

KORN FERRY INTERNATIONAL

Form 10-Q

September 09, 2015

[Table of Contents](#)

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 July 31, 2015

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
(State or Other Jurisdiction of

95-2623879
(I.R.S. Employer

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)

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 ☒ (Do not check if a smaller reporting company)

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 1, 2015 was 51,201,229 shares.

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES

Table of Contents

Item #	Description	Page
Part I. Financial Information		
Item 1.	<u>Consolidated Financial Statements</u>	
	<u>Consolidated Balance Sheets as of July 31, 2015 (unaudited) and April 30, 2015</u>	1
	<u>Unaudited Consolidated Statements of Income for the three months ended July 31, 2015 and 2014</u>	2
	<u>Unaudited Consolidated Statements of Comprehensive Income for the three months ended July 31, 2015 and 2014</u>	3
	<u>Unaudited Consolidated Statements of Cash Flows for the three months ended July 31, 2015 and 2014</u>	4
	<u>Notes to Unaudited Consolidated Financial Statements</u>	5
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	19
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	30
Item 4.	<u>Controls and Procedures</u>	30
Part II. Other Information		
Item 1.	<u>Legal Proceedings</u>	31
Item 1A.	<u>Risk Factors</u>	31
Item 2.	<u>Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u>	31
Item 6.	<u>Exhibits</u>	32
	<u>Signatures</u>	33

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****KORN/FERRY INTERNATIONAL AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

	July 31, 2015 (unaudited)	April 30, 2015
(in thousands, except per share data)		
ASSETS		
Cash and cash equivalents	\$ 276,514	\$ 380,838
Marketable securities	19,859	25,757
Receivables due from clients, net of allowance for doubtful accounts of \$10,344 and \$9,958, respectively	199,533	188,543
Income taxes and other receivables	9,835	10,966
Deferred income taxes	1,211	3,827
Prepaid expenses and other assets	35,923	31,054
Total current assets	542,875	640,985
Marketable securities, non-current	118,079	118,819
Property and equipment, net	61,800	62,088
Cash surrender value of company owned life insurance policies, net of loans	105,111	102,691
Deferred income taxes, net	53,506	56,014
Goodwill	250,835	254,440
Intangible assets, net	45,655	47,901
Investments and other assets	44,683	34,863
Total assets	\$ 1,222,544	\$ 1,317,801
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 18,005	\$ 19,238
Income taxes payable	1,819	3,813
Compensation and benefits payable	120,961	219,364
Other accrued liabilities	62,098	63,595
Total current liabilities	202,883	306,010
Deferred compensation and other retirement plans	174,988	173,432
Other liabilities	22,974	23,110
Total liabilities	400,845	502,552
Stockholders' equity:		
	467,511	463,839

Common stock: \$0.01 par value, 150,000 shares authorized, 63,549 and 62,863

shares issued and 51,195 and 50,573 shares outstanding, respectively

Retained earnings	410,000	392,033
Accumulated other comprehensive loss, net	(55,812)	(40,623)
Total stockholders' equity	821,699	815,249
Total liabilities and stockholders' equity	\$ 1,222,544	\$ 1,317,801

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

Table of Contents**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(unaudited)**

	Three Months Ended July 31,	
	2015	2014
	(in thousands, except per share data)	
Fee revenue	\$ 267,394	\$ 251,188
Reimbursed out-of-pocket engagement expenses	11,941	9,137
Total revenue	279,335	260,325
Compensation and benefits	179,456	169,106
General and administrative expenses	37,491	37,368
Reimbursed expenses	11,941	9,137
Cost of services	10,120	9,465
Depreciation and amortization	7,423	6,770
Restructuring charges, net		9,886
Total operating expenses	246,431	241,732
Operating income	32,904	18,593
Other (loss) income, net	(74)	2,177
Interest expense, net	(299)	(794)
Income before provision for income taxes and equity in earnings of unconsolidated subsidiaries	32,531	19,976
Equity in earnings of unconsolidated subsidiaries, net	725	466
Income tax provision	10,174	5,909
Net income	\$ 23,082	\$ 14,533
Earnings per common share:		
Basic	\$ 0.46	\$ 0.30
Diluted	\$ 0.46	\$ 0.29
Weighted-average common shares outstanding:		
Basic	49,493	48,703
Diluted	50,014	49,591

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

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)

	Three Months Ended	
	July 31,	
	2015	2014
	(in thousands)	
Net income	\$ 23,082	\$ 14,533
Other comprehensive income:		
Foreign currency translation adjustments	(15,632)	(3,680)
Deferred compensation and pension plan adjustments, net of tax	447	487
Unrealized losses on marketable securities, net of tax	(4)	(6)
Comprehensive income	\$ 7,893	\$ 11,334

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

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

	Three Months Ended July 31,	
	2015	2014
	(in thousands)	
Cash flows from operating activities:		
Net income	\$ 23,082	\$ 14,533
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	7,423	6,770
Stock-based compensation expense	3,691	3,319
Provision for doubtful accounts	2,068	1,911
Gain on cash surrender value of life insurance policies	(2,494)	(3,263)
Gain on marketable securities	(665)	(2,018)
Deferred income taxes	5,124	4,859
Change in other assets and liabilities:		
Deferred compensation	(1,820)	1,715
Receivables due from clients	(13,058)	(28,312)
Income tax and other receivables	1,145	152
Prepaid expenses and other assets	(4,869)	(2,909)
Investment in unconsolidated subsidiaries	(725)	(466)
Income taxes payable	(1,990)	(4,967)
Accounts payable and accrued liabilities	(96,737)	(77,636)
Other	(10,368)	(3,735)
Net cash used in operating activities	(90,193)	(90,047)
Cash flows from investing activities:		
Purchase of property and equipment	(5,485)	(6,590)
Purchase of marketable securities	(9,116)	(4,319)
Proceeds from sales/maturities of marketable securities	16,364	7,812
Premium on company-owned life insurance policies	(404)	(419)
Proceeds from life insurance policies	1,659	1,801
Dividends received from unconsolidated subsidiaries	806	318
Net cash provided by (used in) investing activities	3,824	(1,397)
Cash flows from financing activities:		
Purchase of common stock	(6,573)	(3,731)
Proceeds from issuance of common stock upon exercise of employee stock options and in connection with an employee stock purchase plan	2,379	1,479
Tax benefit related to stock-based compensation	4,064	1,165

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Dividends paid to shareholders	(5,115)	
Payments on life insurance policy loans	(1,151)	(705)
Net cash used in financing activities	(6,396)	(1,792)
Effect of exchange rate changes on cash and cash equivalents	(11,559)	(1,908)
Net decrease in cash and cash equivalents	(104,324)	(95,144)
Cash and cash equivalents at beginning of period	380,838	333,717
Cash and cash equivalents at end of period	\$ 276,514	\$ 238,573

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

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

July 31, 2015

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 talent management solutions, including executive recruitment on a retained basis, recruitment for non-executive professionals, recruitment process outsourcing and leadership & talent consulting services. The Company's worldwide network of 78 offices in 37 countries enables it to meet the needs of its clients in all industries.

Basis of Consolidation and Presentation

The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended April 30, 2015 for 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 consolidated financial statements conform with United States (U.S.) generally accepted accounting principles (GAAP) and prevailing practice within the industry. The 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. The results of operations for the interim period are not necessarily indicative of the results for the entire fiscal year.

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.

The Company considers events or transactions that occur after the balance sheet date but before the consolidated financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosures.

Use of Estimates and Uncertainties

The preparation of the 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 as new information is learned or upon the amounts becoming fixed and determinable. The most significant areas that require management judgment are revenue recognition, restructuring, deferred compensation, annual performance related bonuses, evaluation of the carrying value of receivables, goodwill and other intangible assets, fair value of contingent consideration, share-based payments and the recoverability of deferred income taxes.

Revenue Recognition

Substantially all fee revenue is derived from fees for professional services related to executive recruitment performed on a retained basis, recruitment for non-executive professionals, recruitment process outsourcing and leadership &

talent consulting services. Fee revenue from executive recruitment activities and recruitment for non-executive professionals is generally one-third of the estimated first year cash compensation of the placed executive or non-executive professional, as applicable, plus a percentage of the fee to cover indirect engagement related expenses. The Company generally recognizes such revenue on a straight-line basis over a three-month period, commencing upon client acceptance, as this is the period over which the recruitment services are performed. Fees earned in excess of the initial contract amount are recognized upon completion of the engagement, which reflect the difference between the final actual compensation of the placed executive and the estimate used for purposes of the previous billings. Since the initial contract fees are typically not contingent upon placement of a candidate, our assumptions primarily relate to establishing the period over which such service is performed. These assumptions determine the timing of revenue recognition and profitability for the reported period. Any revenues associated with services that are provided on a contingent basis are recognized once the contingency is resolved. In addition to recruitment for non-executive professionals, Futurestep provides recruitment process outsourcing (RPO) services and fee revenue is recognized as services are rendered and/or as milestones are achieved. Fee revenue from Leadership & Talent Consulting (LTC) services is recognized as services are rendered for consulting engagements and other time based

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

July 31, 2015

services, measured by total hours incurred to the total estimated hours at completion. It is possible that updated estimates for the consulting engagement may vary from initial estimates with such updates being recognized in the period of determination. Depending on the timing of billings and services rendered, the Company accrues or defers revenue as appropriate. LTC revenue is also derived from the sale of solution services, which includes revenue from licenses and from the sale of products. Revenue from licenses is recognized using a straight-line method over the term of the contract (generally 12 months). Under the fixed term licenses, the Company is obligated to provide the licensee with access to any updates to the underlying intellectual property that are made by the Company during the term of the license. Once the term of the agreement expires, the client's right to access or use the intellectual property expires and the Company has no further obligations to the client under the license agreement. Revenue from perpetual licenses is recognized when the license is sold since the Company's only obligation is to provide the client access to the intellectual property but is not obligated to provide maintenance, support, updates or upgrades. Products sold by the Company mainly consist of books and automated services covering a variety of topics including performance management, team effectiveness, and coaching and development. The Company recognizes revenue for its products when the product has been sold or shipped in the case of books. As of July 31, 2015 and April 30, 2015, the Company included deferred revenue of \$39.5 million and \$40.5 million, respectively, in other accrued liabilities.

Allowance for Doubtful Accounts

An allowance is established for doubtful accounts by taking a charge to general and administrative expenses. The amount of the allowance is 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 the Company exhausts all collection efforts, the amount of the allowance is reduced for balances identified as uncollectible.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. As of July 31, 2015 and April 30, 2015, the Company's investments in cash equivalents, consist of money market funds for which market prices are readily available. As of July 31, 2015 and April 30, 2015, the Company had cash equivalents of \$168.8 million and \$260.6 million, respectively.

Marketable Securities

The Company currently has investments in marketable securities and mutual funds which are classified as either trading securities or available-for-sale, based upon management's intent and ability to hold, sell or trade such securities. The classification of the investments in these marketable securities and mutual funds is assessed upon purchase and reassessed at each reporting period. These investments are recorded at fair value and are classified as marketable securities in the accompanying consolidated balance sheets. The investments that the Company may sell within the next twelve months are carried as current assets. Realized gains (losses) on marketable securities are determined by specific identification. Interest is recognized on an accrual basis, dividends are recorded as earned on

the ex-dividend date. Interest and dividend income are recorded in the accompanying consolidated statements of income in interest expense, net.

The Company invests in mutual funds (for which market prices are readily available) that are held in trust to satisfy obligations under the Company's deferred compensation plans (see Note 5 *Marketable Securities*) and are classified as trading securities. Such investments are based upon the employees' investment elections in their deemed accounts in the Executive Capital Accumulation Plan and similar plans in Asia Pacific and Canada (ECAP) from a pre-determined set of securities and the Company invests in marketable securities to mirror these elections. The changes in fair value in trading securities are recorded in the accompanying consolidated statements of income in other (loss) income, net.

The Company also invests cash in excess of its daily operating requirements and capital needs primarily in marketable fixed income (debt) securities in accordance with the Company's investment policy, which restricts the type of investments that can be made. The Company's investment portfolio includes corporate bonds. These marketable fixed income (debt) securities are classified as available-for-sale securities based on management's decision, at the date such securities are acquired, not to hold these securities to maturity or actively trade them. The Company carries these marketable debt securities at fair value based on the market prices for these marketable debt securities or similar debt securities whose prices are readily available. The changes in fair values, net of applicable taxes, are recorded as unrealized gains or losses as a

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

July 31, 2015

component of comprehensive income. When, in the opinion of management, a decline in the fair value of an investment below its amortized cost is considered to be other-than-temporary, a credit loss is recorded in the statement of income in other (loss) income, net; any amount in excess of the credit loss is recorded as unrealized gains or losses as a component of comprehensive income. Generally, the amount of the loss is the difference between the cost or amortized cost and its then current fair value; a credit loss is the difference between the discounted expected future cash flows to be collected from the debt security and the cost or amortized cost of the debt security. The determination of the 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. During the three months ended July 31, 2015 and 2014, no other-than-temporary impairment was recognized.

Fair Value of Financial Instruments

Fair value is the price the Company would receive to sell an asset or transfer a liability (exit price) in an orderly transaction between market participants. For those assets and liabilities recorded or disclosed at fair value, the Company determines the fair value based upon the quoted market price, if available. If a quoted market price is not available for identical assets, the fair value is based upon the quoted market price of similar assets. The fair values are assigned a level within the fair value hierarchy as defined below:

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, 2015 and April 30, 2015, the Company held certain assets that are required to be measured at fair value on a recurring basis. These included cash, cash equivalents, accounts receivable 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.

Business Acquisitions

Business acquisitions are accounted for under the acquisition method. The acquisition method requires the reporting entity to identify the acquirer, determine the acquisition date, recognize and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired entity, and recognize and measure goodwill or a gain from the purchase. The acquiree's results are included in the Company's consolidated financial statements from the date of 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, or if the fair value of the assets acquired exceeds the purchase price consideration, a bargain purchase gain is recorded. Adjustments to fair value assessments are generally recorded to goodwill over the measurement period (not longer than twelve months). The acquisition method also requires that acquisition-related transaction and post-acquisition restructuring costs be charged to expense as committed, and requires the Company to recognize and measure certain assets and liabilities including those arising from contingencies and contingent consideration in a business combination.

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

Table of Contents**KORN/FERRY INTERNATIONAL AND SUBSIDIARIES****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****July 31, 2015**

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 is determined using a combination of valuation techniques, including a discounted cash flow methodology. To corroborate the discounted cash flow analysis performed at each reporting unit, a market approach is utilized using observable market data such as comparable companies in similar lines of business that are publicly traded or which are part of a public or private transaction (to the extent available). Results of the annual impairment test performed as of January 31, 2015, indicated that the fair value of each reporting unit exceeded its carrying amount and no reporting units were at risk of failing the impairment test. As a result, no impairment charge was recognized. There were no indicators of impairment as of July 31, 2015 and April 30, 2015 that would have required further testing.

Intangible assets primarily consist of customer lists, non-compete agreements, proprietary databases, intellectual property and trademarks and are recorded at their estimated fair value at the date of acquisition and are amortized in a pattern in which the asset is consumed if that pattern can be reliably determined, or using the straight-line method over their estimated useful lives which range from one 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. Intangible assets with indefinite lives are not amortized, but are reviewed annually for impairment or more frequently whenever events or changes in circumstances indicate that the fair value of the asset may be less than its carrying amount. As of July 31, 2015 and April 30, 2015, there were no indicators of impairment with respect to the Company's intangible assets.

Compensation and Benefits Expense

Compensation and benefits expense in the accompanying consolidated statements of income consist of compensation and benefits paid to consultants (employees who originate business), executive officers and administrative and support personnel. The most significant portions of this expense are salaries and the amounts paid under the annual performance related bonus plan to employees. The portion of the expense applicable to salaries is comprised of amounts earned by employees during a reporting period. The portion of the expenses applicable to annual performance related bonuses refers to the Company's annual employee performance related bonus with respect to a fiscal year, the amount of which is communicated and paid to each eligible employee following the completion of the fiscal year.

Each quarter, management makes its best estimate of its annual performance related bonuses, which requires management to, among other things, project annual consultant productivity (as measured by engagement fees billed and collected by executive search consultants and revenue and other performance metrics for LTC and Futurestep consultants), the level of engagements referred by a fee earner in one line of business to a different line of business, Company performance including profitability, competitive forces and future economic conditions and their impact on the Company's results. At the end of each fiscal year, annual performance related bonuses take into account final individual consultant productivity (including referred work), Company results including profitability, the achievement

of strategic objectives and the results of individual performance appraisals, and the current economic landscape. Accordingly, each quarter the Company reevaluates the assumptions used to estimate annual performance related bonus liability and adjusts the carrying amount of the liability recorded on the consolidated balance sheet and reports any changes in the estimate in current operations.

Because annual performance-based bonuses are communicated and paid only after the Company reports its full fiscal year results, actual performance-based bonus payments may differ from the prior year's estimate. Such changes in the bonus estimate historically have been immaterial and are recorded in current operations in the period in which they are determined. The performance related bonus expense was \$42.4 million and \$39.0 million for the three months ended July 31, 2015 and 2014, respectively, which was reduced by a change in the previous year's estimate recorded in the three months ended July 31, 2015 and 2014, of \$0.6 million and \$0.3 million, respectively. This resulted in net bonus expense of \$41.8 million and \$38.7 million in the three months ended July 31, 2015 and 2014, respectively, included in compensation and benefits expense in the consolidated statements of income.

Other expenses included in compensation and benefits expense are due to changes in deferred compensation and pension plan liabilities, changes in cash surrender value (CSV) of company owned life insurance (COLI) contracts, amortization of stock compensation awards, payroll taxes and employee insurance benefits.

Table of Contents

KORN/FERRY INTERNATIONAL AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

July 31, 2015

Restructuring Charges, Net

The Company accounts for its restructuring charges as a liability when the obligations are incurred and records such charges at fair value. Changes