KORN FERRY INTERNATIONAL
Form 10-Q
March 11, 2008

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended January 31, 2008

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File Number 001-14505

KORN/FERRY INTERNATIONAL
(Exact name of registrant as specified in its charter)

Delaware	**95-2623879**
(State of other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

1900 Avenue of the Stars, Suite 2600, Los Angeles, California 90067
(Address of principal executive offices) (Zip code)
(310) 552-1834
(Registrant s telephone number, including area code)

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, and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

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

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

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

The number of shares outstanding of our common stock as of March 7, 2008 was 46,388,043.

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
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PART I. FINANCIAL INFORMATION

Item 1. ***Condensed Financial Statements***

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)

	As of January 31, 2008 (unaudited)	As of April 30, 2007
ASSETS		
Cash and cash equivalents	$ 223,654	$ 232,531
Marketable securities	74,691	91,736
Receivables due from clients, net of allowance for doubtful accounts of $14,062 and $9,822, respectively	139,965	107,751
Income tax and other receivables	5,987	6,357
Deferred income taxes	10,074	9,524
Prepaid expenses	18,864	16,861
Total current assets	473,235	464,760
Property and equipment, net	31,138	25,999
Cash surrender value of company owned life insurance policies, net of loans	79,458	76,478
Deferred income taxes	46,065	42,013
Goodwill	139,392	124,268
Intangible assets, net	15,638	18,040
Investments and other	10,736	9,933
Total assets	$ 795,662	$ 761,491
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$ 12,104	$ 10,383
Income taxes payable	24,468	22,432
Compensation and benefits payable	148,387	158,145
Other accrued liabilities	35,385	38,529
Total current liabilities	220,344	229,489
Deferred compensation and other retirement plans	104,144	91,360
Other liabilities	5,831	7,687
Total liabilities	330,319	328,536
Stockholders equity:		
Common stock: $0.01 par value, 150,000 shares authorized, 54,226 and 52,323 shares issued and 46,374 and 47,174 shares outstanding, respectively	388,370	400,126
Retained earnings	79,268	32,344
Unearned restricted stock compensation	(34,675)	(19,567)
Accumulated other comprehensive income	32,927	20,605
Stockholders equity	465,890	433,508

Less: Notes receivable from stockholders	(547)	(553)
Total stockholders equity	465,343	432,955
Total liabilities and stockholders equity	$ 795,662	$ 761,491

The accompanying notes are an integral part of these condensed consolidated financial statements.

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2008	**2007**	**2008**	**2007**
Fee revenue	$ 201,156	$ 165,239	$ 582,366	$ 473,720
Reimbursed out-of-pocket engagement expenses	10,935	8,269	32,826	25,721
Total revenue	212,091	173,508	615,192	499,441
Compensation and benefits	138,594	112,343	391,984	318,852
General and administrative expenses	35,255	26,806	101,168	79,431
Out-of-pocket engagement expenses	14,250	10,394	42,664	31,040
Depreciation and amortization	2,812	2,557	7,701	7,214
Total operating expenses	190,911	152,100	543,517	436,537
Operating income	21,180	21,408	71,675	62,904
Interest and other income, net	5,025	3,212	9,769	7,375
Interest expense	1,248	2,548	3,695	7,664
Income before provision for income taxes and equity in earnings of unconsolidated subsidiaries	24,957	22,072	77,749	62,615
Provision for income taxes	9,353	8,100	29,753	23,184
Equity in earnings of unconsolidated subsidiaries, net	652	758	2,469	2,528
Net income	$ 16,256	$ 14,730	$ 50,465	$ 41,959
Basic earnings per common share	$ 0.38	$ 0.37	$ 1.14	$ 1.07
Basic weighted average common shares outstanding	43,247	39,650	44,273	39,229
Diluted earnings per common share	$ 0.37	$ 0.33	$ 1.10	$ 0.95
Diluted weighted average common shares outstanding	44,303	47,449	45,839	46,860

The accompanying notes are an integral part of these condensed consolidated financial statements.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Nine Months Ended January 31, 2008	Nine Months Ended January 31, 2007
Cash from operating activities:		
Net income	$ 50,465	$ 41,959
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,701	7,214
Stock compensation expense	1,929	4,377
Amortization of discount on convertible securities		590
Loss on disposition of property and equipment	130	171
Provision for doubtful accounts	9,332	6,797
Gain on cash surrender value of life insurance policies	(1,908)	(3,690)
Realized gains on marketable securities	(4,013)	(1,835)
Deferred income taxes	(8,143)	(6,287)
Non-cash compensation arrangements	10,002	5,914
Change in other assets and liabilities, net of effect of acquisitions:		
Deferred compensation	12,784	13,410
Receivables	(41,176)	(39,358)
Prepaid expenses	(2,003)	(1,137)
Investment in unconsolidated subsidiaries	(3,123)	(2,843)
Income taxes payable	1,750	11,313
Accounts payable and accrued liabilities	(7,745)	(3,575)
Other	(2,277)	(2,328)
Net cash provided by operating activities	23,705	30,692
Cash from investing activities:		
Purchase of property and equipment	(12,849)	(8,249)
Sales (Purchase) of marketable securities, net	16,023	(14,529)
Cash paid for acquisitions, net of cash acquired	(4,260)	(23,786)
Premiums on life insurance policies	(1,525)	(1,534)
Dividends received from unconsolidated subsidiaries	2,782	2,178
Net cash provided by (used in) investing activities	171	(45,920)
Cash from financing activities:		
Payments on life insurance policy loans	(1,012)	
Borrowings under life insurance policies	1,464	1,347
Purchase of common stock	(62,617)	(25,937)
Proceeds from issuance of common stock upon exercise of employee stock options and in connection with an employee stock purchase plan	17,177	19,616
Tax benefit from exercise of stock options	3,473	6,258
Receipts on stockholders notes	6	5

Net cash (used in) provided by financing activities	(41,509)	1,289
Effect of exchange rates on cash and cash equivalents	8,756	1,516
Net decrease in cash and cash equivalents during the period	(8,877)	(12,423)
Cash and cash equivalents at beginning of the period	232,531	211,768
Cash and cash equivalents at end of the period	$ 223,654	$ 199,345

The accompanying notes are an integral part of these condensed consolidated financial statements.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED STATEMENTS
(in thousands, except per share amounts)

1. Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements for the three and nine months ended January 31, 2008 and 2007 include the accounts of Korn/Ferry International and all of its wholly and majority owned/controlled domestic and international subsidiaries (collectively, the Company). The condensed consolidated financial statements are unaudited, but include all adjustments, consisting of normal recurring accruals and any other adjustments that management considers necessary for a fair presentation of the results for these periods. These financial statements have been prepared consistently with the accounting policies described in the Company s Annual Report on Form 10-K for the fiscal year ended April 30, 2007 (the Annual Report) and should be read together with the Annual Report.

Critical Accounting Policies and Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. As a result, actual results could differ from these estimates. The most significant areas that require management judgment are revenue recognition, deferred compensation and the carrying values of goodwill, other intangible assets and deferred income taxes.

Cash and Cash Equivalents

The Company considers cash equivalents to be only those investments which are highly liquid, readily convertible and mature within three months from the date of purchase.

Available-for-Sale Securities

The Company considers its marketable securities as available-for-sale as defined in Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS No. 115). These investments are recorded at fair value and are classified as marketable securities in the accompanying consolidated balance sheets as of January 31, 2008 and April 30, 2007. The changes in fair values, net of applicable taxes, are recorded as unrealized gains (losses) as a component of accumulated other comprehensive income in stockholders equity. Investments are made based on the Company s investment policy which restricts the types of investments that can be made.

Stock-Based Compensation

The Company has employee compensation plans under which various types of stock-based instruments are granted. These instruments, as more fully described below, principally include stock options, stock appreciation rights (SARs), restricted stock, and an Employee Stock Purchase Plan (ESPP). The Company accounts for stock-based instruments in accordance with Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (SFAS No. 123(R)).

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED STATEMENTS (Continued)
(in thousands, except per share amounts)

The following table reflects the components of stock-based compensation expense recognized in the Company s condensed consolidated statements of income for the three and nine months ended January 31, 2008 and 2007:

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2008	2007	2008	2007
Stock options and SARs	$ 238	$ 1,230	$ 1,265	$ 4,007
Restricted stock	3,518	2,350	10,357	6,021
Employee Stock Purchase Plan	125	114	399	346
Total stock-based compensation expense, pre-tax	3,881	3,694	12,021	10,374
Tax benefit from stock-based compensation expense	(1,417)	(1,395)	(4,388)	(4,022)
Total stock-based compensation expense, net of tax	$ 2,464	$ 2,299	$ 7,633	$ 6,352

The Company uses the Black-Scholes option valuation model to estimate the grant date fair value of employee stock options. The expected volatility reflects the consideration of the historical volatility in the Company s publicly traded instruments during the period the option is granted. The Company believes historical volatility in these instruments is more indicative of expected future volatility than the implied volatility in the price of the Company s common stock. The expected life of the option is estimated using historical data to estimate the expected life of the options. The risk-free interest rate is based on the U.S. Treasury zero-coupon issue with a remaining term approximating the expected term of the options. The Company uses historical data to estimate forfeiture rates applied to the gross amount of expense determined using the option valuation model. The assumptions used to estimate the fair value of the stock options using the Black-Scholes option valuation model were as follows for the nine months ended January 31, 2008 and 2007:

	Nine Months Ended January 31,	
	2008	2007
Expected volatility	44.42%	48.05%
Risk-free interest rate	4.60%	4.95%
Expected option life (in years)	4.00	4.00
Expected dividend yield	0.00%	0.00%

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options. The assumptions used in option valuation models are highly subjective, particularly the expected stock price volatility of the underlying stock.

Stock Option Plans

The Company s employee stock option plans provide for option grants designated as either nonqualified, incentive stock options or SARs. Options granted to officers, non-employee directors and other key employees generally vest over a three to five year period, and generally expire ten years from the date of grant. Key employees are eligible to receive a grant of stock options annually with the number of options determined by the employee s performance level. In addition, certain key management periodically receives stock option or restricted stock grants upon commencement of employment.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED STATEMENTS (Continued)
(in thousands, except per share amounts)

Stock option and SARs information during the nine months ended January 31, 2008 is as follows:

	Options (in thousands)	Weighted-average exercise price	Weighted-average remaining contractual life (Yrs)	Aggregate intrinsic value
Outstanding at April 30, 2007	4,738	$ 14.52		
Granted	6	21.11		
Exercised	(1,066)	13.40		
Forfeited/expired	(68)	19.02		
Outstanding at January 31, 2008	3,610	$ 14.78	5.0	$ 11,821
Exercisable at January 31, 2008	3,277	$ 14.37	4.7	$ 11,821

Included in the table above are 61 SARs outstanding and exercisable at January 31, 2008 with a weighted-average exercise price of $12.42. As of January 31, 2008, there was $1,519 of total unrecognized compensation cost related to nonvested awards of stock options and SARs. That cost is expected to be recognized over a weighted-average period of 1.5 years. For stock option awards subject to graded vesting, we recognize the total compensation cost on a straight-line basis over the service period for the entire award.

Additional information pertaining to stock options:

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2008	2007	2008	2007
Weighted average fair value of stock options granted	$ 7.24	$ 9.83	$ 8.77	$ 9.04
Total fair value of stock options and SARs vested	32	109	3,966	9,579
Total intrinsic value of stock options exercised	528	5,694	12,304	16,893
Total intrinsic value of SARs paid		70		232

Restricted Stock

The Company grants restricted stock to executive officers and other senior employees generally vesting over a three to four year period. Restricted stock is granted at a price equal to the fair market value of the common stock on the date of grant. Employees may receive restricted stock annually in conjunction with the Company s performance review as well as throughout the year upon commencement of employment. The fair values of restricted stock shares are determined based on the closing price of the Company s common stock on the grant dates.

Information regarding our restricted stock during the nine months ended January 31, 2008 is as follows:

Nonvested shares	Shares (in thousands)	Weighted-average grant date fair value
Nonvested at April 30, 2007	1,356	$ 19.26
Granted	1,113	24.79

Vested	(476)		19.71
Forfeited	(25)		23.48
Nonvested at January 31, 2008	1,968	$	22.27

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED STATEMENTS (Continued)
(in thousands, except per share amounts)

As of January 31, 2008, there was $34,675 of total unrecognized compensation cost related to nonvested awards of shares of restricted stock. That cost is expected to be recognized over a weighted-average period of three years. For restricted stock awards subject to graded vesting, the Company recognizes the total compensation cost on a straight-line basis over the service period for the entire award. In the three and nine months ended January 31, 2008, one and 159 restricted stock shares totaling $20 and $4,165, respectively, were repurchased by the Company at the option of the employee to pay for taxes on restricted stock shares vesting in the periods. In the three and nine months ended January 31, 2007, one and 71 restricted shares totaling $13 and $1,394, respectively, were repurchased to pay for taxes on restricted stock shares vesting in the periods.

Employee Stock Purchase Plan

In October 2003, the Company implemented an ESPP that, in accordance with Section 423 of the Internal Revenue Code, allows eligible employees to authorize payroll deductions of up to 15% of their salary to purchase shares of the Company s common stock at 85% of the fair market price of the common stock on the last day of the enrollment period. The maximum number of shares of common stock reserved for ESPP issuance is 1,500, subject to adjustment for certain changes in the Company s capital structure and other extraordinary events. During the three months ended January 31, 2008 and 2007, employees purchased 78 shares at $16.00 per share, and 57 shares at $19.52 per share, respectively. During the nine months ended January 31, 2008 and 2007, employees purchased 151 shares at $19.06 per share, and 142 shares at $17.81 per share, respectively. At January 31, 2008, the ESPP had approximately 800 shares available for future issuance.

Common Stock

The Company issued approximately 80 and 1,066 common shares as a result of the exercise of stock options, and 78 and 151 common shares in conjunction with the Company s ESPP, in the three and nine months ended January 31, 2008, respectively. The Company issued approximately 465 and 1,560 common shares as a result of the exercise of stock options and 57 and 142 common shares in conjunction with the Company s ESPP in the three and nine months ended January 31, 2007, respectively.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

New Accounting Standards

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The Company adopted FIN 48 as of May 1, 2007. FIN 48 clarifies the accounting for income taxes by prescribing a minimum threshold for benefit recognition of a tax position for financial reporting purposes. FIN 48 also establishes tax accounting rules for measurement, classification, interest and penalties, disclosure and interim period accounting. As a result of the adoption of FIN 48, the Company recorded a cumulative effect adjustment which reduced retained earnings by $3,500. As of January 31, 2008, the Company had gross unrecognized benefits of $10,700, which would impact the effective tax rate if recognized. Interest and penalties related to income tax matters are recorded to income tax expense. As of January 31, 2008, the Company accrued interest related to FIN 48 of $500. The Company s Federal and state tax return filings remain subject to examination until 2010 and 2011, respectively.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The statement emphasizes that fair value is a market-based measurement, not an entity-specific measurement and establishes a fair value hierarchy. This statement also clarifies how the assumptions of risk and the effect of restrictions on sales or use of an asset effect the valuation. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is assessing the impact this statement will have on its results of operations and financial position.

In February, 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159) including an amendment of SFAS No. 115. This statement provides companies with an option to report selected financial assets and liabilities at fair value. This statement is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. The Company is assessing the impact this statement will have on its results of operations and financial position.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED STATEMENTS (Continued)
(in thousands, except per share amounts)

2. Basic and Diluted Earnings Per Share

Basic earnings per common share (basic EPS) was computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per common share (diluted EPS) reflects the potential dilution that would occur if all in-the-money outstanding options or other contracts to issue common stock were exercised or converted and was computed by dividing adjusted net income, after assumed conversion of subordinated notes and preferred stock, by the weighted average number of common shares outstanding plus dilutive common equivalent shares. The following is a reconciliation of the numerator and denominator used in the computation of basic and diluted EPS:

	Three Months Ended January 31,		Nine Months Ended January 31,	
	2008	**2007**	**2008**	**2007**
Net income (Numerator):				
Net income for basic EPS	$ 16,256	$ 14,730	$ 50,465	$ 41,959
Interest expense on convertible securities, net of related tax effects	36	785	109	2,354
Net income for diluted EPS	$ 16,292	$ 15,515	$ 50,574	$ 44,313
Shares (Denominator):				
Weighted average shares for basic EPS	43,247	39,650		