

KORN FERRY INTERNATIONAL

Form 10-Q

September 09, 2010

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

Form 10-Q

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

For the quarterly period ended July 31, 2010

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

KORN/FERRY INTERNATIONAL
(Exact Name of Registrant as Specified in its Charter)

Delaware

95-2623879

(State or 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, (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

(Do not check if a smaller reporting company)

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

The number of shares outstanding of our common stock as of September 7, 2010 was 46,288,945 shares.

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
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CONSOLIDATED BALANCE SHEETS**

	July 31, 2010 (unaudited)	April 30, 2010
	(in thousands, except per share data)	
ASSETS		
Cash and cash equivalents	\$ 146,016	\$ 219,233
Marketable securities	12,919	4,114
Receivables due from clients, net of allowance for doubtful accounts of \$7,035 and \$5,983, respectively	127,948	107,215
Income taxes and other receivables	9,024	6,292
Deferred income taxes	20,313	20,844
Prepaid expenses and other assets	27,583	23,166
 Total current assets	 343,803	 380,864
Marketable securities, non-current	73,253	73,105
Property and equipment, net	34,237	24,963
Cash surrender value of company owned life insurance policies, net of loans	69,281	69,069
Deferred income taxes	53,334	59,742
Goodwill	170,785	172,273
Intangible assets, net	24,875	25,425
Investments and other assets	29,752	21,657
 Total assets	 \$ 799,320	 \$ 827,098
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	\$ 10,754	\$ 11,148
Income taxes payable	5,298	6,323
Compensation and benefits payable	94,868	131,550
Other accrued liabilities	45,099	49,062
 Total current liabilities	 156,019	 198,083
Deferred compensation and other retirement plans	127,770	123,794
Other liabilities	20,647	13,879
 Total liabilities	 304,436	 335,756
 Stockholders' equity:		
Common stock: \$0.01 par value, 150,000 shares authorized, 58,448 and 57,614 shares issued and 46,435 and 45,979 shares outstanding, respectively	385,138	388,717
Retained earnings	101,124	90,220

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Accumulated other comprehensive income, net	9,149	12,934
Stockholders' equity	495,411	491,871
Less: notes receivable from stockholders	(527)	(529)
Total stockholders' equity	494,884	491,342
Total liabilities and stockholders' equity	\$ 799,320	\$ 827,098

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 OPERATIONS
(unaudited)

	Three Months Ended	
	July 31,	
	2010	2009
	(in thousands, except per share data)	
Fee revenue	\$ 175,112	\$ 116,803
Reimbursed out-of-pocket engagement expenses	8,050	6,485
Total revenue	183,162	123,288
Compensation and benefits	120,208	90,385
General and administrative expenses	28,615	28,054
Out-of-pocket engagement expenses	12,099	8,789
Depreciation and amortization	2,968	2,829
Restructuring charges		18,183
Total operating expenses	163,890	148,240
Operating income (loss)	19,272	(24,952)
Other (expense) income, net	(1,501)	3,999
Interest expense, net	(808)	(708)
Income (loss) before provision (benefit) for income taxes and equity in earnings of unconsolidated subsidiaries	16,963	(21,661)
Income tax provision (benefit)	6,521	(7,365)
Equity in earnings of unconsolidated subsidiaries, net	462	23
Net income (loss)	\$ 10,904	\$ (14,273)
Earnings (loss) per common share:		
Basic	\$ 0.24	\$ (0.33)
Diluted	\$ 0.24	\$ (0.33)
Weighted-average common shares outstanding:		
Basic	44,642	43,776
Diluted	45,755	43,776

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
(unaudited)

	Three Months Ended	
	July 31,	
	2010	2009
	(in thousands)	
Cash flows from operating activities:		
Net income (loss)	\$ 10,904	\$ (14,273)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	2,968	2,829
Stock-based compensation expense	3,815	4,496
Loss on disposition of property and equipment	60	515
Provision for doubtful accounts	1,826	656
Gain on cash surrender value of life insurance policies	(207)	(3,379)
Loss (gain) on marketable securities classified as trading	1,420	(4,100)
Deferred income taxes	6,939	(3,040)
Change in other assets and liabilities:		
Deferred compensation	3,976	13,850
Receivables	(25,291)	(12,733)
Prepaid expenses	(4,417)	(3,488)
Investment in unconsolidated subsidiaries	(462)	(23)
Income taxes payable	(1,024)	1,625
Accounts payable and accrued liabilities	(41,164)	(48,243)
Other	(139)	(1,066)
Net cash used in operating activities	(40,796)	(66,374)
Cash flows from investing activities:		
Purchase of property and equipment	(11,684)	(1,185)
(Purchase of) proceeds from marketable securities, net	(10,401)	1,083
Cash paid for acquisitions, net of cash acquired and earn-outs		(10,251)
Payment of earn-outs from acquisitions	(675)	
Premiums on life insurance policies	(350)	(425)
Dividends received from unconsolidated subsidiaries	252	157
Net cash used in investing activities	(22,858)	(10,621)
Cash flows from financing activities:		
Borrowings under life insurance policies	347	3,098
Purchase of common stock	(11,124)	(1,230)
Proceeds from exercise of warrants	2,983	
Proceeds from issuance of common stock upon exercise of employee stock options and in connection with an employee stock purchase plan	1,493	3,619
Tax expense from exercise of stock options	(815)	(1,450)
Net cash (used in) provided by financing activities	(7,116)	4,037

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Effect of exchange rate changes on cash and cash equivalents	(2,447)	5,527
Net decrease in cash and cash equivalents	(73,217)	(67,431)
Cash and cash equivalents at beginning of period	219,233	255,000
Cash and cash equivalents at end of period	\$ 146,016	\$ 187,569

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 FINANCIAL STATEMENTS
July 31, 2010

1. Organization and Summary of Significant Accounting Policies

Nature of Business

Korn/Ferry International, a Delaware corporation (the Company), and its subsidiaries are engaged in the business of providing executive recruitment, outsourced recruiting and leadership and talent consulting on a retained basis. The Company's worldwide network of 76 offices in 36 countries enables it to meet the needs of its clients in all industries.

Basis of Consolidation and Presentation

The condensed consolidated financial statements for the three months ended July 31, 2010 and 2009 include the accounts of the Company and its wholly and majority owned/controlled domestic and international subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. The preparation of the condensed consolidated financial statements conform with United States (U.S.) generally accepted accounting principles (GAAP) and prevailing practice within the industry. The condensed consolidated financial statements 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, 2010 (the Annual Report) and should be read together with the Annual Report.

Investments in affiliated companies which are 50% or less owned and where the Company exercises significant influence over operations are accounted for using the equity method.

Certain amounts included in the prior fiscal period consolidated financial statements have been reclassified to conform to the current fiscal year presentation.

Use of Estimates and Uncertainties

The preparation of the condensed consolidated financial statements in conformity with 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 consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates and changes in estimates are reported in current operations. The most significant areas that require management judgment are revenue recognition, deferred compensation, annual incentive compensation, evaluation of the carrying value of receivables, marketable securities, goodwill and other intangible assets and deferred income taxes.

Revenue Recognition

Substantially all professional fee revenue is derived from fees for professional services related to executive recruitment performed on a retained basis, middle-management recruitment and leadership and talent consulting services. Fee revenue from recruitment activities is generally one-third of the estimated first year compensation plus a percentage of the fee to cover indirect expenses. Fee revenue from leadership and talent consulting services is recognized as earned. The Company generally bills clients in three monthly installments commencing the month of client acceptance. Fees earned in excess of the initial contract amount are billed upon completion of the engagement. Any services that are provided on a contingent basis are recognized once the contingency is fulfilled.

Allowance for Doubtful Accounts

A provision is established for doubtful accounts through a charge to general and administrative expenses based on historical loss experience, assessment of the collectability of specific accounts, as well as expectations of future collections based upon trends and the type of work for which services are rendered. After all collection efforts have been exhausted, the Company reduces the allowance for doubtful accounts for balances identified as uncollectible.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
July 31, 2010

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

Marketable Securities

The Company classifies its marketable securities as either trading securities or available-for-sale. These investments are recorded at fair value and are classified as marketable securities in the accompanying consolidated balance sheets. Certain investments, which the Company intends to sell within the next twelve months, are carried as current assets. Investments are made based on the Company's investment policy which restricts the types of investments that can be made.

Trading securities consist of the Company's investments which are held in trust to satisfy obligations under the Company's deferred compensation plans (see Note 5). The changes in fair values on trading securities are recorded as a component of net income (loss) in other (expense) income, net.

Available-for-sale securities consist of corporate bonds, U.S Treasury and agency securities and commercial paper. The changes in fair values, net of applicable taxes, are recorded as unrealized gains (losses) as a component of accumulated other comprehensive income (loss) in stockholders' equity. When, in the opinion of management, a decline in the fair value of an investment below its cost or amortized cost is considered to be other-than-temporary, the investment's cost or amortized cost is written-down to its fair value and the amount written-down is recorded in the statement of operations in interest and other income (loss), net. The determination of other-than-temporary decline includes, in addition to other relevant factors, a presumption that if the market value is below cost by a significant amount for a period of time, a write-down may be necessary. The amount of any write-down is determined by the difference between cost or amortized cost of the investment and its fair value at the time the other-than-temporary decline is identified. During the three months ended July 31, 2010 and 2009, no other-than-temporary impairment was recognized.

Business acquisitions

Business acquisitions are accounted for under the purchase method by assigning the purchase price to tangible and intangible assets acquired and liabilities assumed. The results are included in the Company's consolidated financial statements from the date of each respective acquisition. Assets acquired and liabilities assumed are recorded at their fair values and the excess of the purchase price over the amounts assigned is recorded as goodwill. Purchased intangible assets with finite lives are amortized over their estimated useful lives. Adjustments to fair value assessments are recorded to goodwill over the purchase price allocation period (generally not longer than twelve months).

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of assets acquired. The goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. If the carrying amount of a reporting unit exceeds its fair value, goodwill of the reporting unit would be considered impaired. To measure the amount of the impairment loss, the implied fair value of a reporting unit's goodwill is compared to the carrying amount of that goodwill. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. If the carrying amount of a reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. For each of these tests, the fair value of each of the Company's reporting units was determined using a combination of valuation techniques, including a discounted cash flow methodology. The annual goodwill impairment test performed as of January 31, 2010, indicated that the fair value of each reporting unit exceeded its carrying amount. As a result, no impairment charge was recognized. There was also no indication of impairment as of July 31, 2010 and April 30, 2010.

Intangible assets primarily consist of customer lists, non-compete agreements, proprietary databases, intellectual property and trademarks, and are recorded at the estimated fair value at the date of acquisition and are amortized using the straight-line method over their estimated useful lives of five to 24 years. For intangible assets subject to

amortization, an impairment loss is recognized if the carrying amount of the intangible assets is not recoverable and exceeds fair value. The carrying amount of the intangible assets is considered not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from use of the asset. As of July 31, 2010 and April 30, 2010, there were no indicators of impairment with respect to the Company's intangible assets.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
July 31, 2010

Restructuring Charges

The Company accounts for its restructuring charges as a liability when the costs are incurred and are recorded at fair value. Changes in the estimates of the restructuring charges are recorded in the period the change is determined.

Compensation and Benefits Expense

Compensation and benefits expense in the accompanying statements of operations consist of compensation and benefits paid to consultants, executive officers, and administrative and support personnel. The most significant portions of this expense are salaries and the annual performance related bonus paid to consultants. Compensation and benefits are recognized when incurred. Management makes certain estimates related to the annual performance related bonus. These annual performance related bonuses are generally paid within twelve months following the fiscal year end though the Company deferred certain bonuses earned in fiscal 2009 and 2010 until December 2010 and 2011, respectively. Management reevaluates the estimates up to the payment date, and any changes in the estimate are reported in current operations. Other expenses included in this line item are changes in the deferred compensation liabilities and cash surrender value (CSV) of company owned life insurance (COLI) contracts, amortization of stock compensation awards, payroll taxes and employee insurance benefits.

Stock-Based Compensation

The Company has employee compensation plans under which various types of stock-based instruments are granted. These instruments, principally include stock options, stock appreciation rights (SARs), restricted stock and an Employee Stock Purchase Plan (ESPP). The Company recognizes compensation expense related to restricted stock and SARs and the estimated fair value of stock options and stock purchases under the ESPP.

Fair Value of Financial Instruments

The Company measures the fair values of its financial instruments in accordance with accounting guidance that defines fair value, provides guidance for measuring fair value and requires certain disclosures. The guidance also discusses valuation techniques, such as the market approach (comparable market prices), the income approach (present value of future income or cash flow) and the cost approach (cost to replace the service capacity of an asset or replacement cost). The guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions.

As of July 31, 2010, the Company held certain assets that are required to be measured at fair value on a recurring basis. These included cash equivalents and marketable securities. The carrying amount of cash, cash equivalents and accounts receivable approximates fair value due to the short maturity of these instruments. The fair values of marketable securities classified as trading, are obtained from quoted market prices and the fair values of marketable securities classified as available-for-sale, are obtained from a third party which are based on quoted prices or market prices for similar assets. As of April 30, 2010, the Company also held auction rate securities (ARS) and a related put option. The fair value for these instruments are determined by the use of pricing models (see Note 5). The ARS were redeemed at full value during the three months ended July 31, 2010.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
July 31, 2010

Recently Adopted Accounting Standards

In January 2010, the Financial Accounting Standards Board (FASB) issued guidance on Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements, which amends the disclosure guidance with respect to fair value measurements. Specifically, the new guidance requires disclosure of amounts transferred in and out of Levels 1 and 2 fair value measurements, a reconciliation presented on a gross basis rather than a net basis of activity in Level 3 fair value measurements, greater disaggregation of the assets and liabilities for which fair value measurements are presented and more robust disclosure of the valuation techniques and inputs used to measure Level 2 and 3 fair value measurements. The guidance is effective for interim and annual reporting periods beginning after December 15, 2009, with the exception of the new guidance around the Level 3 activity reconciliation, which is effective for fiscal years beginning after December 15, 2010. The Company adopted the new guidance on February 1, 2010. The adoption did not impact the Company's financial position, results of operations or liquidity.

2. Basic and Diluted Earnings (Loss) Per Share

Basic earnings (loss) per common share was computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding. Diluted earnings per common share 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 net earnings (loss) attributable to common stockholders by the weighted-average number of common shares outstanding plus dilutive common equivalent shares. During the three months ended July 31, 2010, SARs and options to purchase 1.1 million shares were outstanding but not included in the computation of diluted earnings per share because they were anti-dilutive. Due to the loss attributable to common stockholders during the three months ended July 31, 2009, no potentially dilutive shares are included in the loss per share calculation as including such shares in the calculation would be anti-dilutive.

The following table summarizes basic and diluted earnings (loss) per share calculations:

	Three Months Ended	
	July 31,	
	2010	2009
	(in thousands, except per share data)	
Net earnings (loss) attributable to common stockholders:	\$ 10,904	\$ (14,273)
Weighted-average common shares outstanding:		
Basic weighted-average number of common shares outstanding	44,642	43,776
Effect of dilutive securities:		
Restricted stock	780	
Stock options	326	
ESPP	7	
Diluted weighted-average number of common shares outstanding	45,755	43,776
Net earnings (loss) per common share:		
Basic earnings (loss) per share	\$ 0.24	\$ (0.33)
Diluted earnings (loss) per share	\$ 0.24	\$ (0.33)

3. Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income (loss) and all changes to stockholders' equity, except those changes resulting from investments by stockholders (changes in paid in capital) and distributions to stockholders (dividends).

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
July 31, 2010

Total comprehensive income (loss) is as follows:

	Three Months Ended July 31,	
	2010	2009
	(in thousands)	
Net income (loss)	\$ 10,904	\$ (14,273)
Foreign currency translation adjustments	(3,784)	12,284
Unrealized losses on marketable securities, net of taxes	(1)	
Comprehensive income (loss)	\$ 7,119	\$ (1,989)

The components of accumulated other comprehensive income were as follows:

	July 31,	April 30,
	2010	2010
	(in thousands)	
Foreign currency translation adjustments	\$ 15,116	\$ 18,900
Defined benefit adjustments, net of taxes	(5,966)	(5,966)
Unrealized losses on marketable securities, net of taxes	(1)	
Accumulated other comprehensive income	\$ 9,149	\$ 12,934

4. Employee Stock Plans***Stock-Based Compensation***

The following table summarizes the components of stock-based compensation expense recognized in the Company's condensed consolidated statements of operations for the periods indicated:

	Three Months Ended July 31,	
	2010	2009
	(in thousands)	
Restricted stock	\$ 3,564	\$ 4,147
Stock options and SARs	136	236
ESPP	115	113
Total stock-based compensation expense, pre-tax	3,815	4,496
Tax benefit from stock-based compensation expense	(1,392)	(1,641)
Total stock-based compensation expense, net of tax	\$ 2,423	\$ 2,855

The Company uses the Black-Scholes option valuation model to estimate the grant date fair value of employee stock options. The expected volatility reflects 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 each option is estimated using historical data. 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 option. The Company uses historical data to estimate forfeiture rates applied to the gross amount of expense determined using the option valuation model.

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KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
July 31, 2010

The weighted-average assumptions used to estimate the fair value of each employee stock option and SARs were as follows:

	Three Months Ended	
	July 31,	
	2010	2009
Expected volatility	47.67%	48.91%
Risk-free interest rate	1.83%	2.53%
Expected option life (in years)	5.00	5.00
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 Incentive Plans

The Korn/Ferry International 2008 Stock Incentive Plan, as amended (the 2008 Plan) made available an additional 2,360,000 shares of the Company's common stock for stock-based compensation awards. The 2008 Plan, provides for the grant of awards to eligible participants, designated as either nonqualified or incentive stock options, SARs, restricted stock and restricted stock units, any of which may be performance-based, and incentive bonuses, which may be paid in cash or a combination thereof.

Stock Options and SARs

Stock options and SARs transactions under the Company's stock incentive plans were as follows:

	Three Months Ended July 31, 2010			
	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value
Outstanding, April 30, 2010	2,723	\$ 14.72		
Granted	203	\$ 13.92		
Exercised	(27)	\$ 7.90		

(in thousands, except per share data)