

KORN FERRY INTERNATIONAL  
Form 10-Q  
December 11, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended October 31, 2006 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 Number 001-14505

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**KORN/FERRY INTERNATIONAL**

(Exact name of registrant as specified in its charter)

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

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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  No

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

Large accelerated filer  an accelerated filer  or a non-accelerated filer

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

The number of shares outstanding of our common stock as of December 6, 2006 was 42,109,838.

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**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****KORN/FERRY INTERNATIONAL AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except per share amounts)****(unaudited)**

	<b>As of October 31, 2006</b>	<b>As of April 30, 2006</b>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 201,263	\$ 257,543
Marketable securities	28,111	20,654
Receivables due from clients, net of allowance for doubtful accounts of \$10,643 and \$8,818, respectively	114,320	87,287
Income tax and other receivables	5,570	5,328
Deferred income taxes	9,832	9,669
Prepaid expenses	15,297	14,019
Total current assets	374,393	394,500
Property and equipment, net	23,045	20,533
Cash surrender value of company owned life insurance policies, net of loans	72,930	70,592
Deferred income taxes	33,951	32,267
Goodwill and intangible assets, net	135,750	109,484
Deferred financing costs, investments and other	10,816	8,115
Total assets	\$ 650,885	\$ 635,491
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Accounts payable	12,251	9,731
Income taxes payable	24,169	17,138
Compensation and benefits payable	86,189	121,885
Other accrued liabilities	31,276	27,537
Total current liabilities	153,885	176,291
Deferred compensation and other retirement plans	82,076	71,790
Long-term debt	47,275	45,147
Other liabilities	6,750	7,523
7.5% Convertible mandatorily redeemable preferred stock, net of unamortized discount and issuance costs, redemption value \$11,387	11,088	10,989
Total liabilities	301,074	311,740
Stockholders' equity:		
Common stock: \$0.01 par value, 150,000 shares authorized, 45,789 and 43,628 shares issued and 42,016 and 41,201 shares outstanding	358,663	344,285
Retained earnings (deficit)	4,075	(23,154)
Unearned restricted stock compensation	(24,062)	(7,731)

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Accumulated other comprehensive income	11,690	10,910
Stockholders' equity	350,366	324,310
Less: Notes receivable from stockholders	(555)	(559)
Total stockholders' equity	349,811	323,751
Total liabilities and stockholders' equity	\$ 650,885	\$ 635,491

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

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**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended		Six Months Ended	
	October 31, 2006	October 31, 2005	October 31, 2006	October 31, 2005
Fee revenue	\$ 155,718	\$ 125,789	\$ 308,481	\$ 247,990
Reimbursed out-of-pocket engagement expenses	9,069	7,143	17,452	14,037
<b>Total revenue</b>	<b>164,787</b>	<b>132,932</b>	<b>325,933</b>	<b>262,027</b>
Compensation and benefits	102,072	81,209	206,509	159,164
General and administrative expenses	28,260	24,012	52,625	46,729
Out-of-pocket engagement expenses	10,939	7,406	20,646	14,884
Depreciation and amortization	2,368	2,219	4,657	4,420
<b>Total operating expenses</b>	<b>143,639</b>	<b>114,846</b>	<b>284,437</b>	<b>225,197</b>
<b>Operating income</b>	<b>21,148</b>	<b>18,086</b>	<b>41,496</b>	<b>36,830</b>
Interest and other income, net	1,731	1,182	4,163	2,535
Interest expense	2,603	2,602	5,116	5,081
<b>Income before provision for income taxes and equity in earnings of unconsolidated subsidiaries</b>	<b>20,276</b>	<b>16,666</b>	<b>40,543</b>	<b>34,284</b>
Provision for income taxes	7,484	6,342	15,084	12,790
Equity in earnings of unconsolidated subsidiaries	774	580	1,770	1,023
<b>Net income</b>	<b>\$ 13,566</b>	<b>\$ 10,904</b>	<b>\$ 27,229</b>	<b>\$ 22,517</b>
Basic earnings per common share	\$ 0.35	\$ 0.27	\$ 0.70	\$ 0.57
Basic weighted average common shares outstanding	39,018	40,054	39,019	39,719
Diluted earnings per common share	\$ 0.31	\$ 0.25	\$ 0.62	\$ 0.51
Diluted weighted average common shares outstanding	46,568	47,185	46,667	47,133

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

**Table of Contents****KORN/FERRY INTERNATIONAL AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Six Months Ended October 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash from operating activities:</b>		
Net income	\$ 27,229	\$ 22,517
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	4,657	4,420
Stock compensation expense	3,292	
Interest paid in kind and amortization of discount on convertible securities	491	492
Loss on disposition of property and equipment		43
Provision for doubtful accounts	4,104	3,871
Gain on cash surrender value of life insurance policies	(2,152)	(2,402)
Realized gains on marketable securities	(395)	(458)
Deferred income taxes	(4,817)	(4,166)
Non-cash compensation arrangements	3,451	2,511
<b>Change in other assets and liabilities, net of effect of acquisitions:</b>		
Deferred compensation	10,286	7,274
Receivables	(29,269)	(18,626)
Prepaid expenses	(1,023)	224
Investment in unconsolidated subsidiaries	(1,896)	(1,472)
Income taxes payable	7,128	6,430
Accounts payable and accrued liabilities	(33,102)	(42,264)
Other	(1,665)	532
<b>Net cash used in operating activities</b>	<b>(13,681)</b>	<b>(21,074)</b>
<b>Cash from investing activities:</b>		
Purchase of property and equipment	(5,951)	(5,402)
Purchase of marketable securities, net	(6,646)	(9,266)
Cash paid for acquisitions, net of cash acquired	(21,239)	(1,049)
Premiums on life insurance policies	(463)	(473)
Dividends received from unconsolidated subsidiaries	636	1,183
<b>Net cash used in investing activities</b>	<b>(33,663)</b>	<b>(15,007)</b>
<b>Cash from financing activities:</b>		
Borrowings under life insurance policies	277	434
Purchase of common stock	(25,924)	(1,964)
Proceeds from issuance of common stock upon exercise of employee stock options and in connection with an employee stock purchase plan	13,546	8,073
Tax benefit from exercise of stock options	3,668	2,186
Receipts on stockholders' notes	4	5
<b>Net cash (used in) provided by financing activities</b>	<b>(8,429)</b>	<b>8,734</b>
Effect of exchange rates on cash and cash equivalents	(507)	(920)

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Net decrease in cash and cash equivalents during the period	(56,280)	(28,267)
Cash and cash equivalents at beginning of the period	257,543	199,133
Cash and cash equivalents at end of the period	\$ 201,263	\$ 170,866

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



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**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(in thousands, except per share amounts)**

**1. Summary of Significant Accounting Policies**

*Basis of Presentation*

The consolidated financial statements for the three and six months ended October 31, 2006 and 2005 include the accounts of Korn/Ferry International and all of its wholly and majority owned/controlled domestic and international subsidiaries (collectively, the Company). The 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, 2006 (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 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 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 SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. These investments are recorded at fair value and are classified as marketable securities in the accompanying condensed consolidated balance sheets as of October 31, 2006 and April 30, 2006. 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).

Prior to May 1, 2006, the Company accounted for employee stock-based compensation under the recognition and measurement principles of Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, (APB No. 25), and related Interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). Under the recognition principles of APB No. 25, compensation expense related to restricted stock and SARs was recognized in the Company's consolidated financial statements. However, APB No. 25 generally did not require the recognition of compensation expense for stock options because the exercise price of these instruments was generally equal to the market value of the underlying common stock on the date of grant, and the related number of shares granted were fixed at that point in time. Compensation expense for the ESPP was not recognized since the ESPP was considered non-compensatory under APB No. 25.



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**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - (Continued)**

**(in thousands, except per share amounts)**

Effective May 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment ( SFAS No. 123(R) ). In addition to recognizing compensation expense related to restricted stock and SARs, SFAS No. 123(R) also requires the Company to recognize compensation expense related to the estimated fair value of stock options and for purchases under the ESPP. The Company adopted SFAS No. 123(R) using the modified-prospective-transition method. Under that transition method, compensation expense recognized subsequent to adoption includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of May 1, 2006, based on the values estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to May 1, 2006, based on the grant-date fair values estimated in accordance with the provisions of SFAS No. 123(R). Consistent with the modified-prospective-transition method, the Company's results of operations for prior periods have not been adjusted to reflect the adoption of SFAS No. 123(R).

As a result of recognizing compensation expense for stock options and the ESPP pursuant to the provisions of SFAS No. 123(R), the Company's income before income taxes and net income for the three months ended October 31, 2006, were \$1,410 and \$880 lower, respectively, than if the Company had continued to account for the stock-based compensation under APB No. 25. For the six months ended October 31, 2006, the Company's income before income taxes and net income were \$3,292 and \$2,054 lower, respectively. In addition, basic and diluted earnings per share ( EPS ) for the three months ended October 31, 2006 were \$0.02 and \$0.02 lower, respectively, than if the Company had continued to account for the stock-based compensation under APB No.25. For the six months ended October 31, 2006, the Company's basic and diluted EPS were \$0.05 and \$0.04 lower, respectively.

The following table reflects the components of stock-based compensation expense recognized in the Company's condensed consolidated statements of income