "Factors That May Affect Future Results and the Market Price of Common Stock," beginning on page 33.

OVERVIEW

Administaff provides 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, performance management, and training and development services. The Company's overall operating results are largely dependent on the number of worksite employees paid and can be measured in terms of revenues or costs per worksite employee per month. As a result, the Company often uses this unit of measurement in analyzing and discussing its results of operations.

In addition to the ongoing sales of the Company's principal PEO services and the servicing of its client base, the Company currently has several strategic initiatives in progress, which, while supporting the Company's long-term plans, have increased the

level of operating expenses for the near term. The Company believes that these initiatives will provide long-term benefits, including worksite employee unit growth, enhanced client retention, new and incremental revenue streams and increased internal operational efficiencies. The initiatives include:

Sales and Service Expansion The Company is currently executing a long-term national expansion strategy targeting approximately 90 sales offices located in 40 markets. The plan calls for continuous expansion with approximately one new sales office opening each quarter. To support this expansion, the Company plans to open additional service centers as warranted by the growth in the number of clients and worksite employees in different regions of the country. In addition, the Company is expanding its service capacity by placing service personnel in its sales markets as the number of clients and worksite employees grows in each market.

As of December 31, 2000, the Company had 31 sales offices located in 17 markets, three service centers located in Houston, Dallas and Atlanta, and 371 service personnel located in 17 markets, including 278 located in the three service centers.

Telecommunications and Network Upgrade The Company has significantly upgraded and modified its telecommunications and network infrastructure to allow for enhanced communications among its sales offices, service centers and corporate offices.

eBusiness Strategy The Company has implemented and continues to enhance a comprehensive eBusiness strategy comprised of three primary components: Administaff Assistant, bizzport and a best practices human resources site. Administaff Assistant, the Company's Internet-based service delivery platform, provides automated, personalized PEO services to clients and worksite employees. Bizzport is an eCommerce portal designed to provide the Company's clients and worksite employees with a wide variety of value-added products and services. The best practices human resources site will seek to extend the Company's brand and presence

as the premier human resources department for small and medium-sized business by providing a comprehensive human resources information guide on the web sites of alliance partners. The site is expected to be launched during 2001.

Software Development During 2000, the Company implemented the fifth generation of its proprietary PEO information system. Other software development projects ancillary to this system are expected to continue in 2001.

In addition to the expenses associated with these strategic initiatives, the Company continues to be affected by the ongoing IRS audit of the Company's 401(k) plan and IRS Employee Leasing Market Segment Study. For a discussion of these matters, see page 33.

Revenues The Company's revenues are derived from its comprehensive service fees, which are based upon each employee's gross pay and a mark-up computed as a percentage of the gross pay. The comprehensive service fees are invoiced concurrently with each periodic payroll of its worksite employees. The Company's revenues are primarily dependent on the number of clients enrolled, the resulting number of employees paid each period, the gross payroll of these employees and the number of employees enrolled in benefit plans.

Direct Costs The Company's primary direct costs are (i) the salaries and wages of worksite employees ("payroll cost"); (ii) employment-related taxes ("payroll taxes"); (iii) employee benefit plan premiums; and (iv) workers' compensation insurance premiums. Payroll costs of worksite employees are affected by the composition of the worksite employee base, inflationary effects on wage levels and differences in the local economies of the Company's markets. Changes in payroll costs generally have a proportionate impact on the Company's revenues.

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. The federal tax rates are defined by the appropriate federal regulations. State unemployment tax rates are subject to claims histories and vary from state to state.

Employee benefit costs are comprised primarily of health insurance costs, but also include costs of other employee benefits such as life insurance, vision care, dental insurance, disability insurance, prescription card, education assistance, adoption assistance, a dependent care spending account and a worklife program.

Workers' compensation costs include premiums, administrative costs and claims-related expenses under the Company's workers' compensation program. Since November 1994, the Company has been insured under a guaranteed cost program under which premiums are paid for full insurance coverage of all accident claims occurring during the policy period. The current policy expires on September 30, 2001.

The Company's gross profit per worksite employee is determined in part by its ability to accurately estimate and control direct costs and its ability to incorporate changes in these costs into the comprehensive service fees charged to clients, which are subject to contractual arrangements. Gross profit, measured as a percentage of revenue, is also affected by the comprehensive service fees and direct cost structure. However, worksite employee payroll cost is the largest component of both revenues and direct costs and, as a result, changes in the level of payroll cost per worksite employee can cause fluctuations in this statistic that are not necessarily indicative of relative performance from period to period. As a result, the Company uses gross profit per worksite employee per month as its principal measurement of the relative performance at the gross profit level.

Operating Expenses As a result of the strategic initiatives referred to above, operating expenses have increased significantly during the last several years. The types of operating expenses affected by each of the initiatives are as follows:

Sales and Service Expansion

- general and administrative expenses associated with establishing and maintaining sales offices and service centers;
- compensation expense for additional sales and service staff;
- travel expense associated with maintaining a national sales and service presence; and
- depreciation expense associated with capitalized costs of facilities, furniture, equipment and computer hardware and software.

Telecommunications and Infrastructure Upgrade

- compensation expense of additional technology staff;
- consulting expense associated with design and selection of technology products;
- ongoing maintenance costs of network hardware and software;
- ongoing data and voice transmission service costs; and
- depreciation expense associated with capitalized costs of network hardware and software.

eBusiness Initiatives

- compensation expense of service, technology and support staff for Administaff Assistant, bizzport and the best practices human resources site;
- consulting expense associated with the planning and development of these initiatives;
- travel, legal and compensation expenses associated with obtaining alliance partners to participate in bizzport and the best practices human resources site;
- depreciation and amortization expenses associated with computer hardware and software used for, and the development costs of, Administaff Assistant, bizzport and the best practices human resources site; and
- ongoing maintenance costs of hardware and software associated with Administaff Assistant, bizzport and the best practices human resources site.

Software Development Amortization of capitalized software costs, including those related to the Company's proprietary PEO information system.

In addition, the Company has incurred travel and legal expenses associated with the IRS 401(k) plan audit and the IRS Employee Leasing Market Study.

Income Taxes The Company's provision for income taxes typically differs from the U.S. statutory rate of 34% due primarily to state income taxes and tax-exempt interest income. 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 depreciation and amortization, software development costs, accrued state income taxes, client list acquisition costs and the allowance for uncollectible accounts receivable. Changes in these items are reflected in the Company's financial statements through the Company's deferred income tax provision.

RESULTS OF OPERATIONS

Year Ended December 31, 2000 Compared to Year Ended December 31, 1999 The following table presents certain information related to the Company's results of operations for the years ended December 31, 2000 and 1999.

	Year ended December 31,		
	2000	1999	% change
<small>(in thousands, except per share and statistical data)</small>			
Revenues	\$ 3,708,531	\$ 2,260,743	64.0%
Gross profit	138,534	89,528	54.7%
Operating expenses	116,300	78,969	47.3%
Operating income	22,234	10,559	110.6%
Other income	4,380	3,653	19.9%
Net income	16,900	9,358	80.6%
Diluted net income per share of common stock	0.58	0.34	70.6%
STATISTICAL DATA:			
Average number of worksite employees paid per month	62,140	42,479	46.3%
Fee revenue per worksite employee per month	\$ 4,623	\$ 4,084	13.2%
Fee payroll cost per worksite employee per month	3,830	3,360	14.0%
Gross mark-up per worksite employee per month	793	724	9.5%
Gross profit per worksite employee per month	186	176	5.7%
Operating expenses per worksite employee per month	156	155	0.6%
Operating income per worksite employee per month	30	21	42.9%
Net income per worksite employee per month	23	18	27.8%

Revenues The Company's revenues increased 64.0% over 1999 due to a 46.3% increase in the average number of worksite employees paid per month accompanied by a 13.2% increase in the fee revenue per worksite employee per month. The Company's

continued expansion of its sales force through new market and sales office openings was the primary factor contributing to the increase in the average number of worksite employees paid. The general strength of the U.S. economy during the second half of 1999 and the

first three quarters of 2000 was also a contributing factor. Revenues from markets opened prior to 1993 (the commencement of the Company's national expansion plan) increased 30% over 1999, while revenues from markets opened after 1993 increased 98%. Revenues from the state of Texas represented 50% of the Company's total revenues, and Houston, the Company's original market, represented 27% of the total.

The 13.2% increase in fee revenue per worksite employee per month directly related to the 14.0% increase in fee payroll cost per worksite employee per month, reflecting (i) compensation increases within the Company's existing worksite employee base; (ii) the addition of clients with worksite employees that had a higher average base pay than the existing client base; (iii) the attrition of clients with worksite employees that had a lower average base pay than the existing client base; and (iv) further penetration of markets with generally higher wage levels, such as San Francisco, New York and Washington, D.C.

Gross Profit Gross profit increased 54.7% over 1999 due primarily to the 46.3% increase in the average number of worksite employees paid per month accompanied by a 5.7% increase in gross profit per worksite employee per month. Gross profit per worksite employee increased to \$186 per month in 2000 versus \$176 in 1999, reflecting effective execution of the Company's pricing strategy. The Company's pricing objectives attempt to maintain or improve the gross profit per worksite employee by increasing gross mark-up per worksite employee to match or exceed changes in (i) its primary direct costs; and (ii) its operating costs associated with enhancements in the Company's service offering.

Gross mark-up per worksite employee per month increased 9.5% to \$793 in 2000 versus \$724 in 1999. Approximately 55% of the \$69 increase in gross mark-up per employee was the result of increased service fees

designed to match the increased payroll tax expense associated with the higher average payroll cost per worksite employee. The remaining increase in gross mark-up per employee was related to other increases in the Company's comprehensive service fees, including approximately \$3 per worksite employee related to a mid-1999 change in the method used to calculate service fees for clients who experience turnover within their workforce.

Payroll taxes increased \$40 per worksite employee per month, primarily due to the increased average payroll cost per worksite employee. The overall cost of payroll taxes as a percentage of payroll cost was 7.34% in 2000 versus 7.19% in 1999. This increase was primarily the result of the Company's accelerating unit growth during the first three quarters of 2000, which caused a larger proportion of the Company's payroll to be subject to payroll taxes later in the year.

The cost of health insurance and related employee benefits increased \$14 per worksite employee per month over 1999 due to a 3.0% increase in the cost per covered employee and a slight increase in the percentage of worksite employees covered under the Company's health insurance plan to 69.7% in 2000 versus 67.8% in 1999.

Workers' compensation costs increased \$5 per worksite employee per month, but decreased slightly to 1.22% of fee payroll cost in 2000 from 1.25% in 1999.

Gross profit, measured as a percentage of revenue, declined to 3.74% in 2000 from 3.96% in 1999. This decline was due primarily to the increase in average payroll cost per worksite employee. Because payroll cost is the largest single component of both revenues and direct costs, an increase in the average payroll cost per worksite employee creates a mathematical downward pressure on the calculation of gross profit as a percentage of revenue.

Operating Expenses The following table presents certain information related to the Company's operating expenses for the years ended December 31, 2000 and 1999.

	Year ended December 31,					
	(in thousands)			(per worksite employee per month)		
	2000	1999	% change	2000	1999	% change
Salaries, wages and payroll taxes	\$ 54,477	\$ 36,690	48.5 %	\$ 73	\$ 72	1.4 %
General and administrative expenses	35,426	23,219	52.6 %	48	45	6.7 %
Commissions	9,278	6,429	44.3 %	12	13	(7.7)%
Advertising	5,117	4,090	25.1 %	7	8	(12.5)%
Depreciation and amortization	12,002	7,103	69.0 %	16	14	14.3 %
Write-off of software development costs	—	1,438	(100.0)%	—	3	(100.0)%
Total operating expenses	\$ 116,300	\$ 78,969	47.3 %	\$ 156	\$ 155	0.6 %

Operating expenses increased 47.3% over 1999 as a result of the 46.3% growth in the average number of worksite employees paid per month by the Company, combined with the effects of the previously mentioned strategic initiatives, all of which comprise investments in the Company's sales, service and technology infrastructure. Operating expenses per worksite employee per month increased 0.6% to \$156 in 2000 versus \$155 in 1999.

Operating expenses in 1999 included a non-recurring \$1.4 million (\$920,000 net of tax) write-off of certain capitalized software development costs. This write-off was the result of a periodic evaluation of all software development projects, which included a review of costs incurred, estimated costs to complete, estimated maintenance costs and the availability of alternative software packages. Upon completion of this evaluation, the Company determined that the projects would be terminated and that the costs associated with two projects should be written off. The majority of the costs written off related to efforts to customize an electronic document management system to meet the Company's physical records management needs. Excluding the impact of this charge, operating expenses in 2000 increased 50.0% over 1999, and increased to \$156 per worksite employee per month in 2000 from \$152 in 1999.

Salaries, wages and payroll taxes of corporate and sales staff increased to \$73 per worksite employee per month in 2000 versus \$72 in 1999. The ratio of worksite employees to corporate employees improved to 65 in 2000 from 58 in 1999. This improvement was partially offset by an average increase in gross pay per corporate employee of 6.3% over 1999. In addition, incentive compensation as a percentage of corporate employee gross pay increased to 11.2% in 2000 versus 3.5% in 1999 due to the Company's strong financial performance.

General and administrative expenses increased \$3 per worksite employee per month over 1999. The increase resulted from increased travel expenses associated with the Company's expanding national presence, increased outside labor and recruiting costs associated with the Company's accelerated growth rate and increased consulting expenses associated with the development and rollout of new technology projects.

Depreciation and amortization expense increased \$2 per worksite employee per month as a result of the increased capital expenditures placed in service in 1999 and 2000, including (i) the implementation of the fifth generation of the Company's proprietary PEO information system; (ii) the implementation of certain new components of Administaff Assistant, primarily the web payroll and web reporting capabilities, which included

both internal software development costs and externally purchased software; (iii) the opening of new sales offices; (iv) the expansion and relocation of the Houston service center and the opening of the Atlanta service center; and (v) the expansion of corporate headquarters.

Commissions expense declined slightly on a per worksite employee per month basis due to lower sales agency commissions. Advertising costs declined slightly per worksite employee per month, as four of the Company's six new offices opened in 2000 were located in existing sales markets, which provided advertising efficiencies.

Other Income Other income increased 19.9% to \$4.4 million in 2000. Interest income increased 72.9% to \$4.4 million in 2000 from \$2.6 million in 1999, due

to a higher level of cash and marketable securities resulting from the Company's strong financial performance and an increase in the average interest rate related to interest-bearing investments. This increase was partially offset by the effect of a prior year non-recurring gain from the Company's settlement of a 401(k) plan issue with the Internal Revenue Service.

The Company's provision for income taxes differed from the U.S. statutory rate of 34% in 2000 due primarily to state income taxes and tax-exempt interest income.

Net Income Net income for 2000 was \$16.9 million, or \$0.58 per diluted share compared to \$9.4 million, or \$0.34 per diluted share in 1999. These results reflect the two-for-one stock split effected on October 16, 2000. On a per worksite employee per month basis, net income increased 27.8% to \$23 in 2000 versus \$18 in 1999.

Year Ended December 31, 1999 Compared to Year Ended December 31, 1998. The following table presents certain information related to the Company's results of operations for the years ended December 31, 1999 and 1998.

	Year ended December 31,		
	1999	1998	% change
(in thousands, except per share and statistical data)			
Revenues	\$ 2,260,743	\$ 1,683,063	34.3 %
Gross profit	89,528	68,610	30.5 %
Operating expenses	78,969	57,409	37.6 %
Operating income	10,559	11,201	(5.7)%
Other income	3,653	3,417	6.9 %
Net income	9,358	9,123	2.6 %
Diluted net income per share of common stock	0.34	0.31	9.7 %

STATISTICAL DATA:

Average number of worksite employees paid per month	42,479	34,819	22.0 %
Fee revenue per worksite employee per month	\$ 4,084	\$ 3,756	8.7 %
Fee payroll cost per worksite employee per month	3,360	3,083	9.0 %
Gross mark-up per worksite employee per month	724	673	7.6 %
Gross profit per worksite employee per month	176	164	7.3 %
Operating expenses per worksite employee per month	155	137	13.1 %
Operating income per worksite employee per month	21	27	(22.2)%
Net income per worksite employee per month	18	22	(18.2)%

Revenues The Company's revenues increased 34.3% over 1998 due to a 22.0% increase in the average number of worksite employees paid per month accompanied by an 8.7% increase in the fee revenue per worksite employee per month. The Company's continued expansion of its sales force through new market and sales office openings was the primary factor contributing to the increase in the average number of worksite employees paid. Revenues from markets opened prior to 1993 (the commencement of the Company's national expansion plan) increased 14% over 1998, while revenues from markets opened after 1993 increased 63%. Revenues from the state of Texas represented 61% of the Company's total revenues, and Houston, the Company's original market, represented 36% of the total.

The 8.7% increase in fee revenue per worksite employee per month directly related to the 9.0% increase in fee payroll cost per worksite employee per month, reflecting (i) compensation increases within the Company's existing worksite employee base; (ii) the addition of clients with worksite employees that had a higher average base pay than the existing client base; (iii) the attrition of clients with worksite employees that had a lower average base pay than the existing client base; and (iv) the penetration of markets with generally higher wage levels, such as San Francisco, New York and Washington, D.C.

Gross Profit Gross profit increased 30.5% over 1998 due primarily to the 22.0% increase in the average number of worksite employees paid per month accompanied by a 7.3% increase in gross profit per worksite employee per month. Gross profit per worksite employee increased to \$176 per month in 1999 from \$164 per month in 1998, reflecting effective execution of the Company's pricing strategy. The Company's pricing objectives attempt to maintain or improve the gross profit per worksite employee by matching or exceeding changes in its primary direct costs with changes in the gross mark-up per worksite employee.

Gross mark-up per worksite employee per month increased 7.6% to \$724 in 1999 from \$673 in 1998. Approximately 43% of the \$51 increase in gross mark-up per employee was the result of increased service fees designed to match the increased payroll tax expense associated with the higher average payroll cost per worksite employee. The remaining increase in gross mark-up per employee was related to other increases in the Company's comprehensive service fees, which were designed to match or exceed known trends in the Company's primary direct costs, including approximately \$4 per worksite employee related to a change in the method used to calculate service fees for clients who experience turnover within their workforce.

Payroll taxes increased \$23 per worksite employee per month, primarily due to the increased average payroll cost per worksite employee. The overall cost of payroll taxes as a percentage of payroll cost was 7.2% in 1999 versus 7.3% in 1998.

The cost of health insurance and related employee benefits increased \$12 per worksite employee per month over 1998 due to a 3.1% increase in the cost per covered employee and a slight increase in the percentage of worksite employees covered under the Company's health insurance plan to 67.8% in 1999 from 66.4% in 1998.

Workers' compensation costs increased \$5 per worksite employee per month, and increased slightly to 1.25% of payroll cost in 1999 from 1.20% in 1998, primarily due to higher bonus and other year-end compensation of worksite employees, some of which is subject to workers' compensation insurance premiums.

Gross profit, measured as a percentage of revenue, declined to 3.96% in 1999 from 4.08% in 1998. This decline was due primarily to the increase in average payroll cost per worksite employee. Because payroll cost is the largest single component of both revenues and direct costs, an increase in the average payroll cost per worksite employee creates a mathematical downward pressure on the calculation of gross profit as a percentage of revenue.

Operating Expenses The following table presents certain information related to the Company's operating expenses for the years ended December 31, 1999 and 1998.

	Year ended December 31,					
	(in thousands)			(per worksite employee per month)		
	1999	1998	% change	1999	1998	% change
Salaries, wages and payroll taxes	\$ 36,690	\$ 26,522	38.3 %	\$ 72	\$ 63	14.3 %
General and administrative expenses	23,219	17,474	32.9 %	45	42	7.1 %
Commissions	6,429	5,968	7.7 %	13	14	(7.1)%
Advertising	4,090	3,740	9.4 %	8	9	(11.1)%
Depreciation and amortization	7,103	3,705	91.7 %	14	9	55.6 %
Write-off of software development costs	1,438	—	100.0 %	3	—	100.0 %
Total operating expenses	\$ 78,969	\$ 57,409	37.6 %	\$ 155	\$ 137	13.1 %

Operating expenses increased 37.6% over 1998 as a result of the 22.0% growth in the average number of worksite employees paid per month by the Company, combined with the effects of the previously mentioned strategic initiatives, all of which comprise investments in the Company's sales, service and technology infrastructure. Operating expenses per worksite employee per month increased 13.1% to \$155 in 1999 from \$137 in 1998.

Operating expenses in 1999 included a non-recurring \$1.4 million (\$920,000 net of tax) write-off of certain capitalized software development costs. This write-off was the result of a periodic evaluation of all software development projects, which included a review of costs incurred to date, estimated costs to complete, estimated maintenance costs, and the availability of alternative software packages. Upon completion of this evaluation, the Company determined that the projects would be terminated and that the costs associated with two projects should be written off. The majority of the costs written off related to efforts to customize an electronic document management system to meet the Company's physical records management needs. Excluding the impact of this charge,

operating expenses increased 35.1% over 1998, and increased to \$152 per worksite employee per month in 1999 from \$137 in 1998.

Salaries, wages and payroll taxes of corporate and sales staff increased to \$72 per worksite employee per month in 1999 from \$63 in 1998. Approximately \$6 of this increase was the result of a 25.9% increase in corporate and sales staff, combined with an 8.0% increase in the average salary per employee. The remaining increase was related to higher payroll tax rates and the adoption of an employer matching contribution feature in the Company's 401(k) retirement plan. The 25.9% increase in corporate and sales staff was devoted largely to supporting the Company's strategic initiatives, including a 23% increase in sales and sales support staff in the district sales offices, a 23% increase in service personnel, predominantly located in the Company's service centers and sales markets, a 90% increase in technology staff and newly formed departments devoted to the Company's eBusiness initiatives.

General and administrative expenses increased \$3 per worksite employee per month over 1998. The increase resulted from (i) hardware and software maintenance fees and communications costs associated

with the Company's Internet development, national technology platform and other technology initiatives; (ii) higher legal and accounting fees associated with corporate activities such as the ongoing 401(k) plan audit, corporate entity changes and eBusiness alliance contract negotiations; and (iii) higher rent expense due to recent openings of sales offices in St. Louis, San Francisco and New York, and the new Dallas and Atlanta service centers.

Depreciation and amortization expense increased \$5 per worksite employee as a result of the increased capital expenditures placed in service in 1998 and 1999, including (i) the implementation of a national technology infrastructure; (ii) the implementation of certain new components of Administaff Assistant, primarily the web payroll and web reporting capabilities, which include both internal software development costs and externally purchased software; (iii) the opening of new sales offices; (iv) the expansion and relocation of the Dallas service center and the opening of the Atlanta service center; and (v) the expansion of corporate headquarters.

Commissions expense declined slightly on a per worksite employee per month basis due to lower sales agency commissions. Advertising costs also declined slightly per worksite employee, as the Company was able to increase its advertising coverage while incurring lower rates for much of its radio advertising. In addition, the Company utilized resources available through its marketing agreement with American Express to generate leads and appointments for its sales representatives.

Other Income Interest income decreased 23.3% to \$2.6 million in 1999 from \$3.3 million in 1998, due to a lower level of cash and marketable securities resulting from the repurchase of shares of the Company's common stock under the repurchase program approved by the Company's Board of Directors in January 1999. In addition, the average interest rate related to interest-bearing investments declined slightly as the Company shifted a higher portion of its marketable securities into tax-exempt securities.

During the fourth quarter of 1999, the Company entered into a Closing Agreement on Final Determination Covering Specific Matters with the Internal Revenue Service, settling nondiscrimination testing issues involving the Company's 401(k) plan for certain prior plan years. The actual amount of the settlement was substantially lower than the original estimate and accrual made in 1996, resulting in a non-recurring gain of \$932,000 (\$852,000 net of income tax effect) in the fourth quarter of 1999. This gain included the impact of an adjusted amount recoverable from the Company's former third-party record keeper pursuant to a 1996 agreement, under which the record keeper agreed to reimburse the Company for a portion of its settlement of the nondiscrimination testing issues.

The Company's provision for income taxes, which included the effects of the non-recurring gain from settlement of the 401(k) testing issues, differed from the U.S. statutory rate of 34% in 1999 due primarily to certain portions of the final settlement and original accrual being non-deductible for income tax purposes. In addition, the Company's provision for income taxes differs from the U.S. statutory rate due to state income taxes and tax-exempt interest income in both years.

Net Income Net income for 1999 was \$9.4 million, or \$0.34 per diluted share compared to \$9.1 million, or \$0.31 per diluted share in 1998. The 1999 results included the effects of two unrelated, non-recurring items: (i) a \$932,000 gain (\$852,000 net of income tax effect) associated with the settlement of nondiscrimination testing issues related to the ongoing audit of the Company's 401(k) plan for amounts less than the amount originally accrued for such issues in 1996; and (ii) a \$1.4 million (\$920,000 net of income tax effect) write-off of software development costs incurred on projects which are not expected to be completed. Excluding the effects of these items, the 1999 net income and diluted earnings per share were also \$9.4 million and \$0.34.

LIQUIDITY AND CAPITAL RESOURCES

The Company periodically evaluates its liquidity requirements, capital needs and availability of resources in view of, among other things, expansion plans, debt service requirements and other operating cash needs. As a result of this process, the Company has in the past sought, and may in the future seek, to raise additional capital or take other steps to increase or manage its liquidity and capital resources. The Company currently believes that its cash on hand, marketable securities and cash flows from operations will be adequate to meet its short-term liquidity requirements. The Company will rely on these same sources, as well as public and private debt and equity financing, to meet its long-term liquidity and capital needs.

The Company had \$108.7 million in cash and cash equivalents and marketable securities at December 31, 2000, of which approximately \$57.9 million was payable in early January 2001 for withheld federal and state income taxes, employment taxes and other payroll deductions. The remainder is available to the Company for general corporate purposes, including, but not limited to, current working capital requirements, expenditures related to the continued expansion of the Company's sales, service and technology infrastructure, capital expenditures and the Company's stock repurchase program. At December 31, 2000, the Company had working capital of \$51.2 million compared to \$35.8 million at December 31, 1999. The increase in working capital was primarily the result of \$32.4 million in net income adjusted for non-cash items and \$10.1 million in proceeds, including income tax benefit, related to the exercise of employee stock options. These increases were partially offset by the use of funds for capital expenditures of \$20.2 million, and investments in other companies totaling \$5.8 million.

Cash Flows From Operating Activities The Company's cash flows from operating activities in 2000 increased \$56.8 million to \$74.6 million primarily due to an \$11.9 million increase in net income adjusted for

non-cash items to \$32.4 million in 2000 and a \$36.4 million increase in payroll taxes and other payroll deductions payable related to the timing of payroll tax payments surrounding the December 31 payroll periods of each year. The timing and amount of such payments can vary significantly based on various factors, including the day of the week on which a period ends and the existence of holidays on or immediately following a period end.

Cash Flows From Investing Activities Capital expenditures, including software development costs, totaled \$20.2 million in 2000. The level of capital expenditures incurred in the past three years has been significantly higher than the periods prior to 1998 and has related directly to the Company's strategic initiatives and national expansion. Capital expenditures in 2000 can be summarized as follows (in millions):

Computer hardware and software	\$ 6.6
Software development costs	4.8
Furniture and fixtures	4.9
Buildings and improvements	3.0
Vehicles	0.9
Total	\$ 20.2

Capital expenditures for computer hardware and software included the costs of application software directly related to the ongoing development of (i) the Company's eBusiness initiatives and proprietary PEO information system; (ii) the costs of network and telecommunications infrastructure required to support the national technology platform; (iii) the costs of desktop workstations for new employees in the corporate offices, sales offices and service centers; and (iv) the cost of software for various corporate needs.

Capitalized software development costs primarily included (i) \$1.7 million related to the development of the fifth generation of the Company's proprietary PEO information system; (ii) \$1.3 million related to functionality enhancements to Administristaff Assistant; (iii) \$0.5 million related to the development and

subsequent enhancement of bizzport; and (iv) \$0.5 million related to the development of online client census and sales bid functionality.

Capital expenditures for furniture and fixtures, building improvements and vehicles were largely related to equipping and furnishing six new sales offices, a new service center in Houston and expansion to accommodate growth in the number of corporate employees at the Company's corporate offices and in existing markets.

The Company expects a comparable level of capital expenditures in 2001 with a budget of approximately \$21 million, which is primarily composed of continued software development, computer hardware and software costs and continued expansion of sales offices and service centers to accommodate the ongoing growth of the Company. In addition, the Company will begin an expansion to its corporate headquarters in 2001, with an expected completion date in the fourth quarter of 2002 and a total expected cost of approximately \$24 million.

Net purchases of marketable securities during 2000 primarily represented the investment of excess funds in longer-term, higher-yielding securities.

Investments in other companies during the 2000 period consisted of strategic investments in Virtual Growth, Inc. and eProsper, Inc., which are designed to add complementary functionality to Administaff's core PEO service.

Cash Flows From Financing Activities Cash flows from financing activities for 2000 primarily included proceeds from the exercise of employee stock options, partially offset by the use of \$2.6 million to repurchase 100,000 shares of the Company's common stock.

Other Matters The Company had net deferred tax liabilities of \$6.4 million at December 31, 2000, versus \$4.5 million at December 31, 1999. This increase is due primarily to differences between the book and tax basis of software development costs, prepaid commissions and depreciation.

Seasonality, Inflation and Quarterly Fluctuations Historically, the Company's earnings pattern has included losses in the first quarter followed by improved

profitability in subsequent quarters throughout the year. This pattern is due to the effects of employment-related taxes which are based on each employee's cumulative earnings up to specified wage levels, causing employment-related taxes to be highest in the first quarter and then decline over the course of the year. Since the Company's revenues related to each employee are generally earned and collected at a relatively constant rate throughout each year, payment of such tax obligations has a substantial impact on the Company's financial condition and results of operations during the first six months of each year. Other factors that affect direct costs could mitigate or enhance this trend.

The Company believes the effects of inflation have not had a significant impact on its results of operations or financial condition.

FACTORS THAT MAY AFFECT FUTURE RESULTS AND THE MARKET PRICE OF COMMON STOCK

Audit of the Company's 401(k) Plan; IRS Employee Leasing Market Segment Group The Company's 401(k) plan is currently under audit by the IRS for the year ended December 31, 1993. Although the audit is for the 1993 plan year, certain conclusions of the IRS could be applicable to other years as well. In addition, the IRS has established an Employee Leasing Market Segment Group for the purpose of identifying specific compliance issues prevalent in certain segments of the PEO industry. Approximately 70 PEOs, including the Company, have been randomly selected by the IRS for audit pursuant to this program. One issue that has arisen from these audits is whether a PEO can be a co-employer of worksite employees, including officers and owners of client companies, for various purposes under the Internal Revenue Code of 1986, as amended (the "Code"), including participation in the PEO's 401(k) plan. With respect to the 401(k) plan audit, the IRS Houston District has sought technical advice (the "Technical Advice Request") from the IRS National Office about whether participation in the 401(k) plan by worksite

employees, including officers of client companies, violates the exclusive benefit rule under the Code because they are not employees of the Company. A copy of the Technical Advice Request and the Company's response have been sent to the IRS National Office for review. The Technical Advice Request contains the conclusions of the IRS Houston District with respect to the 1993 plan year that the 401(k) plan should be disqualified because it covers worksite employees who are not employees of the Company. The Company's response refutes the conclusions of the IRS Houston District. With respect to the Market Segment Group study, the issue of whether a PEO and a client company may be treated as co-employers of worksite employees for certain federal tax purposes (the "Industry Issue") has also been referred to the IRS National Office.

The Company does not know whether the National Office will address the Technical Advice Request independently of the Industry Issue. The Company is not able to predict either the timing or the nature of any final decision that may be reached with respect to the 401(k) plan audit or with respect to the Technical Advice Request or the Market Segment Group study and the ultimate outcome of such decisions. Should the IRS conclude that the Company is not a "co-employer" of worksite employees for purposes of the Code, worksite employees could not continue to make salary deferral contributions to the 401(k) plan or pursuant to the Company's cafeteria plan or continue to participate in certain other employee benefit plans of the Company. The Company believes that, although unfavorable to the Company, a prospective application of such a conclusion (that is, one applicable only to periods after the conclusion by the IRS is finalized) would not have a material adverse effect on its financial position or results of operations, as the Company could continue to make available comparable benefit programs to its client companies at comparable costs to the Company. However, if the IRS National Office adopts the conclusions of the IRS Houston District set forth in the

Technical Advice Request and any such conclusions were applied retroactively to disqualify the 401(k) plan for 1993 and subsequent years, employees' vested account balances under the 401(k) plan would become taxable, the Company would lose its tax deductions to the extent its matching contributions were not vested, the 401(k) plan's trust would become a taxable trust and the Company would be subject to liability with respect to its failure to withhold applicable taxes with respect to certain contributions and trust earnings. Further, the Company would be subject to liability, including penalties, with respect to its cafeteria plan for the failure to withhold and pay taxes applicable to salary deferral contributions by employees, including worksite employees. In such a scenario, the Company also would face the risk of client dissatisfaction and potential litigation. A retroactive application by the IRS of an adverse conclusion resulting in disqualification of the 401(k) plan would have a material adverse effect on the Company's financial position and results of operations.

Expenses Associated with Expansion The Company's past operating results have been affected by the Company's long-term national sales and service expansion. In many cases, the costs of this expansion have been incurred in advance of the anticipated growth in worksite employees (the primary driver of the Company's revenues). The Company expects to continue to incur substantial additional operating expenses in the foreseeable future as a result of continuing national expansion. See page 20 for a discussion of the types of expenses incurred in this expansion.

Estimated Costs and Effectiveness of Capital Projects and Investments in Infrastructure The Company currently has several strategic initiatives in progress, which have significantly increased the level of capital expenditures and related depreciation expense incurred over the past several years. These capital expenditures have been, and will continue to be, primarily associated with the expansion and upgrade of the Company's technology and telecommunications infrastructure, Internet service delivery capabilities, and corporate headquarters, sales and

service facilities. There can be no assurances that the Company's cost to complete these projects will be as estimated or that the ultimate effectiveness of such projects will provide the necessary operating efficiencies required to offset the resulting increases in depreciation and amortization expense which accompany these expenditures. In addition, the Company may require additional capital resources to fund these and future capital expenditure requirements.

Estimated Costs and Effectiveness of eBusiness Strategy

While the Company believes that its comprehensive eBusiness strategy will ultimately lead to increased profitability through new revenue streams, operating expense savings and higher client retention, there can be no assurances that losses or diminished profitability will not be incurred in future periods as a result of these initiatives.

Among the factors which could affect the success of the Company's eBusiness strategy are (i) the Internet connectivity and computer literacy of the Company's clients; (ii) the willingness of clients to accept an electronic service delivery platform; (iii) the Company's ability to identify, negotiate and integrate agreements with strategic partners; (iv) the attraction of clients and worksite employees to bizzport; (v) the effective generation of revenues from the eBusiness initiatives, particularly bizzport; (vi) unanticipated development costs related to the eBusiness initiatives; and (vii) the Company's ability to control or reduce operating expenses as a result of the eBusiness initiatives, particularly the development of Administaff Assistant.

Increases in Health Insurance Premiums, Unemployment Taxes and Workers' Compensation Rates Health insurance premiums, state unemployment taxes and workers' compensation rates are in part determined by the Company's claims experience and comprise a significant portion of the Company's direct costs. The Company employs extensive risk management procedures in an attempt to control its claims incidence and structures its benefits contracts to provide as much cost stability as possible. However, should the Company experience a large

increase in claim activity, its unemployment taxes, health insurance premiums or workers' compensation insurance rates could increase. The Company's ability to incorporate such increases into service fees to clients is constrained by contractual arrangements with clients, 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 the Company's financial condition or results of operations.

Failure to Manage Growth The Company has experienced significant growth and expects such growth to continue for the foreseeable future. As described under the above caption "Expenses Associated with Expansion," the costs associated with the Company's sales and service expansion have been significant. Accordingly, the Company's expansion plan may place a significant strain on the Company's management, financial, operating and technical resources. Failure to manage this growth effectively could have a material adverse effect on the Company's financial condition or results of operations.

Potential Impairment of Investments in Other Companies

The Company has made investments totaling \$5.8 million in Virtual Growth, Inc. and eProsper, Inc., both of which are in the early stages of development. These companies are likely to require additional capital in the future. If these companies are unable to raise sufficient additional capital to continue as going concerns, or if they raise capital at lower valuation levels than those at the time Administaff made its investments, Administaff's investments in those companies could become impaired. In that event, Administaff would be required to write-off all or a portion of those investments. Although Administaff does not believe that such an impairment would materially affect its consolidated financial position, an impairment would likely reduce Administaff's net income materially in the period in which the impairment occurred.

Liability for Worksite Employee Payroll and Benefits Costs

Under the Client Service Agreement ("CSA"), the Company becomes a co-employer of worksite employees and assumes the obligations to pay the salaries, wages

and related benefit costs and payroll taxes of such worksite employees. The Company assumes such obligations as a principal, not merely as an agent of the client company. The Company's obligations include responsibility for (i) payment of the salaries and wages for work performed by worksite employees, regardless of whether the client company makes timely payment to the Company of the associated service fee; and (ii) providing benefits to worksite employees even if the costs incurred by Administaff to provide such benefits exceed the fees paid by the client company. If a client company does not pay the Company or if the costs of benefits provided to worksite employees exceed the fees paid by a client company, the Company's ultimate liability for worksite employee payroll and benefits costs could have a material adverse effect on its financial condition or results of operations.

Federal, State and Local Regulation As a major employer, the Company's operations are affected by numerous federal, state and local laws relating to labor, tax and employment matters. By entering into a co-employer relationship with employees assigned to work at client company locations, the Company assumes certain obligations and responsibilities of an employer under these laws. However, many of these laws (such as the Employee Retirement Income Security Act ("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 the Company operates have not addressed the PEO relationship for purposes of compliance with applicable state laws governing the employer/employee relationship. If these other federal or state laws are ultimately applied to the Company's PEO relationship with its worksite employees in a manner adverse to the Company, such an application could have a material adverse effect on the Company's results of operations or financial condition.

While many states do not explicitly regulate PEOs, 21 states (including Texas) 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 the Company generally supports licensing regulation because it serves to validate the PEO relationship, there can be no assurance that the Company will be able to satisfy licensing requirements or other applicable regulations for all states. In addition, there can be no assurance that the Company will be able to renew its licenses in all states.

Loss of Benefit Plans The maintenance of health and workers' compensation insurance plans that cover worksite employees is a significant part of the Company's business. The current health and workers' compensation contracts are provided by vendors with whom the Company has an established relationship, and on terms that the Company believes to be favorable. While the Company believes that replacement contracts could be secured on competitive terms without causing significant disruption to the Company's business, there can be no assurance in this regard. The current health and workers' compensation contracts expire on December 31, 2001 and September 30, 2001, respectively.

Need to Renew or Replace Client Companies The Company's standard CSA is subject to cancellation on 60 days notice by either the Company or the client. Accordingly, the short-term nature of the CSA makes the Company vulnerable to potential cancellations by existing clients, which could materially and adversely affect the Company's financial condition and results of operations. In addition, the Company's results of operations are dependent in part upon the Company's ability to retain or replace its client companies upon

the termination or cancellation of the CSA. Historically, approximately 20% of the Company's clients have remained clients for less than one year and there can be no assurance that the number of contract cancellations will not increase in the future.

Marketing Agreement with American Express The Company has entered into a Marketing Agreement with American Express to jointly market the Company's services to American Express' substantial small and medium-sized business customer base across the country. Under the terms of the Marketing Agreement, American Express is utilizing its resources to generate appointments with prospects for the Company's services. In addition, the Company and American Express are working to jointly develop product offerings that enhance the current PEO services offered by the Company. The Company believes that the agreement will enhance its ability to increase its base of worksite employees and clients; however, there can be no assurances to that effect. Among the factors that could cause the effectiveness of the Marketing Agreement to be less than anticipated are the ability of American Express to set qualified appointments, the Company's ability to make timely presentations to all of the appointments set by American Express and the Company's ability to convert those appointments into sales.

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. The Administaff CSA establishes the contractual division of responsibilities between the Company and its clients for various personnel management matters, including compliance with and liability under various governmental regulations. However, because the Company acts as a co-employer, the Company may be subject to liability for violations of these or other laws despite these contractual provisions, even if it does not participate in such violations. Although the CSA provides that the client is to indemnify the

Company for any liability attributable to the conduct of the client, the Company 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 agents of the Company, subjecting the Company to liability for the actions of such worksite employees.

Geographic Market Concentration While the Company has sales offices in 17 markets, 13 of these represent expansion markets pursuant to the Company's national expansion plan. The Company's Houston and Texas (including Houston) markets accounted for approximately 27% and 50%, respectively, of the Company's revenue for the year ended December 31, 2000. Accordingly, while a primary aspect of the Company's strategy is expansion in its current and future markets outside of Texas, for the foreseeable future, a significant portion of the Company's revenues may be subject to economic factors specific to Texas (including Houston). While the Company believes that its market expansion plans will eventually lessen this risk in addition to generating significant revenue growth, there can be no assurance that the Company will be able to duplicate in other markets the revenue growth and operating results experienced in its Texas (including Houston) markets.

Competition and New Market Entrants The PEO industry is highly fragmented. Many of these PEOs have limited operations and fewer than 1,000 worksite employees, but there are several industry participants that are comparable in size to the Company. The Company also encounters competition from "fee for service" companies such as payroll processing firms, insurance companies and human resource consultants. In addition, several of the Company's PEO competitors have recently been acquired by large business services companies, such as Automatic Data Processing, Inc. Such companies have substantially greater resources and provide a broader range of services than the Company. Accordingly, the PEO divisions of such companies may be able to provide more services at more competitive prices than may be offered by the Company. Moreover, the

Company expects that as the PEO industry grows and its regulatory framework becomes better established, well-organized competition with greater resources than the Company may enter the PEO market, possibly including large “fee for service” companies currently providing a more limited range of services.

Potential Client Liability for Employment Taxes Pursuant to the CSA, the Company assumes sole responsibility and liability for the payment of federal employment taxes imposed under the Code with respect to wages and salaries paid to its worksite employees. There are essentially three types of federal employment tax obligations: (i) income tax withholding requirements; (ii) obligations under the Federal Income Contribution Act (“FICA”); and (iii) 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 the Company has 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 the Company. Accordingly, in the event the Company fails to meet its tax withholding and payment obligations, the client company may be held jointly and severally liable therefor. While this interpretive issue has not, to the Company’s knowledge, discouraged clients from enrolling with the Company, there can be no assurance that a definitive adverse resolution of this issue would not do so in the future.

**QUALITATIVE AND QUANTITATIVE
DISCLOSURES ABOUT MARKET RISK**

The Company is primarily exposed to market risks from fluctuations in interest rates and the effects of those fluctuations on the market values of its cash equivalent short-term investments and its available-for-sale marketable securities. The cash equivalent

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

The Company attempts to limit its exposure to interest rate risk primarily through diversification and low investment turnover. The Company’s marketable securities are currently managed by three professional investment management companies, each of whom is guided by the Company’s investment policy. The Company’s investment policy is designed to maximize after-tax interest income while preserving its principal investment. As a result, the Company’s marketable securities consist primarily of short and intermediate-term debt securities.

As of December 31, 2000, the Company’s available-for-sale marketable securities include an investment in a mutual fund, which holds corporate debt securities with maturities ranging up to 18 months. The amortized cost basis, fair market value and 30-day yield of this investment was \$13.0 million, \$13.1 million and 6.3% at December 31, 2000. The following table presents information about the Company’s remaining available-for-sale marketable securities as of December 31, 2000 (dollars in thousands):

	Principal Maturities	Average Interest Rate
2001	\$ 17,820	6.3 %
2002	5,280	5.3 %
2003	645	6.0 %
2004	1,632	5.5 %
2005	200	7.9 %
Total	\$ 25,577	6.1 %
Fair Market Value	\$ 25,827	

REPORT OF INDEPENDENT AUDITORS

BOARD OF DIRECTORS AND STOCKHOLDERS
ADMINISTAFF, INC.

We have audited the accompanying consolidated balance sheets of Administaff, Inc. as of December 31, 2000 and 1999, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2000. 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 auditing standards generally accepted in the 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, 2000 and 1999, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States.

ERNST & YOUNG LLP

Houston, Texas
February 9, 2001