KORN FERRY INTERNATIONAL
Form 10-K
June 29, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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

For the fiscal year ended April 30, 2007

OR

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

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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act. Yes ¨ No x

The number of shares outstanding of our common stock as of June 27, 2007 was 47,642,514 shares. The aggregate market value of the registrant s voting and non-voting common stock held by non-affiliates of the registrant on October 31, 2006, the last business day of the registrant s most recently completed second fiscal quarter, (assuming that the registrant s only affiliates are its officers, directors and 10% or greater stockholders) was approximately $765,451,000 based upon the closing market price of $22.11 on that date of a share of common stock as reported on the New York Stock Exchange.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for its 2007 Annual Meeting of Stockholders scheduled to be held on September 11, 2007 are incorporated by reference into Part III of this Form 10-K.

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PART I.

Item 1. *Business*

Business Overview

Korn/Ferry International (referred herein as the Company, Korn/Ferry, or in the first person notations we, our, and us) is a premier g provider of talent management solutions that help clients to attract, deploy, develop, retain and reward their talent. Since 1969, when we opened our first office in Los Angeles, we have expanded to 71 cities in 39 countries. In 1998, we extended our market reach into the middle-market with the introduction of Futurestep, our outsourced recruiting subsidiary. As of April 30, 2007, we have approximately 2,260 employees, including 490 executive recruitment and 111 Futurestep consultants who are primarily responsible for client services. Our clients include many of the world s largest and most prestigious public and private companies, middle-market and emerging growth companies, as well as government and not-for-profit organizations. We have built strong client loyalty; more than 84% of the executive recruitment assignments we performed during the last three fiscal years were on behalf of clients for whom we had conducted previous assignments.

We were originally formed as a California corporation in November 1969 and reincorporated as a Delaware corporation in fiscal 2000.

We provide the following talent management solutions:

Executive Recruitment: Executive search, our flagship business, focuses on board level, chief executive and other senior executive positions for clients predominantly in the consumer, financial services, industrial, life sciences and technology industries. The relationships that we develop through this business are valuable in introducing our complementary service offerings to clients.

Middle-Management Recruitment: Futurestep, our outsourced recruiting subsidiary, draws from Korn/Ferry s 38 years of industry experience to create customized recruitment solutions based on clients individual workforce needs. In addition to being a pioneer in recruitment process outsourcing (RPO), the Company s multi-tiered portfolio of services includes mid-level search, project recruitment and interim solutions.

Leadership Development Solutions: Our comprehensive blend of leadership services assists clients with the ongoing assessment and development of their leadership teams. Services include succession planning, management & team development, competency modeling, executive coaching, onboarding, merger integration, cultural change, integrated talent management, and executive compensation consulting through our wholly-owned subsidiary, Executive Compensation Advisors. Each service is supported by the highly consultative expertise of our team and is powered by Lominger, a Korn/Ferry company and an internationally recognized provider of research-based, experience-tested leadership development tools.

We file annual, quarterly and current reports, proxy statements and other documents with the Securities and Exchange Commission (the SEC), pursuant to the Securities Exchange Act of 1934 (the Exchange Act). You may read and copy any materials that we file with the SEC at the SEC s Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1 800 732 0330. Our reports, proxy statements and other documents filed electronically with the SEC are available at the website maintained by the SEC at *www.sec.gov*.

We also make available, free of charge on our website at www.kornferry.com, our annual, quarterly, and current reports, and, if applicable, amendments to those reports, filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after we electronically file such reports with, or furnish them to, the SEC.

Our Corporate Governance Guidelines, Code of Business Conduct and Ethics and the charters of the Audit Committee, Compensation and Personnel Committee, and Nominating and Corporate Governance Committee of

our Board of Directors are also posted on our website at www.kornferry.com. Stockholders may request copies of these documents by writing to our Corporate Secretary at 1900 Avenue of the Stars, Suite 2600, Los Angeles, California 90067.

Financial information regarding our business segments for the last three fiscal years is contained in the Notes to our Consolidated Financial Statements.

Industry Overview

Executive Recruitment: The executive recruitment market concentrates on searches for positions with annual compensation of $150,000 or more, which generally involve board level, chief executive and other senior executive positions. The industry is comprised of retained and contingency search firms. Retained firms, such as Korn/Ferry, typically charge a fee for their services equal to approximately one-third of the annual cash compensation for the position being filled regardless of whether a position has been filled. Contingency firms generally work on a non-exclusive basis and are compensated only upon successfully placing a recommended candidate.

We also provide leadership development solutions, which include succession planning, management & team development, competency modeling, executive coaching, onboarding, merger integration, cultural change, integrated talent management, and executive compensation consulting.

Middle-Management Recruitment: The middle-management recruitment market focuses on searches for positions with annual compensation generally in the $100,000 to $150,000 range. This market has undergone a fundamental transformation over the past several years towards a technology-based environment, and has also seen the emergence of outsourced recruitment services commonly referred to as RPO. Technology and the Internet have made identifying, targeting and reaching potential candidates much quicker. This market also benefits from the efficiencies of maintaining large databases of qualified candidates thereby reducing placement times.

Industry Trends

With the global economy continuing to expand, we believe the business outlook for the talent management industry remains positive. The economic upswing, combined with the shortage of qualified executives, will continue to fuel job growth and hiring. We also believe that the following current market trends will contribute to the long-term growth of the industry:

Consolidation of Talent Management Solution Providers In choosing their recruitment and human resource service providers, companies are actively in search of preferred providers in order to create efficiencies and consolidate vendor relationships. Companies that can offer a full suite of talent management solutions are becoming increasingly attractive. Clients seek trusted advisors who understand their business and unique organizational culture in order to manage the multiple needs of their business on a global scale.

Aging Population In many major economic centers, the workforce population is aging at a rapid pace. It is projected that there will be twice as many people retiring this decade as there were in the previous one. Moreover, the supply of available qualified candidates is limited, making it more difficult for employers to secure qualified executives. We believe that this trend will have a positive impact on our business, as employers increasingly seek service providers who can provide solutions for the impending talent shortage.

Globalization of Business As the world markets continue to integrate into one global economy, many successful companies are adding strength to their internal talent with experienced executives who can operate effectively in this global environment. The rapidly changing competitive landscape challenges multinational and local companies to identify and recruit qualified executives with the right combination of skills, experience and

cultural compatibility. Today, clients are turning to firms that combine proven expertise with specialized knowledge of both key industries and local markets, enabling them to address their ongoing global talent needs.

Increased Outsourcing of Recruitment Functions More companies are focusing on core competencies and outsourcing non-core, back-office functions to providers who can provide efficient, high-quality services. A shortage of qualified management-level candidates has made identifying and recruiting exceptional candidates more difficult. Companies increasingly rely on experienced global executive recruitment firms to address their management recruitment needs. By hiring global executive recruitment firms, companies can expect to:

- Have access to a diverse and highly qualified pool of candidates on an as-needed basis;
- Reduce or eliminate the costs required to maintain and train an in-house recruiting department in a rapidly changing industry;
- Benefit from the most updated industry and geographic market information;
- Access cutting-edge search technology software; and
- Maintain management focus on core strategic business issues.

Key role of Advanced Technology At Korn/Ferry we are adding more quality, regimen and scientific research into the recruitment process with emphasis shifting from candidate identification to candidate assessment and placement. Driving this initiative is enhanced technology, as the world of the Internet, search engines and databases makes it possible to identify greater numbers of qualified candidates. Innovative technology, when combined with world-class intellectual property and thought leadership, creates a compelling set of tools to manage the process of identifying, recruiting and assessing the most desirable candidates.

Expanding our Market Reach and Presence through Technology and Assessment Solutions

Information technology has become a critical element of the recruitment business. We have made significant investments in developing a state-of-the-art technology infrastructure, including a worldwide network and our proprietary executive recruitment software, *e-Korn/Ferry*. In fiscal 2007, we continued to invest in enhanced tools and information sharing for competitive advantage. We introduced the *Mobile Searcher* program enabling our search partners to access our proprietary candidate and customer database via mobile PDA devices. This is the initial phase of a two-year plan to significantly upgrade our search technology platform to improve the scope and quality of our database. The new *Searcher* will feature advanced tools for importing data from diverse sources, refining and filtering the data, and transforming the data using reporting tools and business analytics.

As Futurestep continued its growth through RPO, project recruitment, interim solutions and mid-level search, information technology helped fuel all of these lines of business. Fiscal 2007 saw the successful launch of a new global website for Futurestep, with enhanced graphics, client-facing content and streamlined candidate registration. We also created a suite of RPO reporting options including cycle metrics, dashboard analytics, recruitment activity, and productivity metrics.

Leadership Development Solutions (LDS) also received significant upgrades to its management assessment technology and its talent management platform, *Executive Center*. Usage of *Search Assessment*, an assessment technology process for our core search business, increased from 34% to 45% of all search engagements. We continue to refine our technology, including the integration of Lominger intellectual property into our exclusive executive assessment tools, in order to engage with our clients on their broader talent management needs.

Middle-Management Recruitment: The middle-management recruitment market focuses on searches for middle and lower management positions with annual compensation generally in the $100,000 to $150,000 range. This market has been fundamentally transformed over the past several years through the emergence of RPO

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services. This transformation has been further driven through database technology and the Internet, which have introduced greatly improved capabilities in identifying, targeting and reaching potential candidates.

Other Industry Trends In addition to the industry trends mentioned above, we believe the following factors will also contribute to the growth of the talent management industry:

- Increasing demand for managers with broader qualifications;
- Increasing desire by candidates to more actively manage their careers;
- Increasing demand for senior executives who can exceed the high standards of due diligence and public scrutiny as a result of new securities legislation;
- Decreasing executive management tenure and more frequent job changes; and
- Inadequate succession planning.

Growth Strategy

Our objective is to expand our position as a premier global provider of talent management solutions. The principal elements of our strategy include:

Recruiting and Retaining Key Consultants

In an ongoing strategic effort to promote the Company as the leading career destination, we successfully recruited 94 new consultants globally during fiscal 2007. These consultants originated from diverse backgrounds and areas of expertise, and were recruited based on their track records as top performers in their given industry. The number of new consultants in the current year was partially offset by attrition. We believe that we have continued to upgrade our professional staff in the current year, and that the recruitment and retention of key consultants will be an ongoing driver of growth.

Broadening our Product and Service Offerings

In addition to our heritage as a leading provider of executive recruitment, we also offer clients outsourced recruiting, mid-level search, project recruitment, interim solutions, strategic management assessment, executive coaching and development ,and compensation consulting through Futurestep and LDS. We will continue to develop and add new products and services that our clients demand and that are consistent with our brand positioning.

Global Account Management

In an effort to better coordinate global recruiting and to gain operational efficiencies, we expect that multinational clients increasingly will turn to strategic partners who can manage their recruitment needs on a centralized basis. This will require vendors with a global network of offices and technological support systems to manage multiple hires across geographical regions. Our global account management program, Integrated Services, continues to identify account leaders for multinational clients, provide training and software support to manage such accounts, and develop guidelines and protocols to support and increase the rate of cross-border assignments for these clients.

Expanding our Market Reach and Presence through Technology and Assessment Solutions

Information technology has become a critical element to the recruitment business. We have made significant investments in developing a state-of-the-art technology infrastructure, including a worldwide network and our

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proprietary executive recruitment software, *e-Korn/Ferry*. In fiscal 2007, we continued such investments through the deployment of enhanced tools and information sharing for competitive advantage. We rolled out major upgrades of our proprietary candidate database and global engagement management system, while laying the groundwork for the next generation search tool, *K/F One*. We embarked on a similar program to upgrade Futurestep s technology, introducing workflow and reporting enhancements in support of Futurestep s outsourced recruiting offering. Leadership Development Solutions also received significant upgrades to its strategic management assessment technology and its talent management platform, *Executive Center*. Another unique differentiator is *Search Assessment*, a proprietary matching tool that uses an online assessment methodology to match candidates against statistically validated best-in-class profiles. We will continue to refine our technology, including our exclusive candidate assessment tools, in order to strengthen our relationships with our existing clients, attract new clients, expand into new markets and position ourselves to gain a competitive advantage in marketing complementary services.

Leveraging our Leadership and Brand Name in Executive Recruitment

We believe that there are significant opportunities to extend our market share and develop new client relationships by aggressively marketing our global recruitment expertise. Our leadership in executive recruitment enables us to grow our business by increasing the number of recruitment assignments we handle for existing clients. We also believe that our strong relationships and well-recognized brand name will enable us to introduce new services to our existing client base and to potential new clients, while allowing us to build communities of candidates to whom we can directly market our services.

Our Services and Organization

We address the global recruitment needs of our clients at all levels of management by offering the following services:

Executive Recruitment Services

Overview. Our executive recruitment services are typically used to fill executive-level positions, such as board directors, chief executive officers, chief financial officers, chief operating officers, chief information officers and other senior executive officers. Once we are retained by a client to conduct a search, we assemble a team comprised of consultants with appropriate geographic, industry and functional expertise. Our search consultants serve as management advisors who work closely with the client in identifying, assessing and placing qualified candidates. In fiscal 2007, we executed more than 9,600 executive recruitment assignments.

We utilize a search methodology that has been developed through nearly 38 years of experience in conducting executive recruitment. We emphasize a close working relationship with the client and a comprehensive understanding of the client s business issues, strategy and culture, as well as an in-depth knowledge of the skills necessary to succeed within a client s organization. Initially, the search team consults with the client to better understand its history, culture, structure, expectations, challenges, future direction and operations. In these meetings, the team identifies the specific needs of the client and develops a profile of an ideal candidate for the position. Early in the process, the team also works with the client to develop the general parameters of a compensation package that will attract highly qualified candidates.

Once the position is defined, a research team identifies through the use of our proprietary databases and other information resources companies in related industries facing similar issues and with operating characteristics similar to those of the client. In addition, the team consults with its established network of resources and with our databases containing profiles of approximately 3.5 million executives to assist in identifying individuals with the right background, cultural fit and abilities. These sources are a critical element in assessing the marketplace. The original list of candidates is carefully screened through phone interviews, video

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conferences and in-person meetings. The client is then presented final qualified candidates to interview. We conduct thorough due diligence and background verification of the candidate throughout the process, at times with the assistance of an independent third party.

The finalist for the position will usually meet with the client for a second and possibly a third round of discussions. At this point, the compensation package will have been discussed in detail, increasing the likelihood that an offer will be accepted. Generally, the search consultants will participate in the negotiations until a final offer is made and accepted. Throughout the process, ongoing communication with the client is critical to keep client management apprised of progress.

Industry Specialization Consultants in our five global markets and two regional specialty practice groups bring an in-depth understanding of the market conditions and strategic management issues faced by clients within their specific industry and geography. We are continually looking to expand our specialized expertise through internal development and strategic hiring in targeted growth areas.

Percentage of Fiscal 2007 Assignments by Industry Specialization

Global Markets:	
Industrial	26%
Consumer	18%
Financial Services	20%
Technology	17%
Life Sciences	10%
Regional Specialties:	
Healthcare Provider	4%
Education/Not-for-profit	5%

Functional Expertise. We have organized executive recruitment centers of functional expertise, composed of consultants who have extensive backgrounds in placing executives in certain functions, such as board directors, chief executive officers and other senior executive officers. Our Board Services practice, for example, was first established in 1972 to help clients assemble an effective, knowledgeable and cohesive board of directors to meet the growing demands of accountability and facilitate more effective board performance. The shortage of experienced directors, the tightening of governance policies and the desire of companies to broaden the expertise of their board are raising the standards by which we identify and recruit qualified directors. We have significant expertise in this area and have built a proprietary database with the names and backgrounds of every FORTUNE 1000 director, plus a significant number of middle-market and high-growth company board members to assist in board searches. Members of functional groups are located throughout our regions and across our industry groups.

Percentage of Fiscal 2007 Assignments by Functional Expertise

Board Level/CEO/CFO/Senior Executive and General Management	55%
Marketing and Sales	16%
Human Resources and Administration	9%
Manufacturing/Engineering/Research and Development/Technology	9%
Finance and Control	8%
Information Systems	3%

Regions

North America We opened our first office in Los Angeles in 1969, and currently have 25 offices throughout the United States and Canada. In fiscal 2007, the region generated fee revenue of $329.1 million from more than 3,900 assignments billed, with an average of 233 consultants.

Europe, the Middle East and Africa (EMEA) We opened our first European office in London in 1972, and currently have 22 offices in 20 countries throughout the region. In fiscal 2007, fee revenue was $146.2 million from more than 3,000 assignments billed, with an average of 133 consultants.

Asia Pacific We opened our first Asia Pacific office in Tokyo in 1973, and currently have 14 offices in 10 countries throughout the region. In fiscal 2007, fee revenue was $75.0 million from more than 1,800 assignments billed, with an average of 77 consultants.

Latin America We opened our first Latin American office in Brazil in 1974. We expanded our practice to Mexico through the 1977 acquisition of a less than 50% interest in a Mexico City company, and currently conduct operations in Mexico through subsidiaries in which we hold a minority interest. As of April 30, 2007, we operate a network of seven offices in six countries covering the entire South American region and two offices in Mexico. The region, excluding operations in Mexico, generated fee revenue of $17.4 million in fiscal 2007. We handled more than 700 assignments billed in fiscal 2007 in this region, with an average of 22 consultants. Our share of the operating income from our Mexico subsidiaries was $3.2 million and $2.0 million for the years ended April 20, 2007 and 2006, respectively, and is included in equity in earnings of unconsolidated subsidiaries on the consolidated statements of income.

Client Base. Our 4,742 clients include many of the world s largest and most prestigious public and private companies, including 43% of the FORTUNE 500 companies in the current fiscal year. In fiscal 2007, no single client represented more than 2% of fee revenue. We have established strong client loyalty. More than 84% of the executive recruitment assignments we performed during the last three fiscal years were on behalf of clients for whom we had conducted multiple assignments.

Competition. We are a premier global provider of talent management solutions. Other multinational executive recruitment firms include Egon Zehnder International, Heidrick & Struggles International, Inc., Russell Reynolds Associates and Spencer Stuart. Although these firms are our primary competitors, we also compete with smaller boutique firms that specialize in specific regional, industry or functional searches. We believe our brand name, multi-product offerings, cutting-edge technology, global network, prestigious clientele, strong specialty practices and quality of services are recognized worldwide. We also believe that our long-term incentive compensation arrangements, as well as other executive benefits, distinguish us from most of our competitors and are important in attracting and retaining our key consultants.

Leadership Development Solutions. In 2004, we consolidated our strategic management assessment and executive coaching and development services under the name Leadership Development Solutions, with services in EMEA, North and South America, Australia and Japan. In 2007, we continued our investment in this service area with the acquisition of Lominger Limited, Inc. and Lominger Consulting (the Lominger Entities). This comprehensive blend of leadership services helps corporate leaders to evaluate the individual and collective performance of their teams. These solutions further extend the range of talent management solutions available to our clients, and are valuable tools for the chief executive, board of directors and other senior officers in pursuing organizational transformation and alignment with their company s strategic goals and internal values.

Our strategic management assessment offering was introduced in response to our clients demand for a tool to address the challenges of changing company relationships and global restructuring and, for venture capital and private equity firms, to evaluate the leadership team in existing or prospective portfolio companies. This process is performed by consultants with extensive experience in interviewing and evaluating senior executives, who understand local cultural differences and the relevant business and industry challenges. The assessment process is backed by a statistically validated and proprietary assessment instrument developed by leading assessment experts and supported by a proprietary systems platform.

Another crucial component of our Leadership Development Solutions is executive coaching and development. Our global network of highly-skilled coaches is certified at developing future leaders through

individual and team-based coaching. Additionally, we offer clients a Web-based, highly customizable talent management platform. Called *Executive Center*, it automates and streamlines the traditionally cumbersome process of setting objectives and tracking and evaluating performance. Through *Executive Center* s individual and team-based analysis and reporting capabilities, talent assessment and management can be greatly simplified, allowing for skills and experience gaps as well as succession planning to be more efficiently addressed.

During fiscal 2007, our Leadership Development Solutions group acquired both the Lominger Entities and LeaderSource Ltd. These acquisitions provided us with an even stronger suite of experience-tested, research-based development tools and consulting processes.

Middle-Management Recruitment Services

Overview. Futurestep offers clients a portfolio of recruitment solutions, including recruitment process outsourcing (RPO), mid-level search, project recruitment and interim solutions. Each Futurestep service benefits from the in-depth industry and functional expertise of our global consultant network, ensuring that clients work with professionals who understand their business and have the relevant knowledge to qualify candidates effectively.

Futurestep combines traditional search expertise with a multi-tiered portfolio of recruitment solutions. Futurestep consultants, based in 16 countries, have instant access to one of the world s largest databases of pre-screened middle-management professionals. Our global candidate pool complements our international presence and multi-channel sourcing strategy to ensure speed, efficiency and quality service for clients worldwide.

A fully integrated, measurable, single-source RPO solution leverages Futurestep s recruitment capabilities, innovative technology and international brand to reduce clients recruitment costs while also improving quality and attracting the best talent. Futurestep manages part of all of the client s recruitment function, often including on-site consultants from Futurestep.

Futurestep s mid-level search uses multiple sourcing channels, validated cultural assessments and a global database of more than one million pre-screened professionals to offer a low overhead approach that accelerates the recruitment process and provides a diverse, qualified set of mid-level candidates matched with specific cultural and strategic requirements.

For multiple hiring projects, Futurestep consultants utilize proprietary Enterprise Recruitment Methodology to deliver seamless, workflow-driven talent acquisition strategies to organizations. Prior to deployment, Futurestep diagnoses the client s internal HR capabilities to develop a co-sourcing platform emphasizing shared ownership of the recruitment process. Once engaged, the project team adheres to a tightly integrated timeline and metrics to deliver high-volume, concurrent hiring without sacrificing quality.

For clients needing professionals on a short-term basis, Futurestep offers an interim solutions service that delivers direct access to highly qualified mid-management professionals, fulfilling an organization s critical needs for a temporary and flexible workforce. Whether the client needs a mid-level position filled on a monthly or yearly basis, Futurestep draws interim executives from one of the world s largest talent pools of pre-screened, mid-level professionals in the industry.

Regions. We opened our first Futurestep office in Los Angeles in May 1998. In January 2000, we acquired the ESS business of PA Consulting with operations in Europe and Asia Pacific. As of April 30, 2007, we had Futurestep operations in 12 cities in North America, nine in Europe and 10 in Asia Pacific.

Competition. Futurestep primarily competes for assignments with contingency staffing firms, temporary staffing firms and recruitment process outsourcers who do not operate at the middle-management level or offer Futurestep s full suite of solutions.

To a lesser extent, Futurestep competes with firms such as Monster Worldwide in the technology-based middle-management recruitment industry. Although technology-oriented companies may be drawn to the recruitment business by the opportunity to leverage their existing technology, lack of a recognized brand name, global footprint or experienced consultants present significant barriers to entry.

Organization

Our executive recruitment business is managed on a geographic basis throughout our four regions: North America; South America; EMEA; and Asia Pacific. Futurestep is managed on a worldwide basis with operations in North America, Europe and Asia Pacific.

Professional Staff and Employees

As of April 30, 2007, we had approximately 1,705 executive recruitment employees consisting of 490 consultants and 1,215 associates, researchers, administrative and support staff. In addition, we had 15 consultants in our two unconsolidated Mexico offices. Futurestep had 508 employees as of April 30, 2007, consisting of 111 consultants and 397 administrative and support staff. Corporate had 48 professionals at April 30, 2007. We have not been a party to a collective bargaining agreement and consider our relations with our employees to be good. Korn/Ferry is an equal opportunity employer.

In executive search, senior associates, associates and researchers support the efforts of our consultants with candidate sourcing and identification, but do not generally lead assignments. We have extensive training and professional development programs. Promotion to senior client partner is based on a variety of factors, including demonstrated superior execution and business development skills, the ability to identify solutions to complex issues, personal and professional ethics, a thorough understanding of the market and the ability to develop and help build effective teams. In addition, we have a program for recruiting experienced professionals into our firm.

The following table provides information relating to each of our business segments for fiscal 2007:

	Fee Revenue	Operating Income (Loss)	Number of Offices as of April 30, 2007	Number of Consultants as of April 30, 2007
	(dollars in thousands)			
Executive Recruitment:				
North America	$ 329,065	$ 69,815	25	240
EMEA	146,155	24,166	22	142
Asia Pacific	74,987	16,010	14	86
South America	17,426	1,894	8	22
Total Executive Recruitment	567,633	111,885	69	490
Futurestep(1)	85,789	7,854	13	111
Corporate		(37,484)		
Total	$ 653,422	$ 82,255	82	601

(1) Futurestep partially occupies 18 of the executive recruitment offices globally in 11 countries.

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The following table provides information on fee revenues for each of the last three fiscal years attributable to the United States and other geographical regions in which the Company operates for fiscal:

	Fiscal Year Ending April 30,		
	2007	2006	2005
	(dollars in thousands)		
Fee Revenue:			
United States	$ 324,349	$ 260,988	$ 230,145
Canada	35,559	26,432	17,468
EMEA	179,974	147,329	131,956
Asia Pacific	96,114	72,473	61,797
South America	17,426	15,660	10,828
Total	$ 653,422	$ 522,882	$ 452,194

Item 1A. ***Risk Factors***

The risks described below are the material risks facing our Company. Additional risks not presently known to us or that we currently deem immaterial may also impair our business operations. Our business, financial condition or results of operations could be materially adversely affected by any of these risks.

Competition in our industry could result in our losing market share and charging lower prices for services, which could reduce our revenue.

We compete for executive search business with numerous executive search firms and businesses that provide job placement services. Traditional executive search competitors include Egon Zehnder International, Heidrick & Struggles International, Inc., Russell Reynolds Associates and Spencer Stuart. In each of our markets, our competitors may possess greater resources, greater name recognition and longer operating histories than we do, which may give them an advantage in obtaining future clients and attracting qualified professionals in these markets. There are no extensive barriers to entry into the executive search industry, and new recruiting firms continue to enter the market. We believe the continuing development and increased availability of information technology will continue to attract new competitors. Increased competition may lead to pricing pressures that could negatively impact our business.

If we fail to attract and retain qualified and experienced consultants, our revenue could decline and our business could be harmed.

We compete with other executive search firms for qualified consultants. Attracting and retaining consultants in our industry is particularly important because, generally, a small number of consultants have primary responsibility for a client relationship. Because client responsibility is so concentrated, the loss of key consultants may lead to the loss of client relationships. This risk is heightened due to the general portability of a consultant s business. Any decrease in the quality of our reputation, reduction in our compensation levels or restructuring of our compensation program, whether as a result of insufficient revenue, a decline in the market price of our common stock or for any other reason, could impair our ability to retain existing consultants or attract additional qualified consultants with the requisite experience, skills and established client relationships. Our failure to retain our most productive consultants or maintain the quality of service to which our clients are accustomed and the ability of a departing consultant to move business to his or her new employer could result in a loss of clients and harm our business.

Economic conditions in the geographic regions and the industries from which we derive a significant portion of our fee revenue could undermine our future profitability.

Demand for our services is significantly affected by the general level of economic activity in the geographic regions and industries in which we operate. When economic activity slows, many companies hire fewer

permanent employees. Any significant economic downturn, on a global basis, in North America, or in other regions or industries where our operations are heavily concentrated, could harm our business, results of operations and financial condition.

If we are unable to retain our executive officers and key personnel, or integrate new members of our senior management who are critical to our business, we may not be able to successfully manage our business in the future.

Our future success depends upon the continued service of our executive officers and other key management personnel. If we lose the services of one or more of our executives or key employees, or if one or more of them decides to join a competitor or otherwise compete directly or indirectly with us, we may not be able to successfully manage our business or achieve our business objectives.

If we are unable to maintain our professional reputation and brand name, our business will be harmed.

We depend on our overall reputation and brand name recognition to secure new engagements and to hire qualified professionals. Our success also depends on the individual reputations of our professionals. We obtain a majority of our new engagements from existing clients or from referral by those clients. Any client who is dissatisfied with our assignments can adversely affect our ability to secure new engagements.

If any factor, including poor performance, hurts our reputation, we may experience difficulties in competing successfully for both new engagements and qualified consultants. Failing to maintain our professional reputation and the goodwill associated with our brand name could seriously harm our business.

We are subject to potential legal liability from clients, employees and candidates. Insurance coverage may not be available to cover all of our potential liability and available coverage may not be sufficient to cover all claims that we may incur.

Our ability to obtain liability insurance, its coverage levels, deductibles and premiums are all dependent on market factors, our loss history and insurers perception of our overall risk profile. We are exposed to potential claims with respect to the executive search process. A client could assert a claim for matters such as breach of an off-limit agreement or recommending a candidate who subsequently proves to be unsuitable for the position filled. Further, the current employer of a candidate whom we placed could file a claim against us alleging interference with an employment contract. In addition, a candidate could assert an action against us for failure to maintain the confidentiality of the candidate s employment search or for alleged discrimination, violations of employment law or other matters. We cannot ensure that our insurance will cover all claims or that insurance coverage will be available at economically acceptable rates.

We rely heavily on our information systems and if we lose that technology, or fail to further develop our technology, our business could be harmed.

Our success depends in large part upon our ability to store, retrieve, process and manage substantial amounts of information. To achieve our strategic objectives and to remain competitive, we must continue to develop and enhance our information systems. This may require the acquisition of equipment and software and the development of new proprietary software, either internally or through independent consultants. If we are unable to design, develop, implement and utilize, in a cost-effective manner, information systems that provide the capabilities necessary for us to compete effectively, or for any reason any interruption or loss of our information processing capabilities occurs, this could harm our business, results of operations and financial condition.

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We face risks associated with political instability, legal requirements and currency fluctuations in our international operations.

We operate in 39 countries and, as of April 30, 2007, generated nearly half our fee revenue from operations outside of North America. There are certain risks inherent in transacting business worldwide, such as:

- changes in and compliance with applicable laws and regulatory requirements;
- difficulties in staffing and managing global operations;
- social and political instability;
- fluctuations in currency exchange rates;
- statutory equity requirements;
- repatriation controls; and
- potential adverse tax consequences.

We have no hedging or similar foreign currency contracts, and therefore fluctuations in the value of foreign currencies could impact our global operations. We cannot ensure that one or more of these factors will not harm our business, financial condition or results of operations.

We may be limited in our ability to recruit employees from our clients and we could lose those opportunities to our competition, which could harm our business.

Either by agreement with clients, or for client relations or marketing purposes, we sometimes refrain from, for a specified period of time, recruiting employees from a client when conducting searches on behalf of other clients. These off-limit agreements can generally remain in effect for up to two years following completion of an assignment. The duration and scope of the off-limit agreement, including whether it covers all operations of the client and its affiliates or only certain divisions of a client, generally are subject to negotiation or internal policies and may depend on factors such as the scope, size and complexity of the client s business, the length of the client relationship and the frequency with which we have been engaged to perform executive searches for the client. Our inability to recruit employees from these clients may make it difficult for us to obtain search assignments from, or to fulfill search assignments for, other companies in that client s industry. We cannot ensure that off-limit agreements will not impede our growth or our ability to attract and serve new clients, or otherwise harm our business.

We have provisions that make an acquisition of us more difficult and expensive.

Antitakeover provisions in our Certificate of Incorporation, our Bylaws and under Delaware law make it more difficult and expensive for us to be acquired in a transaction that is not approved by our Board of Directors. Some of the provisions in our Certificate of Incorporation and Bylaws include:

- a classified Board of Directors;
- limitations on the removal of directors;

- limitation on stockholder actions;
- advance notification requirements for director nominations and actions to be taken at stockholder meetings; and
- the ability to issue one or more series of preferred stock by action of our Board of Directors.

These provisions could discourage an acquisition attempt or other transaction in which stockholders could receive a premium over the current market price for the common stock.

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Item 1B. ***Unresolved Staff Comments***
Not applicable.

Item 2. ***Properties***
Our corporate office is located in Los Angeles, California. We lease all 82 of our executive recruitment and Futurestep offices located in North America, EMEA, Asia Pacific and South America. As of April 30, 2007, we leased an aggregate of approximately 734,000 square feet of office space. The leases generally are for terms of one to 12 years and contain customary terms and conditions. We believe that our facilities are adequate for our current needs and we do not anticipate any difficulty replacing such facilities or locating additional facilities to accommodate any future growth.

Item 3. ***Legal Proceedings***
From time to time, we are involved in litigation both as plaintiff and defendant, relating to claims arising out of our operations. As of the date of this report, we are not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or results of operations.

Item 4. ***Submission of Matters to a Vote of Security Holders***
No matters were submitted to a vote of security holders during the fourth quarter of fiscal 2007.

Executive Officers of the Registrant

Name	Age	Position
Paul C. Reilly	53	Chairman of the Board and Chief Executive Officer
Gary D. Burnison	46	Executive Vice President, Chief Operating Officer, Chief Financial Officer and Director
Gary C. Hourihan	58	Executive Vice President and President, Leadership Development Solutions
Robert H. McNabb	60	Chief Executive Officer for Korn/Ferry International Futurestep, Inc. and Executive Vice President, Korn/Ferry International

Our executive officers serve at the discretion of our Board of Directors. There is no family relationship between any executive officer or director. The following information sets forth the business experience for at least the past five years for each of our executive officers as of April 30, 2007.

Paul C. Reilly has been Chairman of the Board and Chief Executive Officer since June 2001. Prior to joining Korn/Ferry International, Mr. Reilly was with KPMG International, where he most recently served as Chief Executive Officer. Mr. Reilly joined KPMG LLP in 1987.

Gary D. Burnison has been Executive Vice President and Chief Financial Officer since March 2002, was appointed Chief Operating Officer in November 2003 and was elected to the Board of Directors in June 2007. Prior to joining Korn/Ferry International, Mr. Burnison was Principal and Chief Financial Officer of Guidance Solutions, a privately held consulting firm, from 1999 to 2001. Prior to that, he served as an executive officer and a member of the board of directors of Jefferies and Company, an investment bank and brokerage firm, from 1995 to 1999. Earlier, Mr. Burnison was a partner at KPMG Peat Marwick.

Gary C. Hourihan has been Executive Vice President since January 1999 and was appointed President of Leadership Development Solutions for Korn/Ferry International, responsible for overseeing global operations

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and strategy for our Leadership Development Solutions business in November 2002. Prior to joining Korn/Ferry International, he was the co-founder, Chairman and Chief Executive Officer of SCA Consulting, one of the world s leading executive compensation consulting firms, where he was employed from 1984 until joining Korn/Ferry International.

Robert H. McNabb has been Executive Vice President of Korn/Ferry International since November 2003 and was appointed Chief Executive Officer for Futurestep in July 2002. Prior to becoming the Chief Executive Officer for Futurestep, he was President of the Futurestep Americas and Asia Pacific regions. Before joining Futurestep in December 2001, he was the President and Chief Executive Officer of Corestaff from 1998 to 2001 and President and Chief Operating Officer at Republic Industries in 1997.

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PART II.

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Common Stock

Our common stock is listed on the New York Stock Exchange under the symbol KFY. The following table sets forth the high and low sales price per share of the common stock for the periods indicated, as reported on the New York Stock Exchange:

	High	Low
Fiscal Year Ended April 30, 2007		
First Quarter	$ 21.59	$ 17.73
Second Quarter	$ 23.18	$ 17.83
Third Quarter	$ 24.18	$ 21.51
Fourth Quarter	$ 24.86	$ 22.42
Fiscal Year Ended April 30, 2006		
First Quarter	$ 20.00	$ 14.05
Second Quarter	$ 19.94	$ 14.30
Third Quarter	$ 19.85	$ 16.74
Fourth Quarter	$ 21.45	$ 19.07

On June 27, 2007 the last reported sales price on the New York Stock Exchange for the common stock was $26.70 per share and there were approximately 5,300 beneficial holders of the common stock.

Performance Graph

We have presented below a graph comparing the cumulative total stockholder return on the Company s shares with the cumulative total stockholder return on (1) a broad equity market index and (2) a published industry index or a company-established peer group. The following graph compares the monthly percentage change in the Company s cumulative total stockholder return with the cumulative total return of the companies in the Standard & Poor s 500 Stock Index and a peer group constructed by us. Cumulative total return for each of the periods shown in the performance graph is measured assuming an initial investment of $100 on April 30, 2002, and the reinvestment of any dividends paid by any company in the peer group on the date the dividends were declared.

The peer group is comprised of publicly traded companies, which are engaged principally or in significant part in professional staffing and consulting. The returns of each company have been weighted according to their respective stock market capitalization at the beginning of each measurement period for purposes of arriving at a peer group average. The members of the peer group are Caldwell Partners International Inc. (CWL/A CN), Heidrick & Struggles International, Inc. (HSII) and Hudson Highland Group (HHGP).

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The stock price performance depicted in this graph is not necessarily indicative of future price performance. This graph will not be deemed to be incorporated by reference by any general statement incorporating this Form 10-K into any filing by us under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate this information by reference, and shall not otherwise be deemed soliciting material or deemed filed under those Acts.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

AMONG KORN/FERRY INTERNATIONAL, THE S & P 500 INDEX

AND A PEER GROUP

* $100 invested on 4/30/02 in stock or index-including reinvestment of dividends. Fiscal year ending April 30.

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www.researchdatagroup.com/S&P.htm

Dividends

We have not paid any cash dividends on our common stock since April 30, 1996 and do not currently intend to pay any cash dividends on our common stock in the foreseeable future. The Board of Directors has authorized the Company to repurchase up to $125 million of the Company s outstanding shares of common stock pursuant to issuer repurchase programs. We have repurchased approximately $75 million of the Company s common stock as of April 30, 2007 under these programs. Future dividend policy as well as decisions to execute our currently outstanding issuer repurchase programs will depend on our earnings, capital requirements, financial condition and other factors considered relevant by our Board of Directors. Our credit facility does not restrict our ability to pay dividends.

Recent Sales of Unregistered Securities

On June 13, 2005, Friedman, Fleischer & Lowe (FFL) entered into a forward sale contract with Credit Suisse First Boston LLC (CSFB) to sell FFL s remaining portion of the Company s convertible securities.

On March 7, 2007, the Company issued notice for the redemption (the Redemption Notice) of its 7.5% Convertible Subordinated Notes (the Convertible Notes) in an aggregate principal amount of $40 million and

its 7.5% Convertible Series A Preferred Stock (the Convertible Preferred Stock) in an aggregate principle price of $10 million. As of March 7, 2007, $45.6 million of the Convertible Notes and $11.4 million of the Convertible Preferred Stock was outstanding. In response to the Redemption Notice, the beneficial owner of the Convertible Notes and the Convertible Preferred Stock exercised its option to convert (the Conversion) the Convertible Notes and the Convertible Preferred Stock, pursuant to the terms thereof, which were convertible into shares of the Company s common stock at $10.19 per share. The Conversion resulted in 5,586,187 shares of the Company s common stock being delivered to the holder of the convertible securities in April 2007.

The issuance of the shares of the Company s common stock into which the Convertible Notes and the Convertible Preferred Stock were converted was exempt from the registration provisions of the Securities Act of 1933, as amended, by virtue of the exemption afforded by Section 3(a)(9) thereof. Such determination was based upon the fact that the securities exchanged in connection with the Conversion were made by the Company with its existing security holders exclusively, the then beneficial owners of the Convertible Notes and Convertible Preferred Stock, and no commission or other remuneration was paid of given directly or indirectly for soliciting such exchange.

Issuer Purchases of Equity Securities

During the twelve months ended April 30, 2007, the Company repurchased common stock under the common stock repurchase programs approved by the Board of Directors in December 2005, June 2006, and March 2007. Pursuant to these programs, shares can be repurchased in open market transactions or privately negotiated transactions at the Company s discretion.

The following table summarizes common stocks repurchased during the three months of the last quarter of fiscal 2007:

	Shares Purchased	Average Price Paid Per Share	Shares Purchased as Part of a Publicly-Announced Program (1), (2), and (3)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program (1), (2), and (3)
February 1, 2007-February 28, 2007	194,600	$ 23.60	194,600	$ 77.3 million
March 1, 2007-March 31, 2007	927,465	$ 22.86	922,000	$ 56.2 million
April 1, 2007-April 30, 2007	253,825	$ 23.20	250,250	$ 50.4 million
Total	1,375,890		1,366,850	

(1) On December 7, 2005, the Board of Directors approved the repurchase of up to $50 million of the Company s common stock in a common stock repurchase program (the 2005 program). The shares can be repurchased in open market transactions or privately negotiated transactions at the Company s discretion.
(2) On June 8, 2006 the Board of Directors approved the repurchase of a further $25 million of the Company s common stock in a common stock repurchase program (the 2006 program).
(3) On March 6, 2007, the Board of Directors approved the repurchase of an additional $50 million of the Company s common stock in a common stock repurchase program (the 2007 program).

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Item 6. *Selected Financial Data*

The following selected financial data are qualified by reference to, and should be read together with, our Audited Consolidated Financial Statements and Related Notes and Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this Annual Report on Form 10-K. The selected statement of operations data set forth below for the fiscal years ended April 30, 2007, 2006 and 2005 and the selected balance sheet data as of April 30, 2007 and 2006 are derived from our consolidated financial statements, audited by Ernst & Young LLP appearing elsewhere in this Form 10-K. The selected balance sheet data as of April 30, 2005, 2004 and 2003 and the selected statement of operations data set forth below for the fiscal years ended April 30, 2004 and 2003 are derived from consolidated financial statements and notes thereto which are not included in this Form 10-K report and were audited by Ernst & Young LLP.

	Fiscal Year Ended April 30,				
	2007	2006	2005	2004	2003
	(in thousands, except per share and other operating data)				
Selected Statement of Operations Data:					
Fee revenue	$ 653,422	$ 522,882	$ 452,194	$ 328,331	$ 315,112
Reimbursed out-of-pocket engagement expenses	35,779	28,887	24,183	22,372	23,354
Total revenue	689,201	551,769	476,377	350,703	338,466
Compensation and benefits	447,692	341,196	292,913	221,177	223,192
General and administrative expenses	105,312	93,462	83,544	71,623	73,107
Out-of-pocket engagement expenses	44,662	31,927	25,702	23,557	23,029
Depreciation and amortization	9,280	9,002	8,437	10,030	16,161
Asset impairment and restructuring charges (1)				8,526	16,281
Total operating expenses	606,946	475,587	410,596	334,913	351,770
Operating income (loss)	82,255	76,182	65,781	15,790	(13,304)
Interest and other income, net	10,416	11,086	3,360	1,779	1,189
Interest expense	10,172	10,244	10,463	9,903	10,522
Provision for income taxes	30,164	19,594	20,251	3,218	2,040
Equity in earnings of unconsolidated subsidiaries	3,163	2,000	193	955	1,775
Net income (loss)	$ 55,498	$ 59,430	$ 38,620	$ 5,403	$ (22,902)
Basic earnings (loss) per share	$ 1.40	$ 1.49	$ 1.00	$ 0.14	$ (0.63)
Diluted earnings (loss) per share	$ 1.24	$ 1.32	$ 0.90	$ 0.13	$ (0.63)
Basic weighted average common shares outstanding	39,774	39,890	38,516	37,466	37,576
Diluted weighted average common shares outstanding	46,938	47,270	46,229	40,311	37,576
Other Data:					
Fee revenue by business segment:					
Executive recruitment:					
North America	$ 329,065	$ 259,089	$ 225,850	$ 170,678	$ 162,309
EMEA	146,155	120,059	110,455	78,236	78,990
Asia Pacific	74,987	57,922	51,196	36,818	33,523
South America	17,426	15,660	10,828	8,371	7,616
Total executive recruitment	567,633	452,730	398,329	294,103	282,438
Futurestep	85,789	70,152	53,865	34,228	32,674
Total fee revenue	$ 653,422	$ 522,882	$ 452,194	$ 328,331	$ 315,112
Number of offices (at period end)	82	72	70	69	75
Number of consultants (at period end)	601	507	474	443	487
Number of new engagements opened	10,415	9,608	8,062	6,606	6,792

Selected Balance Sheet Data as of April 30:					
Cash and cash equivalents	$ 289,106	$ 257,543	$ 199,133	$ 108,102	$ 82,685
Marketable securities	35,161	20,654	7,815		
Working capital	235,271	218,206	146,071	88,436	72,885
Total assets	761,491	635,491	534,168	398,012	369,493
Total long-term debt (2)		45,147	44,949	44,400	41,364
Mandatorily redeemable preferred stock (2)		10,989	10,795	10,512	9,606
Total shareholders equity	432,955	323,751	252,902	181,252	166,935

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(1) In response to deteriorating economic conditions encountered in the beginning of fiscal 2002, we developed a restructuring initiative designed to reduce our workforce by nearly 30%. Such initiatives included consolidating back office functions, exiting the college recruitment market, discontinuing the operations of JobDirect and writing down other related assets and goodwill. As a result of that initiative, we recognized $16.3 million of restructuring charges in fiscal 2003 comprised of (a) other asset impairments of $0.8 million, (b) severance restructuring charges of $5.3 million, (c) facilities restructuring charges of $11.8 million and (d) a $1.6 million gain recognized as a result of a litigation settlement. Additionally, in fiscal 2004, we recognized $8.5 million of restructuring charges comprised of (a) severance restructuring charges of $6.7 million and (b) facilities restructuring charges of $1.8 million.

(2) In the fourth quarter of fiscal 2007, we issued notice for the redemption of our 7.5% Convertible Series Subordinated Notes and 7.5% Convertible Series A Preferred Stock. In response, the holder of the notes and preferred stock exercised its option to convert the debt and preferred stock pursuant to the terms of the original agreements. The conversion resulted in approximately $5.6 million shares of our common stock being delivered to the debt and preferred stock holder in April 2007. As of April 30, 2007, we had no outstanding amounts related to these convertible securities. Conversion of debt is discussed in Item 7*, Long-Term Debt*.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Forward-looking Statements

This Annual Report on Form 10-K may contain certain statements that we believe are, or may be considered to be, forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally can be identified by use of statements that include phrases such as believe , expect , anticipate , intend , plan , foresee , may , will , estimates , potential , continue or other similar words or phrases. Similarly, statements that describe our objectives, plans or goals also are forward-looking statements. All of these forward-looking statements are subject to risks and uncertainties that could cause our actual results to differ materially from those contemplated by the relevant forward-looking statement. The principal risk factors that could cause actual performance and future actions to differ materially from the forward-looking statements include, but are not limited to, those set forth above under the caption, Risk Factors , including dependence on attracting and retaining qualified and experienced consultants, portability of client relationships, local political or economic developments in or affecting countries where we have operations, ability to manage growth, restrictions imposed by off-limits agreements, competition, reliance on information processing systems, and employment liability risk. Readers are urged to consider these factors carefully in evaluating the forward-looking statements. The forward-looking statements included in this Annual Report are made only as of the date of this Annual Report and we undertake no obligation to publicly update these forward-looking statements to reflect subsequent events or circumstances.

The following presentation of management s discussion and analysis of our financial condition and results of operations should be read together with our consolidated financial statements and related notes included in this Annual Report on Form 10-K.

Executive Summary

Korn/Ferry is a premier provider of talent management solutions. We are the largest provider of executive search, outsourced recruiting and leadership development solutions with the broadest global presence in the recruitment industry. Our services include executive recruitment, middle-management recruitment (through Futurestep), outsourced recruitment, leadership development solutions and executive coaching. Over half of the executive recruitment searches we performed in fiscal 2007 were for board level, chief executive and other senior executive and general management positions. Our 4,742 clients in fiscal 2007 included approximately 43% of the FORTUNE 500 companies. We have established strong client loyalty; more than 84% of the executive recruitment assignments we performed during the previous three fiscal years were on behalf of clients for whom we had conducted multiple assignments.

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In an effort to maintain our long-term vision of being the leading provider of executive search, outsourced recruiting and leadership development solutions, our strategic focus for fiscal 2008 will center upon increasing market share and further enhancing the cross-selling of our multi-product strategy. We will continue to address areas of increasing client demand, including Recruitment Process Outsourcing (RPO) and Leadership Development Solutions (LDS). We will explore new products and services, continue to pursue a disciplined acquisition strategy, enhance our technology and processes and aggressively leverage our brand through thought leadership and intellectual capital projects as a means of delivering world-class service to our clients.

Fee revenue increased 25% in fiscal year 2007 to $653.4 million with increases in all regions. The North American region experienced the largest dollar increase in fee revenue. In fiscal 2007, we earned an operating profit of $82.3 million with operating income from executive recruitment of $111.9 million and $7.9 million from Futurestep, offset by corporate expenses of $37.5 million. This represents an increase of 8% over the prior fiscal year s operating income of $76.2 million.

We had no long-term debt or outstanding balance under our credit facility at April 30, 2007. Our working capital increased $17.1 million to $235.3 million at April 30, 2007.

Critical Accounting Policies

The following discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements. Preparation of this Annual Report on Form 10-K requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results may differ from those estimates and assumptions. In preparing our financial statements and accounting for the underlying transactions and balances, we apply our accounting policies as disclosed in our notes to consolidated financial statements. We consider the policies discussed below as critical to an understanding of our financial statements because their application places the most significant demands on management s judgment. Specific risks for these critical accounting policies are described in the following paragraphs. Senior management has discussed the development and selection of the critical accounting estimates with the Audit Committee of the Board of Directors.

Revenue Recognition. Management is required to establish policies and procedures to ensure that revenue is recorded over the performance period for valid engagements and related costs are matched against such revenue. We provide recruitment services on a retained basis and generally bill clients in three monthly installments. Since the fees are generally 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. If these assumptions do not accurately reflect the period over which revenue is earned, revenue and profit could differ. Any services that are provided on a contingent basis are recognized once the contingency is fulfilled.

Deferred Compensation. Estimating deferred compensation requires assumptions regarding the timing and probability of payments of benefits to participants and the discount rate. Changes in these assumptions would significantly impact the liability and related cost on our balance sheet and statement of operations. Management engages an independent actuary to periodically review these assumptions in order to ensure that they reflect the population and economics of our deferred compensation plans in all material respects and to assist us in estimating our deferred compensation liability and the related cost. The actuarial assumptions we use may differ from actual results due to changing market conditions or changes in the participant population. These differences could have a significant impact on our deferred compensation liability and the related cost.

Carrying Values. Valuations are required under U.S. generally accepted accounting principles to determine the carrying value of various assets. Our most significant assets for which management is required to prepare valuations are goodwill, intangible assets and deferred income taxes. Management must identify whether

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events have occurred that may impact the carrying value of these assets and make assumptions regarding future events, such as profitability. Differences between the assumptions used to prepare these valuations and actual results could materially impact the carrying amount of these assets and our operating results.

Results of Operations

The following table summarizes the results of our operations as a percentage of fee revenue:

	Fiscal Year Ended April 30,		
	2007	**2006**	**2005**
Fee revenue	100%	100%	100%
Reimbursed out-of-pocket engagement expenses	5	6	5
Revenue	105	106	105
Compensation and benefits	68	65	65
General and administrative expenses	16	18	18
Out-of-pocket engagement expenses	7	6	6
Depreciation and amortization	1	2	2
Operating income	13	15	15
Net income	8%	11%	9%

The following tables summarize the results of our operations by business segment (dollars in thousands):

	Fiscal Year Ended April 30,					
	2007		**2006**		**2005**	
	Dollars	**%**	**Dollars**	**%**	**Dollars**	**%**
Fee revenue						
Executive recruitment:						
North America	$ 329,065	50%	$ 259,089	50%	$ 225,850	50%
EMEA	146,155	23	120,059	23	110,455	24
Asia Pacific	74,987	11	57,922	11	51,196	11
South America	17,426	3	15,660	3	10,828	3
Total executive recruitment	567,633	87	452,730	87	398,329	88
Futurestep	85,789	13	70,152	13	53,865	12
Total fee revenue	653,422	100%	522,882	100%	452,194	100%
Reimbursed out-of-pocket engagement expenses	35,779		28,887		24,183	
Total revenue	$ 689,201		$ 551,769		$ 476,377	

	Fiscal Year Ended April 30,					
	2007		**2006**		**2005**	
	Dollars	**Margin (1)**	**Dollars**	**Margin (1)**	**Dollars**	**Margin (1)**
Operating income (loss)						
Executive recruitment:						

North America	$ 69,815	21%	$ 62,124	24%	$ 53,635	24%
EMEA	24,166	17	22,361	19	19,531	18
Asia Pacific	16,010	21	13,374	23	9,594	19
South America	1,894	11	2,839	18	1,320	12
Total executive recruitment	111,885	2	100,698	22	84,080	21
Futurestep	7,854	9	3,351	5	6,483	12
Corporate	(37,484)		(27,867)		(24,782)	
Total operating income	$ 82,255	13%	$ 76,182	15%	$ 65,781	15%

(1) Margin calculated as a percentage of total fee revenue.

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Fiscal 2007 Compared to Fiscal 2006

Fee Revenue.

Fee revenue increased $130.5 million, or 25%, to $653.4 million in fiscal 2007 compared to $522.9 million in fiscal 2006. The improvement in fee revenue is attributable mainly to an 8% increase in the number of engagements billed within executive recruitment and an increase in average fees from all regions. The Lominger Entities contributed $11.9 million in revenues during fiscal 2007. Exchange rates favorably impacted fee revenues by $14.7 million in the current year.

Executive Recruitment Executive recruitment fee revenue increased $114.9 million, or 25%, due to an increase in the number of engagements billed, an increase in average fee and the Lominger acquisition. On a year-to-date basis, the number of executive recruitment engagements billed have increased by 8% as compared to last year.

North America fee revenue increased $70.0 million, or 27%, to $329.1 million primarily due to a 7% increase in the number of engagements billed as well as a 19% increase in average fees as compared to last year. The financial services, technology and industrial sectors were the primary contributors to the increase in fee revenues. An increased demand for the LDS products also resulted in a $6.3 million increase in fee revenues.

EMEA reported fee revenue of $146.2 million, an increase of $26.1 million, or 22%, compared to $120.1 million last year, which was driven by an 11% increase in the number of engagements billed and an increase in average fees of 10%. The performance in new offices in Denmark, Turkey and the Czech Republic and improved performance in existing offices in Germany, Belgium, Netherlands and the Middle East were the primary contributors to the increase in fee revenues. The financial services, industrial and technology sectors experienced strong growth over the prior year. Exchange rates favorably impacted EMEA fee revenue by $10.8 million in the current year.

Asia Pacific fee revenue increased $17.1 million, or 30%, to $75.0 million, compared to last year due to a 12% increase in the number of engagements billed and an increase in average fees of 16%. The offices of Greater China (Hong Kong, Shanghai and Beijing) and Australasia (Australia and New Zealand) contributed 47% and 22%, respectively of the increase in fee revenue. The financial services, industrial and technology sectors experienced strong growth over the prior year. Exchange rates favorably impacted fee revenue for Asia Pacific by $1.0 million in the current year.

South America reported fee revenue of $17.4 million, an increase of $1.8 million, or 11%, of which $0.4 million related to the favorable impact of exchange rates. Overall engagements billed within the region were comparable to prior year while average fees increased by 16%. Every country in the region experienced growth over the prior year with Brazil contributing approximately one-third of the increase in fee revenues.

Futurestep Fee revenue increased $15.6 million, or 22%, to $85.8 million in fiscal 2007 compared to $70.2 million in fiscal 2006. The improvement in fee revenue, reflected across all regions, is due to an increase in average fees resulting from our continued strategic emphasis on larger outsourced recruiting solutions. Of the total increase in fee revenue, Asia-Pacific experienced the largest increase in fee revenue of $6.6 million, or 45%, to $21.1 million reflecting increased revenue from areas including RPO and Interim Solutions. Europe fee revenue increased $6.6 million, or 24%, to $33.9 million, arising from increased business in France, the United Kingdom, Spain and Australia and a migration to larger engagements. Exchange rates favorably impacted fee revenue by $2.5 million in the current year.

Compensation and Benefits.

Compensation and benefits expense increased $106.5 million, or 31%, to $447.7 million in fiscal 2007 from $341.2 million in fiscal 2006. The increase in compensation and benefits expense is primarily due to increased global headcount of 421, or 23%, compared to prior year, including an 16% increase in the average number of

consultants, coupled with increased profitability and retention awards. Increased compensation and benefits also resulted from a $5.2 million charge for executive employment contract changes recorded in the fourth quarter of fiscal 2007 and $4.6 million of compensation and benefits from the Lominger Entities that wasn t present last year. Exchange rates unfavorably impacted compensation and benefits expense by $9.3 million in the current year.

Executive recruitment compensation and benefits costs of $365.0 million increased $88.5 million, or 32%, compared to $276.5 million in the prior year primarily due to consultants hired over the past year. In the current year, the number of consultants increased by 50, or 11%, compared to last year. Exchange rates impacted executive recruitment compensation and benefits expense unfavorably by $7.7 million. Executive recruitment compensation and benefits expense, as a percentage of fee revenue, increased to 64% in fiscal year 2007 compared to 61% in fiscal 2006.

Futurestep compensation and benefits expense increased $9.8 million, or 20%, to $58.4 million from $48.6 million in the prior year due to significant investments in our employees which increased Futurestep average consultant headcount by 50% over the past year. Exchange rates unfavorably impacted Futurestep compensation and benefits expense by $1.6 million. Futurestep compensation and benefits expense, as a percentage of fee revenue, declined to 68% from 69% in the prior year.

Corporate compensation and benefits expense increased $8.3 million, or 52%, to $24.3 million, primarily from a $5.2 million charge for executive contract changes recorded in the fourth quarter of fiscal 2007 and stock-based compensation expense that wasn t present in the prior year.

General and Administrative Expenses.

General and administrative expenses increased $11.8 million, or 13%, to $105.3 million in fiscal 2007 compared to $93.5 million in 2006. The Lominger Entities contributed $1.3 million to the increase. Exchange rates unfavorably impacted general and administrative expenses by $2.6 million in the current year.

Executive recruitment general and administrative expenses increased $9.4 million, or 14%, from $67.3 million in the prior year to $76.7 million in the current year. The increase was driven by other administrative expenses of $2.1 million, including travel and meeting expenses, an increase in premise and office expense of $4.9 million and a $2.6 million increase in business development expenses. Increased premise and office expense was attributable to all regions due to increased rent expense and total space leased. Executive recruitment general and administrative expenses, as a percentage of fee revenue, decreased to 14% from 15% in the prior year.

Futurestep general and administrative expenses increased $1.7 million, or 12%, to $16.2 million, primarily due to a net increase in premise and office expense of $1.3 million resulting from a $2.2 million increase in rent expense, noted across all regions, and the opening of new offices in Europe and Asia offset by a $0.9 million reversal of a previously recorded lease reserve. Bad debt expense increased $0.3 million resulting from an increase in the level of business and corresponding increase in accounts receivable. Futurestep general and administrative expenses, as a percentage of fee revenue, decreased to 19% from 21% in the prior year.

Corporate general and administrative expenses increased $0.8 million, or 7%, to $12.4 million primarily due to increased professional fees and premise and office expenses related to additional office space leased in fiscal 2007.

Out-of-Pocket Engagement Expenses. Out-of-pocket engagement expenses consist of expenses incurred by candidates and our consultants that are generally billed to clients. Out-of-pocket engagement expenses of $44.7 million increased $12.7 million, or 40%, over the prior year. As a percentage of fee revenue, out-of-pocket engagement expenses increased to 7% in current year compared to 6% in prior year.

Depreciation and Amortization Expenses. Depreciation and amortization expense of $9.3 million in fiscal 2007 increased $0.3 million, or 3%, from prior year. Depreciation expense relates mainly to computer equipment,

software, furniture and leasehold improvements. Increase in expense for the current year is attributable to an increase in fixed asset balances primarily associated with furniture and fixtures and leasehold improvements related to business expansion and office buildout and amortization of software costs that add new functionality in our corporate and executive search segments.

Operating Income.

Operating income increased $6.1 million, or 8%, to $82.3 million in the current year compared to $76.2 million in the prior year, resulting from increased revenue of $137.4 million offset by a $131.3 million increase to operating expenses, primarily compensation and benefits and general and administrative expenses in the current year. The Lominger Entities contributed $2.6 million for the year ended April 30, 2007.

Executive recruitment operating income increased $11.2 million, or 11%, to $111.9 million in fiscal 2007 compared to $100.7 million in fiscal 2006. The improvement in executive recruitment operating income is attributable to increased revenues offset by additional compensation expense relating to increased headcount and variable payouts as discussed previously, as well as increased professional fees, premise and other general administrative expense. Executive recruitment operating income, as a percentage of fee revenue, decreased to 20% from 22%, due to certain executive employment contract changes, our continued investment in Leadership Development Solutions and increases in profitability based compensation during the current year.

Futurestep operating income increased by $4.5 million to $7.9 million in fiscal 2007 as compared to operating income of $3.4 million in fiscal 2006. The increase in Futurestep operating income is primarily due to higher average fees in engagements billed, a $0.9 million reversal of a previously recorded lease reserve and improvements in compensation and benefits and general and administrative expenses as a percentage of fee revenue in the current year. Futurestep operating income, as a percentage of fee revenue, improved to 9% from 5% last year.

Interest Income and Other Income, Net. Interest income and other income, net decreased by $0.7 million in fiscal 2007 from $11.1 million in fiscal 2006. Interest and dividend income increased as a result of higher yields on larger balances of funds available for investment compared to prior year; however, this increase was not large enough to offset the $4.5 million realization of a loss recovery on a previously impaired investment in fiscal 2006.

Interest Expense. Interest expense, primarily related to convertible securities and borrowings under Company Owned Life Insurance Policies (COLI) policies, was $10.2 million in fiscal year 2007 and 2006. Interest expense related to the convertible securities was $4.9 million in fiscal 2007; as these securities were converted to shares of the Company s common stock in April 2007 there will not be any interest expense in fiscal 2008 related to the securities. See Note 10 of the Notes to our Consolidated Financial Statements for more detailed information on the conversion of these securities.

Provision for Income Taxes. The provision for income taxes was $30.2 million in fiscal 2007 compared to $19.6 million in fiscal 2006. The provision for income taxes in the current year reflects a 36.6% effective tax rate. The provision for income taxes for the prior year reflects a 25.4% tax rate. Excluding the $4.5 million realization of a loss recovery on a previously impaired investment and a net one-time tax benefit of $6.5 million the effective tax rate for the fiscal year 2006 would have been 36.0%, which is comparable to the year ended April 30, 2007.

Equity in Earnings of Unconsolidated Subsidiaries. Equity in earnings of unconsolidated subsidiaries is comprised of our less than 50% interest in our Mexican subsidiaries. We report our interest in earnings or loss of our Mexican subsidiaries on the equity basis as a one line adjustment to net income, net of taxes. Equity in earnings was $3.2 million compared to $2.0 million last year, resulting from increased profitability in both subsidiaries. Dividends received from the Company s unconsolidated subsidiaries equaled $2.4 million in the current year, and is reflected as a reduction in the carrying value of our investment.

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Fiscal 2006 Compared to Fiscal 2005

Fee Revenue.

Fee revenue increased $70.7 million, or 16%, to $522.9 million in fiscal 2006 compared to $452.2 million in fiscal 2005. The improvement in fee revenue is attributable mainly to a 29% increase in the number of engagements billed. Contributing factors to increased revenue during fiscal year 2006 include the opening of new offices in Europe and Asia, strong performances in the North America and Asia Pacific regions, as well as the continued growth of our Futurestep subsidiary. Exchange rates unfavorably impacted fee revenues by $4.9 million in fiscal 2006, mainly related to European revenues.

Executive Recruitment Executive recruitment fee revenue increased $54.4 million, or 14%, due to a 15% increase in the number of engagements billed as well as average fee increases in certain regions. Emergent economies, newly established offices, as well as expanding industries in various regions also factored in the overall growth in fee revenue.

North America fee revenue increased $33.2 million, or 15%, to $259.1 million due to an 11% increase in the number of engagements billed as well as a 3% increase in average fees as compared to fiscal 2005. Increased revenue obtained in the industrial sector contributed significantly to the region s revenue, along with growth in the financial services and in the consumer goods markets over the prior fiscal year.

EMEA reported fee revenue of $120.1 million, an increase of $9.6 million, or 9%, compared to $110.5 million in prior year, which was driven by an 11% increase in the number of engagements billed. Business in the European market expanded in 2006 due to strong performances from consultants in the United Kingdom and France, and growth in newer offices established in recent years, such as in the Middle East, Czech Republic, and an affiliate relationship in Russia. Exchange rates unfavorably impacted EMEA fee revenue by $5.4 million in fiscal 2006.

Asia Pacific fee revenue increased $6.7 million, or 13%, to $57.9 million in the year ended April 30, 2006, compared to prior fiscal year due to a 20% increase in the number of engagements billed as well as strong performance in our China offices in Beijing and Shanghai. The growing economy in China has significantly contributed to the improved business experienced by the region in fiscal 2006, attributing to almost half of the total increase in Asia fee revenues over prior year.

South America reported fee revenue of $15.7 million, an increase of $4.9 million, or 45%, of which $1.6 million related to the favorable impact of exchange rates. Revenue increased $2.5 million in Brazil, a 54% increase over fiscal 2005, primarily due to an 81% increase in the number of engagements billed in fiscal 2006. Overall in the entire region, engagements billed increased by 26% since prior year while average fees increased by 15%.

Futurestep Fee revenue increased $16.3 million, or 30%, to $70.2 million in fiscal 2006 compared to $53.9 million in fiscal 2005. The improvement in fee revenue is due to an increase in the number of engagements billed combined with our continued strategic emphasis on larger outsourced recruiting solutions. Of the total increase in fee revenue, North America experienced the largest increase in fee revenue of $6.6 million, or 30%, to $28.3 million reflecting increased revenue from areas including RPO and Interim Solutions. Europe fee revenue increased $5.8 million, or 27%, to $27.3 million, arising from increased business in the United Kingdom and Belgium, again attributable to a migration to larger engagements. Exchange rates unfavorably impacted Futurestep Europe fee revenue by $1.1 million. Asia Pacific fee revenue increased $3.9 million, or 37% to $14.6 million, where increased revenues were derived from Australia and New Zealand. Revenue resulting from the opening of an office in India in fiscal year 2006 also contributed to growth.

Compensation and Benefits.

Compensation and benefits expense increased $48.3 million, or 17%, to $341.2 million in fiscal 2006 from $292.9 million in fiscal 2005. Increased headcount along with increased profitability and internal promotions have contributed to the overall increase in expense in fiscal year 2006. Total headcount increased globally by 266, or 17% over last year as the Company continues to expand its operations across industries and regions worldwide. Exchange rates impacted compensation and benefits expense favorably by $3.4 million in the current year, due to changes in exchange rates between the US dollar and the Euro and Pound Sterling.

Executive recruitment compensation and benefits costs of $276.5 million increased $32.0 million, or 13%, compared to $244.5 million in the prior year due to increased profitability based rewards and new consultants joining the firm. In the fiscal year 2006, the number of consultants increased by 42 or 11% as compared to prior year. Exchange rates impacted executive recruitment compensation and benefits expense favorably by $2.8 million. Executive recruitment compensation and benefits expense, as a percentage of fee revenue, remained stable at 61%.

Futurestep compensation and benefits expense increased $14.5 million, or 43%, to $48.6 million from $34.1 million in the prior year primarily due to increased variable compensation as well as increased external contractors expense arising from increased business, especially in North America. Additionally, average headcount increased by 34%, which significantly contributed to the overall increase in compensation and benefits since fiscal 2005. Exchange rates impacted Futurestep compensation and benefits expense favorably by $0.6 million. Futurestep compensation and benefits expense, as a percentage of fee revenue, increased to 69% from 63% in the prior year.

Corporate compensation and benefits expense increased $1.7 million, or 12%, to $16.0 million, reflecting increased profitability-based rewards and executive benefits. Increases also reflect additional expense derived from fiscal 2006 restricted stock grants as well as from added amortization arising from the Company s prior year contribution to deferred compensation plans.

General and Administrative Expenses.

General and administrative expenses increased $10.0 million, or 12%, to $93.5 million in fiscal 2006 compared to $83.5 million in 2005. Increases to general and administrative expenses related to increased premise and office expense of $4.3 million, business development expense of $2.1 million, bad debt expense of $1.0 million, and other types of general expenses of $2.6 million including administrative meeting and travel expense along with certain legal expenses. Exchange rates favorably impacted general and administrative expenses by $0.5 million in the year ended April 30, 2006.

Executive recruitment general and administrative expenses of $67.3 million increased $3.9 million, or 6%, due to premise and office expense of $2.5 million, business development costs of $1.4 million, and bad debt expense of $0.4 million These were offset by a decrease to other general expenses of $0.4 million versus the prior year.

Premise and office expense increased $3.1 million in our North and South American regions, resulting from additional space leased as well as rent increases from renewed contracts or office relocations. This was offset by a decrease in Asia of $0.6 million, resulting from a decrease in the allocation of premise and office expense between shared offices in Australia.

Increased business development costs in the North American and EMEA Search practices were most significant. In North America, increases were $0.9 million while in EMEA, these increases amounted to $0.3 million. In Asia and South America, business development expense increased by $0.1 million in each region. Business development expenses generally fluctuate in conjunction with revenue and overall business activity.

During the year ended April 30, 2006, North America experienced the largest increase in bad debt expense of $0.6 million, with EMEA having a total increase of $0.5 million. Both increases are consistent with the

increase in revenue in both regions, as opposed to deterioration in collection activity. These amounts were offset by a decrease in Asia of $0.5 million. Lower bad debt expense for this region in fiscal year 2006 is due to improved collections activity prior to year end. Executive recruitment general and administrative expenses, as a percentage of fee revenue, declined to 15% from 16% in the prior year.

Futurestep general and administrative expenses in fiscal 2006 increased $4.4 million, or 44%, to $14.5 million due to a $1.8 million increase in premise and office expense and a $1.6 million increase in other general expenses, which included increased meeting and travel expense of $0.7 million and legal expense $0.5 million, along with a $0.4 million increase across the regions in general office expenses, such as regional marketing expenses. The increase in premise and office expense was noted throughout all regions, which all increased since the prior year at $0.6 million per region. In Europe and Asia, additional rental expense incurred in fiscal year 2006 in relation to new offices opened in Spain and India, respectively, contributed to their overall increase since prior year. Business development expense increased by $0.5 million, relating mainly to Futurestep s North American and Asian regions. Business development expenses generally fluctuate in conjunction with revenue and overall business activity. The remaining increase of $0.5 million related to bad debt expense and write offs of accounts receivable in the North American region. Futurestep general and administrative expenses, as a percentage of fee revenue, increased to 21% from 19% in the prior year.

Corporate general and administrative expenses increased $1.6 million, or 16%, to $11.6 million primarily due to increased professional fees.

Out-of-Pocket Engagement Expenses. Out-of-pocket engagement expenses consist of expenses incurred by candidates and our consultants that are generally billed to clients. During fiscal year 2006, out-of-pocket engagement expenses of $31.9 million increased $6.2 million, or 24%, over the prior year. As a percentage of fee revenue, out-of-pocket engagement expenses remained stable at 6% in both years.

Depreciation and Amortization Expenses. Depreciation and amortization expense of $9.0 million in fiscal 2006 increased $0.6 million, or 7%, from prior year. The primary source of the overall increase since the prior year is the $0.5 million increase in the EMEA Search region, due to replacements of software and hardware in the region in fiscal 2006 as well as office relocations in the Middle East and Germany, which caused larger depreciation expense related to leasehold improvements and furniture and fixtures. North America Search, Futurestep and South America Search depreciation expense increases mainly related to computer software and hardware additions were offset by decreases in Corporate and Asia Search, which experienced decreased expense due to fully depreciated computer equipment by prior year-end.

Operating Income.

Operating income increased $10.4 million, or 16%, to $76.2 million in fiscal 2006 compared to $65.8 million in the prior year, resulting from increased revenue of $75.4 million offset by a $65.0 million increase to operating expenses, primarily compensation and benefits and general and administrative expenses.

Executive recruitment operating income increased $16.6 million, or 20%, to $100.7 million in fiscal 2006 compared to $84.1 million in fiscal 2005. The improvement in executive recruitment operating income is attributable to increased revenues offset by additional compensation expense relating to increased headcount and variable payouts as discussed previously, as well as increased professional fees, premise and other general administrative expense. Executive recruitment operating income, as a percentage of fee revenue, as a result, increased to 22% from 21%, resulting from revenue growth.

Futurestep operating income decreased by $3.1 million to $3.4 million in fiscal 2006 as compared to operating income of $6.5 million in fiscal 2005. The decrease in Futurestep operating income is due to increased compensation and benefits costs arising from increased headcount, significant investment in internal technology to better serve the Futurestep clients and business, as well as one-time write offs of receivables in fiscal year 2006. Futurestep operating income, as a percentage of fee revenue, declined to 5% from 12% last year.

Interest Income and Other Income, Net. Interest income and other income, net includes interest income of $11.1 million and $3.4 million in fiscal 2006 and 2005, respectively. During fiscal year 2006, the Company continued to transfer cash to higher interest rate investments due to the Company s improved cash position, resulting in an increase to interest income of $2.5 million. Additionally, the Company recovered $4.5 on an investment that had been previously impaired in 2002. In addition, during fiscal 2006, the Company recognized $1.0 million in realized gains as a result of the sale of equity securities and $0.2 million of the increase is associated with interest and dividends, both arising from our ECAP investments.

Interest Expense. Interest expense, primarily related to convertible securities and borrowings under Company Owned Life Insurance Policies (COLI) policies, was $10.2 million in fiscal 2006, a decrease of $0.3 million from $10.5 million in the prior year due to declining rates.

Provision for Income Taxes. The provision for income taxes was $19.6 million in fiscal 2006 compared to $20.3 million in fiscal 2005. The provision for income taxes in fiscal 2006 reflects a 25.4% effective tax rate. In the third quarter of the year ended April 30, 2006, the Company recovered $4.5 million on a previously impaired investment, which management considers a non-recurring event. When the investment was originally impaired in fiscal year 2002, a deferred tax asset was booked with a 100% valuation allowance due to the uncertainty regarding the Company s ability to realize a capital loss deduction after the sale of the investment. As a result, there was no tax expense booked on the loss recovery during fiscal year 2006 as there is no taxable income associated with the recovery. In the fourth quarter of fiscal year 2006, the Company recorded a tax benefit of $8.6 million resulting from the conclusion, on February 16, 2006, of an audit of the Company s U.S. Federal Income Tax returns for the years ended April 30, 1997 through April 30, 2003. The Company also recorded $2.1 million in tax expense for the expected tax consequences of repatriating certain funds that had previously been considered as permanently reinvested abroad. Excluding these events, the effective tax rate for the year would have been 36.0%.

Equity in Earnings of Unconsolidated Subsidiaries. Equity in earnings of unconsolidated subsidiaries is comprised of our less than 50% interest in our Mexican subsidiaries. We report our interest in earnings or loss of our Mexican subsidiaries on the equity basis as a one line adjustment to net income. Equity in earnings was $2.0 million compared to $0.2 million last year, resulting from increased profitability in both subsidiaries. Dividends received from the Company s unconsolidated subsidiaries equaled $2.7 million in fiscal 2006, and is reflected as a reduction in the carrying value of our investment. Fiscal 2005 equity in earnings included an adjustment of $0.9 million related to stock options issued to our Mexican subsidiaries employees.

Liquidity and Capital Resources

We believe that cash on hand, borrowings available under our credit facility and funds from operations will be sufficient to meet our anticipated working capital, debt service requirements, capital expenditures and general corporate requirements. However, adverse changes in our revenue could require us to cut costs or obtain financing to meet our cash needs. There are no trends or demands or commitments that would materially affect liquidity or those that relate to the Company s resources.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements and have not entered into any transactions involving unconsolidated, limited purpose entities.

Contractual Obligations

Contractual obligations represent future cash commitments and liabilities under agreements with third parties, and exclude contingent liabilities for which we cannot reasonably predict future payment. The following table represents our contractual obligations as of April 30, 2007 (in thousands):

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		Payments due In:			
		Less than			More than
	Total	1 year	1-3 years	3-5 years	5 years
Operating lease commitments(1)	$ 114,273	$ 29,356	$ 48,124	$ 20,696	$ 16,097
Accrued restructuring charges(2)	3,800	999	1,903	898	
Total	$ 118,073	$ 30,355	$ 50,027	$ 21,594	$ 16,097

(1) See Note 15, Commitments and Contingencies, in the notes to consolidated financial statements for additional information.

(2) See Note 5, Restructuring Liabilities, in the notes to consolidated financial statements for additional information. Note that the above amounts represent rent payments, net of sublease income, on an undiscounted basis.

In addition to the contractual obligations above, we have liabilities related to certain employee benefit plans. These liabilities are recorded in our Consolidated Balance Sheets. The obligations related to these employee benefit plans are described in Note 7, Deferred Compensation and Retirement Plans, Pension Plan, Company Owned Life Insurance Policies and Executive Capital Accumulation Plan.

We also make interest payments on our COLI loans. These loans are described in Note 11 to the Notes to our Consolidated Financial Statements, Long-Term Debt. As the timing of these loan repayments are uncertain, we have not included these obligations in the table above.

Lastly, we have contingent commitments under certain employment agreements that are payable upon termination of employment.

Liquidity.

The following table presents selected financial information (in thousands):

		As of April 30,	
	2007	2006	2005
Cash and cash equivalents	$ 289,106	$ 257,543	$ 199,133
Marketable securities	35,161	20,654	7,815
Working capital	235,271	218,209	146,071
Long-term debt		45,147	44,949
Convertible mandatorily redeemable preferred stock		10,989	10,795

The net increase in our working capital of $17.1 million in fiscal 2007 compared to fiscal 2006 is primarily attributable to increases in accounts receivable balances related to overall growth in the number of engagements billed plus higher average fees per engagement in all regions and consistent accounts receivable collection. The net cash position reflects proceeds from exercises of stock options offset by continued investment in the business through our stock buy back program, current year acquisitions and increases in accrued liabilities related primarily to increases in profitability based compensation during the current year.

Cash provided by operating activities was $102.3 million in the current year, an increase of $21.9 million, from $80.5 million in fiscal 2006. The increase in cash provided by operating activities is primarily due to an increase in accounts payable and accrued liabilities of $28.9 million related to profitability based compensation accruals and $6.9 million of deferred compensation plan accruals associated to contributions by the Company in various deferred compensations plans on behalf of employees compared to the prior year. The profitability based compensation increases are a direct result of the substantial increase in revenues across business segments compared to prior year. Offsetting these increases is an increase of receivables balances of $6.5 million resulting

from overall growth in the number of engagements billed plus higher average fees per engagement billed throughout the regions and an increase in deferred income tax benefits of $9.6 primarily associated with increases in deferred compensation plan accruals, ECAP contributions and restricted stock grants.

Cash used in investing activities was $48.5 million for fiscal 2007, compared to $21.7 million used in the prior year. For the year ended April 30, 2007, the increase in cash used was primarily attributable to the acquisition of the Lominger Entities of $20.3 million. Capital expenditures during the year were $14.1 million, an increase of $2.8 million over prior year, primarily related to continuing expansion of our Futurestep business and increased systems hardware and software costs. These expenditures primarily related to leasehold improvements from office expansion and internally-developed software projects including *Executive Center* and *Searcher* as well as the implementation of financial reporting software.

Cash used by financing activities was $26.0 million in fiscal 2007, a $27.2 million increase from 2006. In the current fiscal year, we repurchased $57.6 million of common stock, $56.0 million of which related to the previously announced stock buyback programs approved by the Board of Directors in December 2005, June 2006, and March 2007 as we continue to reinvest in the business. These repurchases were offset by proceeds received from the exercise of stock options of $20.4 million and the associate tax benefits of $7.0 million from stock option exercises in the current fiscal year due in part to an increase in vested shares and exercise activity attributable to an increase in the Company s share price.

Long-Term Debt.

Total outstanding borrowings under our COLI policies were $60.0 million, $58.4 million and $56.6 million as of April 30, 2007, 2006 and 2005, respectively. Generally, we borrow under our COLI policies to pay related premiums. Such borrowings do not require annual principal repayments, bear interest primarily at variable rates and are secured by the cash surrender value of the life insurance policies of $136.5 million, $129.0 million and $121.7 million as of April 30, 2007, 2006 and 2005, respectively. At April 30, 2007, the net cash value of these policies was $76.5 million of which $63.7 million was held in a trust.

As of April 30, 2007, we had no outstanding amounts related to our 7.5% Convertible Subordinated Notes and 7.5% Convertible Series A Preferred Stock. On March 7, 2007, the Company issued notice for the redemption of its 7.5% Convertible Subordinated Notes in an aggregate principal amount of $40 million and its 7.5% Convertible Series A Preferred Stock in an aggregate principal price of $10 million. As of March 7, 2007, $45.6 million of the 7.5% Convertible Subordinated Notes and $11.4 million of the 7.5% Convertible Series A Preferred Stock was outstanding. The notes and preferred stock were convertible into shares of the Company s common stock at $10.19 per share. In response to the redemption notice, the holder of the notes and preferred stock exercised its option to convert the debt and preferred stock pursuant to the terms of the original agreements. The conversion resulted in 5,586,187 shares of the Company s common stock being delivered to the holders of the convertible securities in April 2007.

We have a Senior Secured Revolving Credit Facility which we amended in February 2005 to a $50 million borrowing capacity with no borrowing base restrictions. The credit facility is secured by substantially all of our assets including certain accounts receivable balances and guarantees by and pledges of a portion of the capital stock of our significant subsidiaries. We are required to meet certain financial condition covenants on a quarterly basis. As of April 30, 2007, we had no outstanding borrowings on our credit facility.

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Quarterly Results

The following table sets forth certain unaudited statement of operations data for the quarters in fiscal 2007 and 2006. The unaudited quarterly information has been prepared on the same basis as the annual financial statements and, in management s opinion, includes all adjustments necessary to present fairly the information for the quarters presented (dollars in thousands, except per share amounts).

	Quarters Ended							
	Fiscal 2007				Fiscal 2006			
	April 30	Jan. 31	Oct. 31	July 31	April 30	Jan. 31	Oct. 31	July 31
Fee revenue	$ 179,702	$ 165,239	$ 155,718	$ 152,763	$ 145,266	$ 129,626	$ 125,789	$ 122,201
Operating income	19,351	21,408	21,148	20,348	20,637	18,714	18,086	18,745
Net income	13,539	14,730	13,566	13,663	20,300	16,613	10,904	11,613
Net income per share								
Basic	0.33	0.37	0.35	0.35	0.51	0.41	0.27	0.30
Diluted	0.30	0.33	0.31	0.31	0.45	0.37	0.25	0.27

Recently Issued Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004) (Statement 123(R)), Share-Based Payment, which is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation (Statement 123). Statement 123(R) supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FASB Statement No. 95, Statement of Cash Flows. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. Statement 123(R) is required to be adopted in fiscal years beginning after June 15, 2005. We adopted Statement 123(R) on May 1, 2006 using the modified-prospective method.

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Among other things, FIN 48 creates a model to address uncertainty in tax positions and clarifies the accounting for income taxes by prescribing a minimum recognition threshold which all income tax positions must achieve to meet before being recognized in the financial statements. In addition, FIN 48 requires expanded annual disclosures, including a tabular rollforward of the beginning and ending aggregate unrecognized tax benefits as well as specific detail related to tax uncertainties for which it is reasonably possible the amount of unrecognized tax benefit will significantly increase or decrease within 12 months. FIN 48 is effective for the Company on May 1, 2007. Any differences between the amounts recognized in the statement of financial position prior to the adoption of FIN 48 and the amounts reported after adoption are generally accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. The Company is currently evaluating the impact of FIN 48; however, it is not expected to have a material impact on the Company s consolidated financial position and results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157). The 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 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. Management is evaluating the impact this statement may have on the Company s financial statements.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements

No. 87, 88, 106, and 132(R) (SFAS No. 158). SFAS No. 158 retains the previous measurement and disclosure requirements of prior accounting guidance, but now requires the recognition of the funded status of pension and other postretirement benefit plans on the balance sheet (recognition provisions). Furthermore, for fiscal years ending after December 15, 2008, FAS 158 requires fiscal-year-end measurements of plan assets and benefit obligations, eliminating the use of earlier measurement dates currently permissible. The recognition provisions of SFAS No. 158 were effective for the Company on April 30, 2007. Previously unrecognized actuarial gains or losses, prior service cost, and any remaining unamortized transition obligation will be recognized on the balance sheet with an offset to accumulated other comprehensive income, net of any resulting deferred tax balances. We adopted SFAS No. 158 on April 30, 2007. Adoption did not have a material impact on the consolidated financial statements.

In February, 2007, FASB issued Statement of Financial Accounting Standards 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 SFAS No. 159 and has not yet determined the impact that the adoption of SFAS No. 159 will have on our results of operations or financial position, if any.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk***

As a result of our global operating activities, we are exposed to certain market risks, including foreign currency exchange fluctuations and fluctuations in interest. We manage our exposure to these risks in the normal course of our business as described below. We have not utilized financial instruments for trading, hedging or other speculative purposes nor do we trade in derivative financial instruments.

Foreign Currency Risk.

Substantially all our foreign subsidiaries operations are measured in their local currencies. Assets and liabilities are translated into U.S. dollars at the rates of exchange in effect at the end of each reporting period and revenue and expenses are translated at average rates of exchange during the reporting period. Resulting translation adjustments are reported as a component of comprehensive income on our consolidated Statement of Stockholders Equity.

Transactions denominated in a currency other than the reporting entity s functional currency may give rise to transaction gains and losses that impact our results of operations. Historically, we have not realized significant foreign currency gains or losses on such transactions. In the year ended April 30, 2007, we recognized foreign currency gains, after income taxes, of $0.7 million primarily related to our EMEA operations.

Our primary exposure to exchange losses is based on outstanding intercompany loan balances denominated in U.S. dollars. If the U.S. dollar strengthened 15%, 25% and 35% against the Pound Sterling, the Euro, the Canadian dollar, the Australian dollar and the Yen, the Company s exchange loss would have been $2.6 million, $4.3 million and $6.1 million, respectively, based on outstanding balances at April 30, 2007. If the U.S. dollar weakened by the same increments against Pounds Sterling, the Euro, the Canadian dollar, the Australian dollar and the Yen, the Company s exchange gain would have been $2.6 m> 47 31 1,049 3,366

Net charge-offs (recoveries)				
5,287	249	70	(1,049)	4,557

Ending balance	$48,295	$	$14,752	$20,070	$193	$2,224	$5,580	$91,114

Period end amount allocated to:

Loans individually evaluated for impairment

$6,293 $ $ $722 $ $3 $ $7,018

Loans collectively evaluated for impairment

42,002 14,752 19,348 193 2,221 5,580 84,096

Ending balance	$48,295	$	$14,752	$20,070	$193	$2,224	$5,580	$91,114

June 30, 2013 (in thousands)	Commercial	Mortgage Finance	Construction	Real Estate	Consumer	Leases	Unallocated	Total
Beginning balance	$21,547	$	$12,097	$30,893	$226	$2,460	$7,114	$74,337
Provision for loan losses	13,139		615	(2,905)	11	343	(2,528)	8,675
Charge-offs	4,474			131	45			4,650
Recoveries	745			15	45	261		1,066

Net charge-offs (recoveries)			
3,729	116	(261)	3,584

Ending balance								
	$30,957	$	$12,712	$27,872	$237	$3,064	$4,586	$79,428

Period end amount allocated to:

Loans individually evaluated for impairment

$2,934 $ $ $548 $1 $10 $ $3,493

Loans collectively evaluated for impairment

28,023 12,712 27,324 236 3,054 4,586 75,935

Ending balance							
$30,957	$	$12,712	$27,872	$237	$3,064	$4,586	$79,428

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Our recorded investment in loans as of June 30, 2014, December 31, 2013 and June 30, 2013 related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of our impairment methodology was as follows (in thousands):

June 30, 2014

	Commercial	Mortgage Finance	Construction	Real Estate	Consumer	Leases	Total
Loans individually evaluated for impairment	$ 27,679	$	$	$ 19,790	$	$ 22	$ 47,491
Loans collectively evaluated for impairment	5,267,689	3,700,253	1,567,667	2,211,840	15,847	95,892	12,859,188
Total	$ 5,295,368	$ 3,700,253	$ 1,567,667	$ 2,231,630	$ 15,847	$ 95,914	$ 12,906,679

December 31, 2013

	Commercial	Mortgage Finance	Construction	Real Estate	Consumer	Leases	Total
Loans individually evaluated for impairment	$ 15,139	$	$ 705	$ 24,028	$ 54	$ 50	$ 39,976
Loans collectively evaluated for impairment	5,005,426	2,784,265	1,262,200	2,122,200	15,296	93,110	11,282,497
Total	$ 5,020,565	$ 2,784,265	$ 1,262,905	$ 2,146,228	$ 15,350	$ 93,160	$ 11,322,473

June 30, 2013

	Commercial	Mortgage Finance	Construction	Real Estate	Consumer	Leases	Total
Loans individually evaluated for impairment	$ 19,475	$	$	$ 23,666	$ 9	$ 65	$ 43,215
Loans collectively evaluated for impairment	4,451,387	2,838,234	969,071	1,991,378	24,017	77,046	10,351,133
Total	$ 4,470,862	$ 2,838,234	$ 969,071	$ 2,015,044	$ 24,026	$ 77,111	$ 10,394,348

We have traditionally maintained an unallocated reserve component to allow for uncertainty in economic and other conditions affecting the quality of the loan portfolio. The unallocated portion of our loan loss reserve has remained consistent since December 31, 2013. We believe the level of unallocated reserves at June 30, 2014 is warranted due to the continued uncertain economic environment which has produced losses, including those resulting from fraud by

borrowers, that are not necessarily correlated with historical loss trends or general economic conditions. Our methodology used to calculate the allowance considers historical losses, however, the historical loss rates for specific product types or credit risk grades may not fully incorporate the effects of continued weakness in the economy.

Generally we place loans on non-accrual when there is a clear indication that the borrower s cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. When a loan is placed on non-accrual status, all previously accrued and unpaid interest is reversed. Interest income is subsequently recognized on a cash basis as long as the remaining unpaid principal amount of the loan is deemed to be fully collectible. If collectability is questionable, then cash payments are applied to principal. As of June 30, 2014, $480,000 of our non-accrual loans were earning on a cash basis. A loan is placed back on accrual status when both principal and interest are current and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement. The table below summarizes our non-accrual loans by type and purpose as of June 30, 2014 and December 31, 2013 (in thousands):

	June 30, 2014	December 31, 2013
Commercial		
Business loans	$ 24,245	$ 12,896
Energy	1,300	
Construction		
Market risk		705
Real estate		
Market risk	9,539	15,607
Commercial	4,079	508
Secured by 1-4 family	2,380	2,555
Consumer		54
Leases	22	50
Total non-accrual loans	$ 41,565	$ 32,375

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As of June 30, 2014, non-accrual loans included in the table above included $16.2 million related to loans that met the criteria for restructured compared to $17.8 million at December 31, 2013.

A loan held for investment is considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. In accordance with *ASC 310 Receivables*, we have also included all restructured loans in our impaired loan totals. The following tables detail our impaired loans, by portfolio class as of June 30, 2014 and December 31, 2013 (in thousands):

June 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial					
Business loans	$ 9,226	$ 11,475	$	$ 5,412	$
Energy	425	425		609	
Construction					
Market risk				235	
Real estate					
Market risk	8,089	8,089		9,936	
Commercial	3,595	3,595		2,023	
Secured by 1-4 family	1,320	1,320		1,320	
Consumer					
Leases					
Total impaired loans with no allowance recorded	$ 22,655	$ 24,904	$	$ 19,535	$
With an allowance recorded:					
Commercial					
Business loans	$ 17,153	$ 17,853	$ 6,162	$ 17,163	$
Energy	875	875	131	987	
Construction					
Market risk					
Real estate					
Market risk	4,103	4,103	360	5,332	
Commercial	484	484	73	918	
Secured by 1-4 family	2,199	2,231	289	2,335	
Consumer				22	
Leases	22	22	3	41	
Total impaired loans with an allowance recorded	$ 24,836	$ 25,568	$ 7,018	$ 26,798	$
Combined:					
Commercial					
Business loans	$ 26,379	$ 29,328	$ 6,162	$ 22,575	$

Energy	1,300	1,300	131	1,596	
Construction					
Market risk				235	
Real estate					
Market risk	12,192	12,192	360	15,268	
Commercial	4,079	4,079	73	2,941	
Secured by 1-4 family	3,519	3,551	289	3,655	
Consumer				22	
Leases	22	22	3	41	
Total impaired loans	$ 47,491	$ 50,472	$ 7,018	$ 46,333	$

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December 31, 2013

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial					
Business loans	$ 2,005	$ 2,005	$	$ 4,265	$
Energy	1,614	3,443		969	
Construction					
Market risk	705	705		3,111	114
Real estate					
Market risk	13,524	13,524		9,796	
Commercial	508	508		5,458	
Secured by 1-4 family	1,320	1,320		2,464	
Consumer					
Leases					
Total impaired loans with no allowance recorded	$ 19,676	$ 21,505	$	$ 26,063	$ 114
With an allowance recorded:					
Commercial					
Business loans	$ 11,060	$ 12,425	$ 1,946	$ 14,240	$
Energy	460	460	69	913	
Construction					
Market risk				160	
Real estate					
Market risk	6,289	6,289	822	7,912	
Commercial				477	
Secured by 1-4 family	2,387	2,387	321	914	
Consumer	54	54	8	43	
Leases	50	50	8	72	
Total impaired loans with an allowance recorded	$ 20,300	$ 21,665	$ 3,174	$ 24,731	$
Combined:					
Commercial					
Business loans	$ 13,065	$ 14,430	$ 1,946	$ 18,505	$
Energy	2,074	3,903	69	1,882	
Construction					
Market risk	705	705		3,271	114
Real estate					
Market risk	19,813	19,813	822	17,708	
Commercial	508	508		5,935	
Secured by 1-4 family	3,707	3,707	321	3,378	
Consumer	54	54	8	43	
Leases	50	50	8	72	
Total impaired loans	$ 39,976	$ 43,170	$ 3,174	$ 50,794	$ 114

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Average impaired loans outstanding during the six months ended June 30, 2014 and 2013 totaled $46.3 million and $56.9 million, respectively.

The table below provides an age analysis of our past due loans that are still accruing as of June 30, 2014 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days and Accruing[1]	Total Past Due	Current	Total
Commercial						
Business loans	$ 16,215	$ 4,333	$ 4,793	$ 25,341	$ 4,282,751	$ 4,308,092
Energy	2,170			2,170	959,561	961,731
Mortgage finance loans					3,700,253	3,700,253
Construction						
Market risk	883			883	1,545,656	1,546,539
Secured by 1-4 family					21,128	21,128
Real estate						
Market risk	8,328			8,328	1,645,288	1,653,616
Commercial	6,001			6,001	464,534	470,535
Secured by 1-4 family	261			261	91,220	91,481
Consumer					15,847	15,847
Leases					95,892	95,892
Total loans held for investment	$ 33,858	$ 4,333	$ 4,793	$ 42,984	$ 12,822,130	$ 12,865,114

(1) Loans past due 90 days and still accruing includes premium finance loans of $4.6 million. These loans are generally secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take 180 days or longer from the cancellation date.

Restructured loans are loans on which, due to the borrower s financial difficulties, we have granted a concession that we would not otherwise consider for borrowers of similar credit quality. This may include a transfer of real estate or other assets from the borrower, a modification of loan terms, or a combination of the two. Modifications of terms that could potentially qualify as a restructuring include reduction of contractual interest rate, extension of the maturity date at a contractual interest rate lower than the current rate for new debt with similar risk, or a reduction of the face amount of debt, or forgiveness of either principal or accrued interest. As of June 30, 2014 and December 31, 2013, we had $249,000 and $1.9 million, respectively, in loans considered restructured that are not on non-accrual. These loans did not have unfunded commitments at June 30, 2014 or December 31, 2013. Of the non-accrual loans at June 30, 2014 and December 31, 2013, $16.2 million and $17.8 million, respectively, met the criteria for restructured. These loans had no unfunded commitments at their respective balance sheet dates. A loan continues to qualify as restructured until a consistent payment history or change in borrower s financial condition has been evidenced, generally no less than twelve months. Assuming that the restructuring agreement specifies an interest rate at the time of the restructuring that is greater than or equal to the rate that we are willing to accept for a new extension of credit with comparable risk, then the loan no longer has to be considered a restructuring if it is in compliance with modified terms in calendar years after the year of the restructure.

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The following tables summarize, for the six months ended June 30, 2014 and 2013, loans that were restructured during 2014 and 2013 (in thousands):

June 30, 2014	Number of Restructured Loans	Pre-Restructuring Outstanding Recorded Investment	Post-Restructuring Outstanding Recorded Investment
Real estate commercial	1	$ 1,441	$ 1,430
Total new restructured loans in 2014	1	$ 1,441	$ 1,430

June 30, 2013	Number of Restructured Loans	Pre-Restructuring Outstanding Recorded Investment	Post-Restructuring Outstanding Recorded Investment
Commercial business loans	1	$ 1,945	$ 1,898
Total new restructured loans in 2013	1	$ 1,945	$ 1,898

The restructured loans generally include terms to temporarily place loans on interest only, extend the payment terms or reduce the interest rate. We did not forgive any principal on the above loans. The restructuring of the loans did not have a significant impact on our allowance for loan losses at June 30, 2014 or 2013.

The following table provides information on how restructured loans were modified during the six months ended June 30, 2014 and 2013 (in thousands):

	Six months ended June 30,	
	2014	2013
Extended maturity	$ 1,430	$
Combination of maturity extension and payment schedule adjustment		1,898
Total	$ 1,430	$ 1,898

As of June 30, 2014 and 2013, we did not have any loans that were restructured within the last 12 months that subsequently defaulted.

(5) OREO AND VALUATION ALLOWANCE FOR LOSSES ON OREO

The table below presents a summary of the activity related to OREO (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Beginning balance	$ 2,420	$ 14,426	$ 5,110	$ 15,991
Additions		912	851	912
Sales	(1,735)	(1,902)	(5,276)	(3,396)
Valuation allowance for OREO		(164)		(164)
Direct write-downs		(219)		(290)
Ending balance	$ 685	$ 13,053	$ 685	$ 13,053

(6) FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit which involve varying degrees of credit risk in excess of the amount recognized in the consolidated balance sheets. The Bank s exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is

represented by the contractual amount of these instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The amount of collateral obtained, if deemed necessary, is based on management s credit evaluation of the borrower.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer s credit-worthiness on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

The table below summarizes our off-balance sheet financial instruments whose contract amounts represented credit risk (in thousands):

	June 30, 2014	December 31, 2013
Commitments to extend credit	$ 4,497,052	$ 3,674,391
Standby letters of credit	173,531	145,662

(7) REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory (and possibly additional discretionary) actions by regulators that, if undertaken, could have a direct material effect on the Company s and the Bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company s and the Bank s assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company s and the Bank s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets, each as defined in the regulations. Management believes, as of June 30, 2014, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

Financial institutions are categorized as well capitalized or adequately capitalized, based on minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios. As shown in the table below, the Company s capital ratios exceed the regulatory definition of adequately capitalized as of June 30, 2014 and December 31, 2013. Based upon the information in its most recently filed call report, the Bank meets the capital ratios necessary to be well capitalized. The regulatory authorities can apply changes in classification of assets and such change may retroactively subject the Company to change in capital ratios. Any such change could result in reducing one or more capital ratios below well-capitalized status. In addition, a change may result in imposition of additional assessments by the FDIC or could result in regulatory actions that could have a material effect on condition and results of operations.

The table below summarizes our capital ratios:

	June 30, 2014	December 31, 2013
Company		
Risk-based capital:		
Tier 1 capital	9.09%	9.15%
Total capital	11.67%	10.73%
Leverage	10.94%	10.87%

Dividends that may be paid by subsidiary banks are routinely restricted by various regulatory authorities. The amount that can be paid in any calendar year without prior approval of the Bank s regulatory agencies cannot exceed the lesser of the net profits (as defined) for that year plus the net profits for the preceding two calendar years, or retained earnings. The Basel III Capital Rules, effective for us on January 1, 2015, will further limit the amount of dividends that may be paid by our bank. No dividends were declared or paid on common stock during the six months ended June 30, 2014 or 2013.

On March 28, 2013, we completed a sale of 6.0 million shares of 6.5% non-cumulative preferred stock, par value $0.01, with a liquidation preference of $25 per share, in a public offering. Dividends on the preferred stock are not cumulative and will be paid when declared by our board of directors to the extent that we have lawfully available funds to pay dividends. If declared, dividends will accrue and be payable quarterly, in arrears, on the liquidation preference amount, on a non-cumulative basis, at a rate of 6.50% per annum. We paid $4.9 million in dividends on the preferred stock for the six months ended June 30, 2014. Holders of preferred stock will not have voting rights, except with respect to authorizing or increasing the authorized amount of senior stock, certain changes in the terms of the preferred stock, certain dividend non-payments and as otherwise required by applicable law. Net proceeds from the sale totaled $145.0 million. The additional equity was used for general corporate purposes, including funding regulatory capital infusions into the Bank.

During January 2014, we completed an offering of 1.9 million shares of our common stock. Net proceeds from the sale totaled $106.5 million. On January 31, 2014, the Bank issued $175.0 million of subordinated notes in an offering to institutional investors exempt from registration under Section 3(a)(2) of the Securities Act of 1933 and 12 C.F.R. Part 16. Net proceeds from the transaction were $172.4 million. The notes mature in January 2026 and bear interest at a rate of 5.25% per annum, payable semi-annually. The notes are unsecured and are subordinate to the Bank s obligations to its deposits, its obligations under banker s acceptances and letters of credit, certain obligations to Federal Reserve Banks and the FDIC and the Bank s obligations to its other creditors, except any obligations which expressly rank on a parity with or junior to the notes. The notes are expected to qualify as Tier 2 capital for regulatory capital purposes, subject to applicable limitations. The net proceeds of both offerings were available to the Company for general corporate purposes, including retirement of $15.0 million of short-term debt that was outstanding at December 31, 2013, and additional capital to support continued loan growth.

(8) STOCK-BASED COMPENSATION

The fair value of our stock option and stock appreciation right (SAR) grants are estimated at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because our employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide the best single measure of the fair value of our employee stock options.

Stock-based compensation consists of SARs and RSUs granted from 2007 through 2013.

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(in thousands)	Three months ended June 30, 2014	2013	Six months ended June 30, 2014	2013
Stock- based compensation expense recognized:				
SARs	$ 148	$ 134	$ 291	$ 282
RSUs	1,118	804	2,237	1,561
Total compensation expense recognized	$ 1,266	$ 938	$ 2,528	$ 1,843

(in thousands)	June 30, 2014 Options	SARs and RSUs
Unrecognized compensation expense related to unvested awards	$	$ 12,252
Weighted average period over which expense is expected to be recognized, in years	N/A	3.6

In connection with the 2010 Long-term Incentive Plan, the Company has issued cash-based performance units. A summary of the compensation cost for these units is as follows (in thousands):

	Three months ended June 30, 2014	2013	Six months ended June 30, 2014	2013
Cash-based performance units	$ 1,312	$ 8,368	$ 4,705	$ 9,407

(9) DISCONTINUED OPERATIONS

Subsequent to the end of the first quarter of 2007, we and the purchaser of our residential mortgage loan division (RML) agreed to terminate and settle the contractual arrangements related to the sale of the division, which had been completed as of the end of the third quarter of 2006. Historical operating results of RML are reflected as discontinued operations in the financial statements.

We hold approximately $290,000 in loans held for sale from discontinued operations that are carried at the estimated market value at quarter-end, which is less than the original cost. We plan to sell these loans, but timing and price to be realized cannot be determined at this time due to market conditions. In addition, we continue to address requests from investors related to repurchasing loans previously sold. While the balances as of June 30, 2014 include a liability for exposure to additional contingencies, including the risk of having to repurchase loans previously sold, we recognize that market conditions may result in additional exposure to loss and the extension of time necessary to complete the discontinued mortgage operation.

(10) FAIR VALUE DISCLOSURES

ASC 820, *Fair Value Measurements and Disclosures* (ASC 820), defines fair value, establishes a framework for measuring fair value under GAAP and requires enhanced disclosures about fair value measurements. Fair value is defined under ASC 820 as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal market for the asset or liability in an orderly transaction between market participants on the measurement date.

We determine the fair market values of our assets and liabilities measured at fair value on a recurring and nonrecurring basis using the fair value hierarchy as prescribed in ASC 820. The standard describes three levels of inputs that may be used to measure fair value as provided below.

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets include U.S. government and agency mortgage-backed debt securities,

municipal bonds, and Community Reinvestment Act funds. This category includes derivative assets and liabilities where values are obtained from independent pricing services.

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Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair values requires significant management judgment or estimation. This category includes impaired loans and OREO where collateral values have been based on third party appraisals; however, due to current economic conditions, comparative sales data typically used in appraisals may be unavailable or more subjective due to lack of market activity.

Assets and liabilities measured at fair value at June 30, 2014 and December 31, 2013 are as follows (in thousands):

	Fair Value Measurements Using		
June 30, 2014	Level 1	Level 2	Level 3
Available for sale securities:(1)			
Residential mortgage-backed securities	$	$ 36,002	$
Municipals		5,952	
Equity securities(2)		7,376	
Loans(3) (5)			24,068
OREO(4) (5)			685
Derivative assets(6)		24,453	
Derivative liabilities(6)		(24,453)	
December 31, 2013			
Available for sale securities:(1)			
Residential mortgage-backed securities	$	$ 41,462	$
Municipals		14,505	
Equity securities(2)		7,247	
Loans(3) (5)			13,474
OREO(4) (5)			5,110
Derivative assets(6)		9,317	
Derivative liabilities(6)		(9,317)	

(1) Securities are measured at fair value on a recurring basis, generally monthly.
(2) Equity securities consist of Community Reinvestment Act funds.
(3) Includes impaired loans that have been measured for impairment at the fair value of the loan s collateral.
(4) OREO is transferred from loans to OREO at fair value less selling costs.
(5) Fair value of loans and OREO is measured on a nonrecurring basis, generally annually or more often as warranted by market and economic conditions.
(6) Derivative assets and liabilities are measured at fair value on a recurring basis, generally quarterly.

Level 3 Valuations

Financial instruments are considered Level 3 when their values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 financial instruments also include those for which the determination of fair value requires significant management judgment or estimation. Currently, we measure fair value for certain loans and OREO on a nonrecurring basis as described below.

Loans

During the three months and six months ended June 30, 2014, certain impaired loans were reevaluated and reported at fair value through a specific allocation of the allowance for loan losses based upon the fair value of the underlying collateral. The $24.1 million total above includes impaired loans at June 30, 2014 with a carrying value of $29.2 million that were reduced by specific allowance allocations totaling $5.1 million for a total reported fair value of $24.1 million based on collateral valuations utilizing Level 3 valuation inputs. Fair values were based on third party appraisals.

OREO

Certain foreclosed assets, upon initial recognition, are valued based on third party appraisals less estimated selling costs. At June 30, 2014, OREO had a carrying value of $685,000 with no specific valuation allowance. The fair value of OREO was computed based on third party appraisals, which are Level 3 valuation inputs.

Fair Value of Financial Instruments

Generally accepted accounting principles require disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. This disclosure does not and is not intended to represent the fair value of the Company.

A summary of the carrying amounts and estimated fair values of financial instruments is as follows (in thousands):

	June 30, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Cash and cash equivalents	$ 357,142	$ 357,142	$ 153,911	$ 153,911
Securities, available-for-sale	49,330	49,330	63,214	63,214
Loans held for sale from discontinued operations	290	290	294	294
Loans held for investment, net	12,761,854	12,766,383	11,182,970	11,179,145
Derivative assets	24,453	24,453	9,317	9,317
Deposits	10,757,316	10,757,495	9,257,379	9,257,574
Federal funds purchased	273,041	273,041	148,650	148,650
Customer repurchase agreements	27,491	27,491	21,954	21,954
Other borrowings	700,016	700,016	855,026	855,026
Subordinated notes	286,000	286,066	111,000	96,647
Trust preferred subordinated debentures	113,406	113,406	113,406	113,406
Derivative liabilities	24,453	24,453	9,317	9,317

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents

The carrying amounts reported in the consolidated balance sheet for cash and cash equivalents approximate their fair value, which is characterized as a Level 1 asset in the fair value hierarchy.

Securities

The fair value of investment securities is based on prices obtained from independent pricing services which are based on quoted market prices for the same or similar securities, which is characterized as a Level 2 asset in the fair value hierarchy. We have obtained documentation from the primary pricing service we use about their processes and

controls over pricing. In addition, on a quarterly basis we independently verify the prices that we receive from the service provider using two additional independent pricing sources. Any significant differences are investigated and resolved.

Loans, net

Loans are characterized as Level 3 assets in the fair value hierarchy. For variable-rate loans that reprice frequently with no significant change in credit risk, fair values are generally based on carrying values. The fair value for all other loans is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest approximates its fair value. The carrying amount of loans held for sale approximates fair value.

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Derivatives

The estimated fair value of the interest rate swaps are obtained from independent pricing services based on quote market prices for the same or similar derivative contracts and are characterized as a Level 2 asset in the fair value hierarchy. On a quarterly basis, we independently verify the fair value using an additional independent pricing source.

Deposits

Deposits are characterized as Level 3 liabilities in the fair value hierarchy. The carrying amounts for variable-rate money market accounts approximate their fair value. Fixed-term certificates of deposit fair values are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities.

Federal funds purchased, customer repurchase agreements, other borrowings, subordinated notes and trust preferred subordinated debentures

The carrying value reported in the consolidated balance sheet for Federal funds purchased, customer repurchase agreements and other short-term, floating rate borrowings approximates their fair value, which is characterized as a Level 1 asset in the fair value hierarchy. The fair value of any fixed rate short-term borrowings and trust preferred subordinated debentures are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar borrowings, which is characterized as a Level 3 liability in the fair value hierarchy. The subordinated notes are publicly traded and are valued based on market prices, which is characterized as a Level 2 liability in the fair value hierarchy.

(11) DERIVATIVE FINANCIAL INSTRUMENTS

The fair value of derivative positions outstanding is included in other assets and other liabilities in the accompanying consolidated balance sheets.

During 2014 and 2013, we entered into certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which we enter into an interest rate swap, cap and/or floor with a customer while at the same time entering into an offsetting interest rate swap, cap and/or floor with another financial institution. In connection with each swap transaction, we agree to pay interest to the customer on a notional amount at a variable interest rate and receive interest from the customer on a similar notional amount at a fixed interest rate. At the same time, we agree to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows our customer to effectively convert a variable rate loan to a fixed rate. Because we act as an intermediary for our customer, changes in the fair value of the underlying derivative contracts substantially offset each other and do not have a material impact on our results of operations.

The notional amounts and estimated fair values of interest rate derivative positions outstanding at June 30, 2014 and December 31, 2013 are presented in the following tables (in thousands):

	June 30, 2014		December 31, 2013	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Non-hedging interest rate derivative:				
Commercial loan/lease interest rate swaps	$ 835,562	$ 23,422	$ 764,939	$ 8,652
Commercial loan/lease interest rate swaps	(835,562)	(23,422)	(764,939)	(8,652)
Commercial loan/lease interest rate caps	(54,428)	(1,031)	(58,706)	(665)
Commercial loan/lease interest rate caps	54,428	1,031	58,706	665

The weighted-average receive and pay interest rates for interest rate swaps outstanding at June 30, 2014 were as follows:

	June 30, 2014		December 31, 2013	
	Weighted-Average Interest Rate		Weighted-Average Interest Rate	
	Received	Paid	Received	Paid
Non-hedging interest rate swaps	4.84%	2.85%	2.99%	4.89%

The weighted-average strike rate for outstanding interest rate caps was 1.51% at June 30, 2014 and 1.87% at December 31, 2013.

Our credit exposure on interest rate swaps and caps is limited to the net favorable value and interest payments of all swaps and caps by each counterparty. In such cases collateral may be required from the counterparties involved if the net value of the swaps and caps exceeds a nominal amount considered to be immaterial. Our credit exposure, net of any collateral pledged, relating to interest rate swaps and caps was approximately $24.5 million at June 30, 2014 and approximately $9.3 million at December 31, 2013, all of which relates to bank customers. Collateral levels are monitored and adjusted on a regular basis for changes in interest rate swap and cap values. At June 30, 2014 and December 31, 2013, we had $23.5 million and $10.7 million, respectively, in cash collateral pledged for these derivatives included in interest-bearing deposits.

(12) STOCKHOLDERS EQUITY

On March 28, 2013, we completed a sale of 6.0 million shares of 6.5% non-cumulative preferred stock, par value $0.01, with a liquidation preference of $25 per share, in a public offering. Dividends on the preferred stock are not cumulative and will be paid if and when declared by our board of directors to the extent that we have lawfully available funds to pay dividends. If declared, dividends will accrue and be payable quarterly, in arrears, on the liquidation preference amount, on a non-cumulative basis, at a rate of 6.50% per annum. For the six months ended June 30, 2014, we paid $4.9 million in dividends on the preferred stock. Holders of preferred stock do not have voting rights, except with respect to authorizing or increasing the authorized amount of senior stock, certain changes in the terms of the preferred stock, certain dividend non-payments and as otherwise required by applicable law. Net proceeds from the sale totaled $145.0 million. The proceeds were used for general corporate purposes, including funding regulatory capital infusions into the Bank.

During January 2014, we completed an offering of 1.9 million shares of our common stock. Net proceeds from the sale totaled $106.5 million. The net proceeds of the offering were available to the Company for general corporate purposes, including retirement of $15.0 million of short-term debt that was outstanding at December 31, 2013, and additional capital to support continued loan growth.

(13) NEW ACCOUNTING PRONOUNCEMENTS

ASU 2014-04 Receivables (Topic 310) Troubled Debt Restructurings by Creditors (ASU 2014-04) amends Topic 310 Receivables to clarify the terms defining when an in substance repossession or foreclosure occurs, which determines when the receivable should be derecognized and the real estate property is recognized. ASU 2013-04 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. It is not expected to have a significant impact on our financial statements.

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QUARTERLY FINANCIAL SUMMARY UNAUDITED

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

	For the three months ended June 30, 2014			For the three months ended June 30, 2013		
	Average Balance	Revenue/ Expense[1]	Yield/ Rate	Average Balance	Revenue/ Expense[1]	Yield/ Rate
Assets						
Securities taxable	$ 44,216	$ 410	3.72%	$ 60,063	$ 594	3.97%
Securities non-taxable[2]	6,271	94	6.01%	18,843	275	5.85%
Federal funds sold	14,997	8	0.21%	54,448	13	0.10%
Deposits in other banks	183,061	100	0.22%	91,177	60	0.26%
Loans held for investment, mortgage finance loans	2,822,560	23,231	3.30%	2,406,246	22,440	3.74%
Loans held for investment	8,984,230	101,003	4.51%	7,152,323	83,978	4.71%
Less reserve for loan losses	90,105			75,006		
Loans, net of reserve	11,716,685	124,234	4.25%	9,483,563	106,418	4.50%
Total earning assets	11,965,230	124,846	4.19%	9,708,094	107,360	4.44%
Cash and other assets	396,938			402,898		
Total assets	$ 12,362,168			$ 10,110,992		
Liabilities and Stockholders Equity						
Transaction deposits	$ 895,827	$ 170	0.08%	$ 1,051,199	$ 233	0.09%
Savings deposits	4,679,140	3,395	0.29%	3,340,420	2,292	0.28%
Time deposits	401,024	390	0.39%	397,868	407	0.41%
Deposits in foreign branches	350,043	291	0.33%	340,713	296	0.35%
Total interest bearing deposits	6,326,034	4,246	0.27%	5,130,200	3,228	0.25%
Other borrowings	666,405	300	0.18%	727,158	354	0.20%
Subordinated notes	286,000	4,241	5.95%	111,000	1,829	6.61%
Trust preferred subordinated debentures	113,406	619	2.19%	113,406	633	2.24%
Total interest bearing liabilities	7,391,845	9,406	0.51%	6,081,764	6,044	0.40%
Demand deposits	3,629,941			2,914,341		
Other liabilities	98,595			91,608		
Stockholders equity	1,241,787			1,023,279		
Total liabilities and stockholders equity	$ 12,362,168			$ 10,110,992		
Net interest income[2]		$ 115,440			$ 101,316	

Net interest margin				3.87%				4.19%
Net interest spread				3.67%				4.04%
Loan spread				4.08%				4.34%
Additional information from discontinued operations:								
Loans held for sale	$ 291				$ 299			
Borrowed funds	291				299			
Net interest income			$ 7				$ 6	
Net interest margin consolidated				3.87%				4.19%

(1) The loan averages include loans on which the accrual of interest has been discontinued and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

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QUARTERLY FINANCIAL SUMMARY UNAUDITED

Consolidated Daily Average Balances, Average Yields and Rates

(In thousands)

	For the six months ended June 30, 2014			For the six months ended June 30, 2013		
	Average Balance	Revenue/ Expense[1]	Yield/ Rate	Average Balance	Revenue/ Expense[1]	Yield/ Rate
Assets						
Securities taxable	$ 45,614	$ 852	3.77%	$ 65,611	$ 1,323	4.07%
Securities non-taxable[2]	8,401	245	5.88%	20,499	598	5.88%
Federal funds sold	44,209	48	0.22%	39,698	19	0.10%
Deposits in other banks	206,548	259	0.25%	84,982	112	0.27%
Loans held for sale	2,427,109	40,013	3.32%	2,384,566	45,081	3.81%
Loans held for investment	8,851,835	200,093	4.56%	6,998,400	164,519	4.74%
Less reserve for loan losses	88,902			74,726		
Loans, net of reserve	11,190,042	240,106	4.33%	9,308,240	209,600	4.54%
Total earning assets	11,494,814	241,510	4.24%	9,519,030	211,652	4.48%
Cash and other assets	389,608			402,299		
Total assets	$ 11,884,422			$ 9,921,329		
Liabilities and Stockholders Equity						
Transaction deposits	$ 839,378	$ 250	0.06%	$ 1,027,598	$ 486	0.10%
Savings deposits	4,635,559	6,699	0.29%	3,293,806	4,589	0.28%
Time deposits	388,364	741	0.38%	400,476	821	0.41%
Deposits in foreign branches	352,934	586	0.33%	338,004	577	0.34%
Total interest bearing deposits	6,216,235	8,276	0.27%	5,059,884	6,473	0.26%
Other borrowings	480,740	471	0.20%	883,497	783	0.18%
Subordinated notes	256,995	7,720	6.06%	111,000	3,658	6.65%
Trust preferred subordinated debentures	113,406	1,235	2.20%	113,406	1,267	2.25%
Total interest bearing liabilities	7,067,376	17,702	0.51%	6,167,787	12,181	0.40%
Demand deposits	3,506,407			2,723,196		
Other liabilities	101,040			91,076		
Stockholders equity	1,209,599			939,270		
Total liabilities and stockholders equity	$ 11,884,422			$ 9,921,329		
Net interest income[2]		$ 223,808			$ 199,471	

Net interest margin		3.93%		4.23%
Net interest spread		3.73%		4.08%
Loan spread		4.16%		4.37%
Additional information from discontinued operations:				
Loans held for sale	$ 292		$ 300	
Borrowed funds	292		300	
Net interest income		$ 14		$ 12
Net interest margin consolidated		3.93%		4.23%

(1) The loan averages include loans on which the accrual of interest has been discontinued and are stated net of unearned income.

(2) Taxable equivalent rates used where applicable.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

Statements and financial analysis contained in this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 (the Act). In addition, certain statements may be contained in our future filings with SEC, in press releases, and in oral and written statements made by us or with our approval that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Forward-looking statements describe our future plans, strategies and expectations and are based on certain assumptions. Words such as believes , anticipates , plans , goals , objectives , expects , intends , seeks , likely , targeted , continue , remain , will , should , may and other similar exp to identify forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements are subject to various risks and uncertainties, which change over time, are based on management s expectations and assumptions at the time the statements are made and are not guarantees of future results. Important factors that could cause actual results to differ materially from the forward-looking statements are disclosed under the heading Risk Factors in our 2013 Form 10-K and include, but are not limited to, the following:

Deterioration of the credit quality of our loan portfolio, increased default rates and loan losses or adverse changes in the industry concentrations of our loan portfolio.

Developments adversely affecting our commercial, entrepreneur and professional customers.

Changes in the value of commercial and residential real estate securing our loans or in the demand for credit to support the purchase and ownership of such assets.

The failure of assumptions supporting our allowance for loan losses causing it to become inadequate as loan quality decreases and losses and charge-offs increase.

A failure to effectively manage our interest rate risk resulting from unexpectedly large or sudden changes in interest rates or rate or maturity imbalances in our assets and liabilities, where such changes could affect the results of operations.

Failure to execute our business strategy, including any inability to expand into new markets and lines of business in Texas, regionally and nationally.

Loss of access to capital market transactions and other sources of funding, or a failure to effectively balance our funding sources with cash demands by depositors and borrowers.

Failure to successfully develop and launch new lines of business and new products and services within the expected time frames and budgets, or failure to anticipate and appropriately manage the associated risks.

The failure to attract and retain key personnel or the loss of key individuals or groups of employees.

Changes in the U.S. economy in general or the Texas economy specifically resulting in deterioration of credit quality or reduced demand for credit or other financial services we offer.

Legislative and regulatory changes imposing further restrictions and costs on our business, a failure to remain well capitalized or regulatory enforcement actions against us.

An increase in the incidence or severity of fraud, illegal payments, security breaches and other illegal acts impacting our bank and our customers.

Structural changes in the markets for origination, sale and servicing of residential mortgages.

Increased or more effective competition from banks and other financial service providers in our markets.

Material failures of our accounting estimates and risk management processes based on management judgment, or the supporting analytical and forecasting models.

Unavailability of funds obtained from capital transactions or from our bank to fund our obligations.

Failures of counterparties or third party vendors to perform their obligations.

Failures or breaches of our information systems that are not effectively managed.

Severe weather, natural disasters, acts of war or terrorism and other external events.

Incurrence of material costs and liabilities associated with claims and litigation.

Failure of our risk management strategies and procedures, including failure or circumvention of our controls.

Actual outcomes and results may differ materially from what is expressed in our forward-looking statements and from our historical financial results due to the factors discussed elsewhere in this report or disclosed in our other SEC filings. Forward-looking statements included herein should not be relied upon as representing our expectations or beliefs as of any date subsequent to the date of this report. Except as required by law, we undertake no obligation to update or revise any forward-looking statements contained in this report or our other SEC filings, whether as a result of new information, future events or otherwise. The factors discussed herein are not intended to be a complete summary of all risks and uncertainties that may affect our businesses. Though we strive to monitor and mitigate risk, we cannot anticipate all potential economic, operational and financial developments that may adversely impact our operations and our financial results. Forward-looking statements should not be viewed as predictions and should not be the primary basis upon which investors evaluate an investment in our securities.

Overview of Our Business Operations

We commenced our banking operations in December 1998. An important aspect of our growth strategy has been our ability to service and effectively manage a large number of loans and deposit accounts in multiple markets in Texas. Accordingly, we have created an operations infrastructure sufficient to support state-wide lending and banking operations that we continue to build out as needed to serve a larger customer base and specialized industries.

The following discussion and analysis presents the significant factors affecting our financial condition as of June 30, 2014 and December 31, 2013 and results of operations for three and six months in the periods ended June 30, 2014 and 2013. This discussion should be read in conjunction with our consolidated financial statements and notes to the financial statements appearing in Part I, Item 1 of this report.

Except as otherwise noted, all amounts and disclosures throughout this document reflect continuing operations. See Part I, Item 1 herein for a discussion of discontinued operations and at Note 9 Discontinued Operations.

Results of Operations

Summary of Performance

We reported net income of $33.4 million and net income available to common stockholders of $31.0 million, or $0.71 per diluted common share, for the second quarter of 2014 compared to net income of $24.1 million and net income available to common stockholders of $21.6 million, or $0.52 per diluted common share, for the second quarter of 2013. Return on average common equity (ROE) was 11.38% and return on average assets was 1.08% for the second quarter of 2014, compared to 9.94% and 0.95%, respectively, for the second quarter of 2013. Net income and net income available to common stockholders for the six months ended June 30, 2014 totaled $61.7 million and $56.8 million, respectively, or $1.30 per diluted common share, compared to net income and net income available to common stockholders of $57.2 million and $54.7 million, respectively, or $1.31 per diluted common share, for the same period in 2013. Return on average common equity was 10.81% and return on average assets was 1.05% for the six months ended June 30, 2014, compared to 11.74% and 1.36%, respectively, for the six months ended June 30, 2013. During January 2014, we completed an equity offering of 1.9 million shares, which increased diluted shares. We also completed a $175.0 million subordinated debt offering, which resulted in an additional $3.9 million in interest expense for the six months ended June 30, 2014. The sale of 1.9 million common shares during the first quarter of 2014 increased common equity by $106.5 million and had the effect of reducing ROE.

Net income increased $9.3 million, or 39%, for the three months ended June 30, 2014 as compared to the same period in 2013. The increase was primarily the result of a $14.2 million increase in net interest income and a $3.0 million decrease in the provision for credit losses, offset by a $595,000 decrease in non-interest income, a $1.0 million

increase in non-interest expense and a $6.2 million increase in income tax expense. Net income increased $4.5 million, or 8%, during the six months ended June 30, 2014 primarily as the result of a $24.5 million increase in net interest income offset by a $1.5 million decrease in non-interest income, a $14.7 million increase in non-interest expense and a $3.8 million increase in income tax expense.

Details of the changes in the various components of net income are further discussed below.

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Net Interest Income

Net interest income was $115.4 million for the second quarter of 2014, compared to $101.2 million for the second quarter of 2013. The increase was due to an increase in average earning assets of $2.3 billion as compared to the second quarter of 2013. The increase in average earning assets included a $2.2 billion increase in average net loans and a $52.4 million increase in average liquidity assets, offset by a $28.4 million decrease in average securities. For each of the quarters ended June 30, 2014 and June 30, 2013, average net loans, liquidity assets and securities represented approximately 98%, 2% and less than 1%, respectively, of average earning assets.

Average interest-bearing liabilities for the quarter ended June 30, 2014 increased $1.3 billion from the second quarter of 2013, which included a $1.2 billion increase in interest-bearing deposits and a $175.0 million increase in long-term debt as a result of the Bank s issuance of subordinated notes in January 2014, offset by a $60.8 million decrease in other borrowings. Average demand deposits increased from $2.9 billion at June 30, 2013 to $3.6 billion at June 30, 2014. The average cost of total deposits and borrowed funds increased from .16% for the second quarter of 2013 to .17% for the second quarter of 2014. The total cost of interest-bearing liabilities included $2.3 million attributable to $175.0 million in long-term debt issued in January 2014. Including the increase in long-term debt, the cost of interest-bearing liabilities increased from .40% for the quarter ended June 30, 2013 to .51% for the same period of 2014.

Net interest income was $223.7 million for the six months ended June 30, 2014, compared to $199.3 million for the same period in 2013. The increase was due to an increase in average earning assets of $2.0 billion as compared to the six months ended June 30, 2013. The increase in average earning assets included a $1.9 billion increase in average net loans and a $126.1 million increase in average liquidity assets, offset by a $32.1 million decrease in average securities. For the six months ended June 30, 2014, average net loans, liquidity assets and securities represented approximately 97%, 2% and 1%, respectively, of average earning assets compared to 98%, 1% and 1%, respectively, in the same period of 2013.

Average interest-bearing liabilities for the six months ended June 30, 2014 increased $899.6 million from the first six months of 2013, which included a $1.2 billion increase in interest-bearing deposits and a $146.0 million increase in subordinated notes, offset by a $402.8 million decrease in other borrowings. Average demand deposits increased from $2.7 billion at June 30, 2013 to $3.5 billion at June 30, 2014. The average cost of total deposits and borrowed funds remained at .17% for the six months ended June 30, 2014 compared to the same period in the prior year. The total cost of interest-bearing liabilities included $3.9 million attributable to $175.0 million of long-term debt issued in January 2014. Including the increase in long-term debt, the cost of interest-bearing liabilities, including long-term debt, increased from .40% for the six months ended June 30, 2013 to .51% for the same period of 2014.

The following table presents the changes (in thousands) in taxable-equivalent net interest income and identifies the changes due to differences in the average volume of earning assets and interest-bearing liabilities and the changes due to changes in the average interest rate on those assets and liabilities.

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	Three months ended June 30, 2014/2013			Six months ended June 30, 2014/2013		
	Net	Change Due To[1]		Net	Change Due To[1]	
	Change	Volume	Yield/Rate	Change	Volume	Yield/Rate
Interest income:						
Securities[2]	$ (365)	$ (340)	$ (25)	$ (824)	$ (756)	$ (68)
Loans held for investment, mortgage finance loans	791	3,882	(3,091)	(5,068)	804	(5,872)
Loans held for investment	17,025	21,509	(4,484)	35,574	43,571	(7,997)
Federal funds sold	(5)	(9)	4	29	2	27
Deposits in other banks	40	60	(20)	147	160	(13)
Total	17,486	25,102	(7,616)	29,858	43,781	(13,923)
Interest expense:						
Transaction deposits	(63)	(34)	(29)	(236)	(89)	(147)
Savings deposits	1,103	919	184	2,110	1,869	241
Time deposits	(17)	3	(20)	(80)	(25)	(55)
Deposits in foreign branches	(5)	8	(13)	9	25	(16)
Borrowed funds	(54)	(30)	(24)	(312)	(357)	45
Long-term debt	2,398	2,884	(486)	4,030	4,811	(781)
Total	3,362	3,750	(388)	5,521	6,234	(713)
Net interest income	$ 14,124	$ 21,352	$ (7,228)	$ 24,337	$ 37,547	$ (13,210)

(1) Changes attributable to both volume and yield/rate are allocated to both volume and yield/rate on an equal basis.
(2) Taxable equivalent rates used where applicable and assume a 35% tax rate.

Net interest margin, the ratio of net interest income to average earning assets, was 3.87% for the second quarter of 2014 compared to 4.19% for the second quarter of 2013. The year over year decrease is due to the growth in loans with lower yields, the impact of the subordinated note offering and the $52.4 million increase in average balances of liquidity assets, which includes Federal funds sold and deposits from other banks. Funding costs, including demand deposits and borrowed funds, increased to .17% for the second quarter of 2014 compared to .16% for the second quarter of 2013. The spread on total earning assets, net of the cost of deposits and borrowed funds, was 4.02% for the second quarter of 2014 compared to 4.28% for the second quarter of 2013. The decrease resulted from the reduction in yields on total loans, primarily due to the increased proportion of mortgage finance loans to total loans. Total funding costs, including all deposits, long-term debt and stockholders equity increased to ..31% for the second quarter of 2014 compared to .24% for the second quarter of 2013. Average long-term debt increased by $175.0 million from the second quarter of 2013 and the average interest rate on long-term debt for the second quarter of 2014 was 4.88% compared to 4.40% for the same period of 2013.

Non-interest Income

The components of non-interest income were as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Service charges on deposit accounts	$ 1,764	$ 1,749	$ 3,460	$ 3,450
Trust fee income	1,242	1,269	2,524	2,510
Bank owned life insurance (BOLI) income	521	463	1,030	961
Brokered loan fees	3,357	4,778	6,181	9,522
Swap fees	410	981	1,634	2,633
Other	3,239	1,888	6,060	3,333
Total non-interest income	$ 10,533	$ 11,128	$ 20,889	$ 22,409

Non-interest income decreased $595,000 during the three months ended June 30, 2014 compared to the same period of 2013. This decrease was primarily due to a $1.4 million decrease in brokered loan fees as a result of lower per loan fees during the second quarter of 2014. Swap fee income decreased $571,000 during the three months ended June 30, 2014 compared to the same period of 2013. These fees fluctuate from quarter to quarter based on the number and volume of transactions closed during the quarter. Swap fees are fees related to

customer swap transactions and are received from the institution that is our counterparty on the transaction. Offsetting these decreases was a $1.4 million increase in other non-interest income. Other non-interest income includes such items as letter of credit fees and other general operating income, none of which account for 1% or more of total interest income and non-interest income.

Non-interest income decreased $1.5 million during the six months ended June 30, 2014 compared to the same period of 2013. This decrease was primarily due to a $3.3 million decrease in brokered loan fees as a result of lower per loan fees. Swap fee income decreased $999,000 during the six months ended June 30, 2014 compared to the same period of 2013. These fees fluctuate from quarter to quarter based on the number and volume of transactions closed during the quarter. Swap fees are fees related to customer swap transactions and are received from the institution that is our counterparty on the transaction. Offsetting these decreases was a $2.7 million increase in other non-interest income. Other non-interest income includes such items as letter of credit fees and other general operating income, none of which account for 1% or more of total interest income and non-interest income.

While management expects continued growth in certain components of non-interest income, the future rate of growth could be affected by increased competition from nationwide and regional financial institutions. In order to achieve continued growth in non-interest income, we may need to introduce new products or enter into new lines of business or expand existing lines of business. Any new product introduction or new market entry could place additional demands on capital and managerial resources.

Non-interest Expense

The components of non-interest expense were as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Salaries and employee benefits	$ 39,896	$ 45,191	$ 81,952	$ 78,732
Net occupancy expense	5,073	4,135	9,841	7,992
Marketing	3,795	4,074	7,554	8,046
Legal and professional	7,181	4,707	12,583	8,647
Communications and technology	4,361	3,347	8,285	6,469
FDIC insurance assessment	2,544	699	5,269	1,777
Allowance and other carrying costs for OREO	11	482	56	912
Other[1]	6,907	6,099	13,549	11,859
Total non-interest expense	$ 69,768	$ 68,734	$ 139,089	$ 124,434

(1) Other expense includes such items as courier expenses, regulatory assessments other than FDIC insurance, due from bank charges and other general operating expenses, none of which account for 1% or more of total interest income and non-interest income.

Non-interest expense for the second quarter of 2014 increased $1.1 million, or 1%, to $69.8 million from $68.7 million in the second quarter of 2013. The increase is primarily attributable to a $2.5 million increase in legal and professional expense. Our legal and professional expense will continue to fluctuate and could increase in the future with growth and as we respond to continued regulatory changes and strategic initiatives. We expect to continue to see

a decrease in the cost of resolving problem assets under improving economic conditions.

Salaries and employee benefits for the second quarter of 2014 decreased $5.3 million as the second quarter of 2013 included expenses of $7.7 million related to the succession announced last year that were non-recurring.

Net occupancy expense for the three months ended June 30, 2014 increased $1.0 million as a result of general business growth and continued build-out needed to support that growth.

Communications and technology expense for the three months ended June 30, 2014 increased $1.0 million due to general business growth.

FDIC insurance assessment expense for the three months ended June 30, 2014 increased $1.8 million compared to the same quarter in 2013 as a result of the difference in rates applied to banks with over $10 billion in assets.

Non-interest expense for the six months ended June 30, 2014 increased $14.7 million, or 12%, to $139.1 million from $124.4 million compared to the same period in 2013. The increase is primarily attributable to a $3.9 million increase in legal and professional expense. Our legal and professional expense will continue to fluctuate and could increase in the future with growth and as we respond to continued regulatory changes and strategic initiatives. We expect to continue to see a decrease in the cost of resolving problem assets under improving economic conditions.

Salaries and employee benefits for the six months ended June 30, 2014 increased $3.2 million due to general business growth, offset by the expenses of $7.7 million related to the succession announced last year that were non-recurring.

Net occupancy expense for the six months ended June 30, 2014 increased $1.8 million as a result of general business growth and continued build-out needed to support that growth.

Communications and technology expense for the six months ended June 30, 2014 increased $1.8 million due to general business growth.

FDIC insurance assessment expense for the six months ended June 30, 2014 increased $3.5 million compared to the same period in 2013 as a result of the difference in rates applied to banks with over $10 billion in assets.

Analysis of Financial Condition

Loan Portfolio

Total loans net of allowance for loan losses at June 30, 2014 increased $1.6 billion from December 31, 2013 to $12.8 billion. Our business plan focuses primarily on lending to middle market businesses and successful professionals and entrepreneurs, and as such, commercial, real estate and construction loans have comprised a majority of our loan portfolio. Consumer loans generally have represented 1% or less of the portfolio. Mortgage finance loans relate to our mortgage warehouse lending operations in which we invest in mortgage loan ownership interests that are typically sold within 10 to 20 days. Volumes fluctuate based on the level of market demand in the product and the number of days between purchase and sale of the loans, as well as overall market interest rates.

We originate a substantial majority of all loans held for investment. We also participate in syndicated loan relationships, both as a participant and as an agent. As of June 30, 2014, we had $1.4 billion in syndicated loans, $409.5 million of which we acted as agent. All syndicated loans, whether we act as agent or participant, are underwritten to the same standards as all other loans we originate. In addition, as of June 30, 2014, none of our syndicated loans were on non-accrual.

Loans were as follows as of the dates indicated (in thousands):

	June 30, 2014	December 31, 2013
Commercial	$ 5,295,368	$ 5,020,565
Mortgage finance	3,700,253	2,784,265
Construction	1,567,667	1,262,905
Real estate	2,231,630	2,146,228
Consumer	15,847	15,350
Leases	95,914	93,160

Gross loans held for investment	12,906,679	11,322,473
Deferred income (net of direct origination costs)	(53,711)	(51,899)
Allowance for loan losses	(91,114)	(87,604)
Total loans held for investment, net	$ 12,761,854	$ 11,182,970

Commercial Loans and Leases. Our commercial loan and lease portfolio is comprised of lines of credit for working capital and term loans and leases to finance equipment and other business assets. Our energy production loans are generally collateralized with proven reserves based on appropriate valuation standards.

Our commercial loans and leases are underwritten after carefully evaluating and understanding the borrower s ability to operate profitably. Our underwriting standards are designed to promote relationship banking rather than making loans on a transactional basis. Our lines of credit typically are limited to a percentage of the value of the assets securing the line. Lines of credit and term loans typically are reviewed annually and are supported by accounts receivable, inventory, equipment and other assets of our clients businesses.

Mortgage finance loans. Our mortgage finance loans consist of ownership interests purchased in single-family residential mortgages funded through our warehouse lending group. These loans are typically on our balance sheet for 10 to 20 days or less. We have agreements with mortgage lenders and purchase interests in individual loans they originate. All loans are underwritten consistent with established programs for permanent financing with financially sound investors. Substantially all loans are conforming loans. Mortgage finance loans as of June 30, 2014 are net of $93.8 million of participations sold.

Construction Loans. Our construction loan portfolio consists primarily of single- and multi-family residential properties and commercial projects used in manufacturing, warehousing, service or retail businesses. Our construction loans generally have terms of one to three years. We typically make construction loans to developers, builders and contractors that have an established record of successful project completion and loan repayment and have a substantial equity investment in the borrowers equity. However, construction loans are generally based upon estimates of costs and value associated with the completed project. Sources of repayment for these types of loans may be pre-committed permanent loans from other lenders, sales of developed property, or an interim loan commitment from us until permanent financing is obtained. The nature of these loans makes ultimate repayment extremely sensitive to overall economic conditions. Borrowers may not be able to correct conditions of default in loans, increasing risk of exposure to classification, non-performing status, reserve allocation and actual credit loss and foreclosure. These loans typically have floating rates and commitment fees.

Real Estate Loans. A portion of our real estate loan portfolio is comprised of loans secured by properties other than market risk or investment-type real estate. Market risk loans are real estate loans where the primary source of repayment is expected to come from the sale or lease of the real property collateral. We generally provide temporary financing for commercial and residential property. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Our real estate loans generally have maximum terms of five to seven years, and we provide loans with both floating and fixed rates. We generally avoid long-term loans for commercial real estate held for investment. Real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Appraised values may be highly variable due to market conditions and the impact of the inability of potential purchasers and lessees to obtain financing and lack of transactions at comparable values.

Portfolio Geographic Concentration

As of June 30, 2014, a substantial majority of the principal amount of the loans held for investment in our portfolio was to businesses and individuals in Texas. This geographic concentration subjects the loan portfolio to the general economic conditions within this area. The risks created by this concentration have been considered by management in the determination of the appropriateness of the allowance for loan losses. Management believes the allowance for loan losses is appropriate to cover estimated losses on loans at each balance sheet date.

Summary of Loan Loss Experience

The provision for credit losses is a charge to earnings to maintain the reserve for loan losses at a level consistent with management s assessment of the loan portfolio in light of current economic conditions and market trends. We recorded a provision of $4.0 million during the second quarter of 2014 compared to $5.0 million in the first quarter of 2014 and

$7.0 million in the second quarter of 2013. Despite experiencing improvements in credit quality, we have seen levels of reserves and provision increase due to growth in the portfolio. We continue to maintain an unallocated reserve component to allow for continued uncertainty in the economic environment which has produced losses, including those resulting from fraud by borrowers, that are not necessarily correlated with historical loss trends or general economic conditions. Our methodology used to calculate the allowance considers historical losses, however, the historical loss rates for specific product types or credit risk grades may not fully incorporate the effects of continued weakness in the economy.

The reserve for loan losses is comprised of specific reserves for impaired loans and an estimate of losses inherent in the portfolio at the balance sheet date, but not yet identified with specified loans. We regularly evaluate our reserve for loan losses to maintain an appropriate level to absorb estimated loan losses inherent in the loan portfolio. Factors contributing to the determination of reserves include the credit worthiness of the borrower, changes in the value of pledged collateral, and general economic conditions. All loan commitments rated substandard or worse and greater than $500,000 are specifically reviewed for loss potential. For loans deemed to be impaired, a specific allocation is assigned based on the losses expected to be realized from those loans. For purposes of determining the general reserve, the portfolio is segregated by product types to recognize differing risk profiles among categories, and then further segregated by credit grades. Credit grades are assigned to all loans. Each credit grade is assigned a risk factor, or reserve allocation percentage. These risk factors are multiplied by the outstanding principal balance and risk-weighted by product type to calculate the required reserve. A similar process is employed to calculate a reserve assigned to off-balance sheet commitments, specifically unfunded loan commitments and letters of credit. Even though portions of the allowance may be allocated to specific loans, the entire allowance is available for any credit that, in management s judgment, should be charged off.

The reserve allocation percentages assigned to each credit grade have been developed based primarily on an analysis of our historical loss rates. The allocations are adjusted for certain qualitative factors, including general economic conditions, changes in credit policies and lending standards. Changes in the trend and severity of problem loans can cause the estimation of losses to differ from past experience. In addition, the reserve considers the results of reviews performed by independent third party reviewers as reflected in their confirmations of assigned credit grades within the portfolio. The portion of the allowance that is not derived by the allowance allocation percentages compensates for the uncertainty and complexity in estimating loan and lease losses including factors and conditions that may not be fully reflected in the determination and application of the allowance allocation percentages. We evaluate many factors and conditions in determining the unallocated portion of the allowance, including the economic and business conditions affecting key lending areas, credit quality trends and general growth in the portfolio. The allowance is considered appropriate, given management s assessment of potential losses within the portfolio as of the evaluation date, the significant growth in the loan and lease portfolio, current economic conditions in the Company s market areas and other factors.

The methodology used in the periodic review of reserve adequacy, which is performed at least quarterly, is designed to be dynamic and responsive to changes in portfolio credit quality. The changes are reflected in the general reserve and in specific reserves as the collectability of larger classified loans is evaluated with new information. As our portfolio has matured, historical loss ratios have been closely monitored, and our reserve adequacy relies primarily on our loss history. The review of the reserve adequacy is performed by executive management and presented to a committee of our board of directors for their review. The committee reports to the board as part of the board s review on quarterly basis of the Company s consolidated financial statements.

The combined reserve for credit losses, which includes a liability for losses on unfunded commitments, totaled $96.7 million at June 30, 2014, $92.3 million at December 31, 2013 and $83.6 million at June 30, 2013. Due to the growth in loans, the total reserve percentage decreased to 1.06% at June 30, 2014 from 1.09% and 1.11% of loans excluding mortgage finance loans at December 31, 2013 and June 30, 2013, respectively. The combined reserve percentage has trended down as we recognize losses on loans for which there were specific or general allocations of reserves and see improvement in our overall credit quality. The overall reserve for loan losses continues to result from consistent application of the loan loss reserve methodology as described above. At June 30, 2014, we believe the reserve is sufficient to cover all expected losses in the portfolio and has been derived from consistent application of the methodology described above. Should any of the factors considered by management in evaluating the adequacy of the allowance for loan losses change or prove to be inaccurate, our estimate of inherent losses in the portfolio could also change or become insufficient, which would affect the level of future provisions for loan losses.

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Activity in the reserve for loan losses is presented in the following table (in thousands):

	Six months ended June 30, 2014	Year ended December 31, 2013	Six months ended June 30, 2013
Reserve for loan losses:			
Beginning balance	$ 87,604	$ 74,337	$ 74,337
Loans charged-off:			
Commercial	7,526	6,575	4,474
Real estate	296	144	131
Consumer	101	45	45
Leases		2	
Total charge-offs	7,923	6,766	4,650
Recoveries:			
Commercial	3,150	1,203	745
Real estate	43	270	15
Consumer	31	73	45
Leases	142	322	261
Total recoveries	3,366	1,868	1,066
Net charge-offs	4,557	4,898	3,584
Provision for loan losses	8,067	18,165	8,675
Ending balance	$ 91,114	$ 87,604	$ 79,428
Reserve for off-balance sheet credit losses:			
Beginning balance	$ 4,690	$ 3,855	$ 3,855
Provision for off-balance sheet credit losses	933	835	325
Ending balance	$ 5,623	$ 4,690	$ 4,180
Total reserve for credit losses	$ 96,737	$ 92,294	$ 83,608
Total provision for credit losses	$ 9,000	$ 19,000	$ 9,000
Reserve for loan losses to loans	0.71%	0.78%	0.77%
Reserve for loan losses to loans excluding mortgage finance loans[2]	1.00%	1.03%	1.06%
Net charge-offs to average loans[1]	0.08%	0.05%	0.08%
Net charge-offs to average loans excluding mortgage finance loans[1] [2]	0.10%	0.07%	0.10%
Total provision for credit losses to average loans	0.16%	0.19%	0.19%
Total provision for credit losses to average loans excluding mortgage finance loans[2]	0.21%	0.25%	0.26%
Recoveries to total charge-offs	42.48%	27.61%	22.92%
Reserve for off-balance sheet credit losses to off-balance sheet credit commitments	0.12%	0.12%	0.14%

Combined reserves for credit losses to loans held for investment	0.75%	0.82%	0.81%
Combined reserves for credit losses to loans held for investment excluding mortgage finance loans[(2)]	1.06%	1.09%	1.11%
Non-performing assets:			
Non-accrual loans[(5)]	$ 41,565	$ 32,375	$ 38,450
OREO[(4)]	685	5,110	13,053
Other repossessed assets			19
Total	$ 42,250	$ 37,485	$ 51,522
Restructured loans	$ 249	$ 1,935	$ 4,765
Loans past due 90 days and still accruing[(3)]	4,793	9,325	7,633
Reserve as a percent of non-performing loans	2.2x	2.7x	2.1x

(1) Interim period ratios are annualized.

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(2) Mortgage finance loans were previously classified as loans held for sale but have been reclassified as loans held for investment as described in Note 1 Operations and Summary of Significant Accounting Policies. The indicated ratios are presented excluding the mortgage finance loans because the risk profile of our mortgage finance loans is different than our other loans held for investment. No provision is allocated to these loans based on the internal risk grade assigned.
(3) At June 30, 2014, December 31, 2013 and June 30, 2013, loans past due 90 days and still accruing includes premium finance loans of $4.6 million, $3.8 million and $4.2 million, respectively. These loans are generally secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take 180 days or longer from the cancellation date.
(4) At June 30, 2014, we did not have a valuation allowance recorded against the OREO balance. At December 31, 2013 and June 30, 2013, OREO balance is net of a $5.6 million and a $4.6 million valuation allowance, respectively.
(5) As of June 30, 2014, December 31, 2013 and June 30, 2013, non-accrual loans included $16.2 million, $17.8 million and $16.4 million, respectively, in loans that met the criteria for restructured.

Non-performing Assets

Non-performing assets include non-accrual loans and leases and repossessed assets. The table below summarizes our non-accrual loans by type and OREO (in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Non-accrual loans:			
Commercial	$ 25,545	$ 12,896	$ 17,577
Construction		705	
Real estate	15,998	18,670	20,799
Consumer		54	9
Leases	22	50	65
Total non-accrual loans	41,565	32,375	38,450
Repossessed assets:			
OREO	685	5,110	13,053
Other repossessed assets			19
Total repossessed assets	685	5,110	13,072
Total non-performing assets	$ 42,250	$ 37,485	$ 51,522

The table below summarizes the non-accrual loans as segregated by loan type and type of property securing the credit as of June 30, 2014 (in thousands):

Non-accrual loans:	
Commercial	
Lines of credit secured by the following:	
Oil and gas properties	$ 820

Assets of the borrowers	22,409
Other	2,316
Total commercial	25,545
Real estate	
Secured by:	
Commercial property	9,482
Unimproved land and/or undeveloped residential lots	3,945
Other	2,571
Total real estate	15,998
Leases (commercial leases primarily secured by assets of the lessor)	22
Total non-accrual loans	$ 41,565

Generally, we place loans on non-accrual when there is a clear indication that the borrower s cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. When a loan is placed on non-accrual status, all previously accrued and unpaid interest is reversed. Interest income is subsequently recognized on a cash basis as long as the remaining unpaid principal amount of the loan is deemed to be fully collectible. If collectability is questionable, then cash payments are applied to principal. As of June 30, 2014, $480,000 of our non-accrual loans were earning on a cash basis. A loan is placed back on accrual status when both principal and interest are current and it is probable that we will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

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A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect all amounts due (both principal and interest) according to the terms of the original loan agreement. All loans classified as restructured loans are also considered impaired. Reserves on impaired loans are measured based on the present value of the expected future cash flows discounted at the loan s effective interest rate or the fair value of the underlying collateral.

At June 30, 2014, we had $4.8 million in loans past due 90 days and still accruing interest. At June 30, 2014, $4.6 million of the loans past due 90 days and still accruing are premium finance loans. These loans are primarily secured by obligations of insurance carriers to refund premiums on cancelled insurance policies. The refund of premiums from the insurance carriers can take 180 days or longer from the cancellation date.

Restructured loans are loans on which, due to the borrower s financial difficulties, we have granted a concession that we would not otherwise consider. This may include a transfer of real estate or other assets from the borrower, a modification of loan terms, or a combination of the two. Modifications of terms that could potentially qualify as a restructuring include reduction of contractual interest rate, extension of the maturity date at a contractual interest rate lower than the current rate for new debt with similar risk, or a reduction of the face amount of debt, or forgiveness of either principal or accrued interest. As of June 30, 2014, we had $249,000 in loans considered restructured that are not on non-accrual. Of the non-accrual loans at June 30, 2014, $16.2 million met the criteria for restructured. A loan continues to qualify as restructured until a consistent payment history or change in borrower s financial condition has been evidenced, generally no less than twelve months. Assuming that the restructuring agreement specifies an interest rate at the time of the restructuring that is greater than or equal to the rate that we are willing to accept for a new extension of credit with comparable risk, the loan no longer has to be considered a restructuring if it is in compliance with modified terms in calendar years after the year of the restructuring.

Potential problem loans consist of loans that are performing in accordance with contractual terms but for which we have concerns about the borrower s ability to comply with repayment terms because of the borrower s potential financial difficulties. We monitor these loans closely and review their performance on a regular basis. At June 30, 2014 and 2013, we had $14.8 million and $9.3 million, respectively, in loans of this type which were not included in either non-accrual or 90 days past due categories.

The table below presents a summary of the activity related to OREO (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Beginning balance	$ 2,420	$ 14,426	$ 5,110	$ 15,991
Additions		912	851	912
Sales	(1,735)	(1,902)	(5,276)	(3,396)
Valuation allowance for OREO		(164)		(164)
Direct write-downs		(219)		(290)
Ending balance	$ 685	$ 13,053	$ 685	$ 13,053

The following table summarizes the assets held in OREO at June 30, 2014 (in thousands):

Undeveloped land and residential lots	$ 487
Other	198
Total OREO	$ 685

When foreclosure occurs, fair value, which is generally based on appraised values, may result in partial charge-off of a loan upon taking property, and so long as property is retained, subsequent reductions in appraised values will result in valuation adjustments taken as non-interest expense. In addition, if the decline in value is believed to be permanent and not just driven by market conditions, a direct write-down to the OREO balance may be taken. We generally pursue sales of OREO when conditions warrant, but we may choose to hold certain properties for a longer term, which can result in additional exposure related to the appraised values during that holding period. During the six months ended June 30, 2014 we did not record a valuation expense compared to $454,000 recorded during the same period of 2013. Of the $454,000 recorded for the six months ended June 30, 2013, $164,000 related to direct write-downs and $290,000 related to increasing the valuation allowance.

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Liquidity and Capital Resources

In general terms, liquidity is a measurement of our ability to meet our cash needs. Our objective in managing our liquidity is to maintain our ability to meet loan commitments, purchase securities or repay deposits and other liabilities in accordance with their terms, without an adverse impact on our current or future earnings. Our liquidity strategy is guided by policies, which are formulated and monitored by our senior management and our Balance Sheet Management Committee (BSMC), and which take into account the demonstrated marketability of assets, the sources and stability of funding and the level of unfunded commitments. We regularly evaluate all of our various funding sources with an emphasis on accessibility, stability, reliability and cost-effectiveness. For the year ended December 31, 2013 and for the six months ended June 30, 2014, our principal source of funding has been our customer deposits, supplemented by our short-term and long-term borrowings, primarily from Federal funds purchased and Federal Home Loan Bank (FHLB) borrowings.

Our liquidity needs for support of growth in loans held for investment have been fulfilled through growth in our core customer deposits. Our goal is to obtain as much of our funding for loans held for investment and other earnings assets as possible from deposits of these core customers. These deposits are generated principally through development of long-term relationships with customers and stockholders, with a significant focus on treasury management products. In addition to deposits from our core customers, we also have access to deposits through brokered customer relationships. For regulatory purposes, these relationship brokered deposits are now categorized as brokered deposits; however, since these deposits arise from a customer relationship, we consider these deposits to be core deposits for our reporting purposes. We also have access to incremental deposits through brokered retail certificates of deposit, or CDs. These traditional brokered deposits are generally of short maturities, 30 to 90 days, and are used to supplement temporary differences in the growth in loans, including growth in loans held for sale or other specific categories of loans, compared to customer deposits. The following table summarizes our period-end and average year-to-date core customer deposits and brokered deposits (in millions):

	June 30, 2014	December 31, 2013	June 30, 2013
Deposits from core customers	$ 8,642.9	$ 7,840.1	$ 6,900.9
Deposits from core customers as a percent of total deposits	80.4%	84.7%	86.5%
Relationship brokered deposits	$ 1,863.0	$ 1,417.3	$ 1,079.7
Relationship brokered deposits as a percent of total deposits	17.3%	15.3%	13.5%
Traditional brokered deposits	$ 251.4	$	$
Traditional brokered deposits as a percent of total deposits	2.3%	0.0%	0.0%
Average deposits from core customers(1)	$ 8,062.9	$ 7,040.4	$ 6,715.8
Average deposits from core customers as a percent of total quarterly average deposits(1)	83.0%	84.1%	86.3%
Average relationship brokered deposits(1)	$ 1,618.0	$ 1,334.5	$ 1,067.2
Average relationship brokered deposits as a percent of total quarterly average deposits(1)	16.6%	15.9%	13.7%
Average traditional brokered deposits(1)	$ 41.7	$	$
Average traditional brokered deposits as a percent of total quarterly average deposits(1)	0.4%	0.0%	0.0%

(1) Annual averages presented for December 31, 2013.

We have access to, and have periodically utilized, sources of brokered deposits of not less than an additional $3.2 billion. Customer deposits (total deposits, including relationship brokered deposits, minus brokered CDs) increased by $997.1 million from December 31, 2013 and increased $2.3 billion from June 30, 2013.

Additionally, we have borrowing sources available to supplement deposits and meet our funding needs. Such borrowings are generally used to fund our loans held for sale, due to their liquidity, short duration and interest spreads available. These borrowing sources typically include Federal funds purchased from our downstream

correspondent bank relationships (which consist of banks that are smaller than our bank) and from our upstream correspondent bank relationships (which consist of banks that are larger than our bank), customer repurchase agreements, treasury, tax and loan notes, and advances from the FHLB and the Federal Reserve. The following table summarizes our borrowings as of June 30, 2014 (in thousands):

Federal funds purchased	$ 273,041
Repurchase agreements	27,491
FHLB borrowings	700,016
Subordinated notes	286,000
Trust preferred subordinated debentures	113,406
Total borrowings	$ 1,399,954
Maximum borrowings outstanding at any month-end during the year	$ 1,709,096

The following table summarizes our other borrowing capacities in excess of balances outstanding at June 30, 2014 (in thousands):

FHLB borrowing capacity relating to loans	$ 1,147,413
FHLB borrowing capacity relating to securities	3,561
Total FHLB borrowing capacity	$ 1,150,974
Unused Federal funds lines available from commercial banks	$ 925,000

At June 30, 2014, we had a non-revolving amortizing line of credit with $100.0 million of unused capacity. This line of credit matures on December 15, 2014. The loan proceeds may be used for general corporate purposes including funding regulatory capital infusions into the Bank. The loan agreement contains customary financial covenants and restrictions. At June 30, 2014, no borrowings were outstanding compared to $15.0 million outstanding at December 31, 2013.

Our equity capital, including $150 million in preferred stock, averaged $1.2 billion for the six months ended June 30, 2014, as compared to $939.3 million for the same period in 2013 when the average balance of preferred stock outstanding was $78.7 million. We have not paid any cash dividends on our common stock since we commenced operations and have no plans to do so in the near future.

On January 29, 2014, we completed a sale of 1.9 million shares of our common stock in a public offering. Net proceeds from the sale totaled $106.5 million. On January 31, 2014, the Bank issued $175.0 million of subordinated notes in an offering to institutional investors exempt from registration under Section 3(a)(2) of the Securities Act of 1933 and 12 C.F.R. Part 16. Net proceeds from the transaction were $172.4 million. The notes mature in January 2026 and bear interest at a rate of 5.25% per annum, payable semi-annually. The notes are unsecured and are subordinate to the Bank s obligations to its deposit-holders, its obligations under banker s acceptances and letters of credit, certain obligations to Federal Reserve Banks and the FDIC and the Bank s obligations to its other creditors, except any

obligations which expressly rank on a parity with or junior to the notes. The notes are expected to qualify as Tier 2 capital for regulatory capital purposes, subject to applicable limitations. The net proceeds of both offerings were available to the Company for general corporate purposes, including retirement of $15.0 million of short-term debt that was outstanding at December 31, 2013, and additional capital to support continued loan growth.

Our capital ratios remain above the levels required to be well capitalized. We believe that periodic capital raising transactions, along with the addition of loan and deposit relationships, will allow us to continue to grow organically.

Commitments and Contractual Obligations

The following table presents significant fixed and determinable contractual obligations to third parties by payment date. Payments for borrowings do not include interest. Payments related to leases are based on actual payments specified in the underlying contracts. As of June 30, 2014, our significant fixed and determinable contractual obligations to third parties, excluding interest, were as follows (in thousands):

	Within One Year	After One but Within Three Years	After Three but Within Five Years	After Five Years	Total
Deposits without a stated maturity	$ 9,801,592	$	$	$	$ 9,801,592
Time deposits	937,724	15,170	2,756	74	955,724
repurchase agreements	300,532				300,532
FHLB borrowings	700,016				700,016
Operating lease obligations[(1)]	14,111	28,884	28,556	56,477	128,028
Subordinated notes				286,000	286,000
Total contractual obligations	$ 11,753,975	$	$	$ 113,406	$ 113,406

(1) Non-balance sheet item.

Critical Accounting Policies

SEC guidance requires disclosure of critical accounting policies. The SEC defines critical accounting policies as those that are most important to the presentation of a company s financial condition and results, and require management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

We follow financial accounting and reporting policies that are in accordance with accounting principles generally accepted in the United States. The more significant of these policies are summarized in Note 1 to the consolidated financial statements. Not all these significant accounting policies require management to make difficult, subjective or complex judgments. However, the policy noted below could be deemed to meet the SEC s definition of a critical accounting policy.

Management considers the policies related to the allowance for loan losses as the most critical to the financial statement presentation. The total allowance for loan losses includes activity related to allowances calculated in accordance with ASC 310, *Receivables*, and ASC 450, *Contingencies*. The allowance for loan losses is established through a provision for loan losses charged to current earnings. The amount maintained in the allowance reflects management s continuing evaluation of the loan losses inherent in the loan portfolio. The allowance for loan losses is comprised of specific reserves assigned to certain classified loans and general reserves. Factors contributing to the determination of specific reserves include the credit-worthiness of the borrower, and more specifically, changes in the expected future receipt of principal and interest payments and/or in the value of pledged collateral. A reserve is recorded when the carrying amount of the loan exceeds the discounted estimated cash flows using the loan s initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. For purposes of

determining the general reserve, the portfolio is segregated by product types in order to recognize differing risk profiles among categories, and then further segregated by credit grades. See Summary of Loan Loss Experience above and Note 4 Loans and Allowance for Loan Losses in the accompanying notes to the consolidated financial statements included elsewhere in this report for further discussion of the risk factors considered by management in establishing the allowance for loan losses.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is a broad term for the risk of economic loss due to adverse changes in the fair value of a financial instrument. These changes may be the result of various factors, including interest rates, foreign exchange rates, commodity prices, or equity prices. Additionally, the financial instruments subject to market risk can be classified either as held for trading purposes or held for other than trading.

We are subject to market risk primarily through the effect of changes in interest rates on our portfolio of assets held for purposes other than trading. The effect of other changes, such as foreign exchange rates, commodity prices, and/or equity prices do not pose significant market risk to us.

The responsibility for managing market risk rests with the BSMC, which operates under policy guidelines established by our board of directors. The negative acceptable variation in net interest revenue due to a 200 basis point increase or decrease in interest rates is generally limited by these guidelines to +/- 5%. These guidelines also establish maximum levels for short-term borrowings, short-term assets and public and brokered deposits. They also establish minimum levels for unpledged assets, among other things. Compliance with these guidelines is the ongoing responsibility of the BSMC, with exceptions reported to our board of directors on a quarterly basis.

Interest Rate Risk Management

Our interest rate sensitivity is illustrated in the following table. The table reflects rate-sensitive positions as of June 30, 2014, and is not necessarily indicative of positions on other dates. The balances of interest rate sensitive assets and liabilities are presented in the periods in which they next reprice to market rates or mature and are aggregated to show the interest rate sensitivity gap. The mismatch between repricings or maturities within a time period is commonly referred to as the gap for that period. A positive gap (asset sensitive), where interest rate sensitive assets exceed interest rate sensitive liabilities, generally will result in the net interest margin increasing in a rising rate environment and decreasing in a falling rate environment. A negative gap (liability sensitive) will generally have the opposite results on the net interest margin. To reflect anticipated prepayments, certain asset and liability categories are shown in the table using estimated cash flows rather than contractual cash flows. The Company employs interest rate floors in certain variable rate loans to enhance the yield on those loans at times when market interest rates are extraordinarily low. The degree of asset sensitivity, spreads on loans and net interest margin may be reduced until rates increase by an amount sufficient to eliminate the effects of floors. The adverse effect of floors as market rates increase may also be offset by the positive gap, the extent to which rates on deposits and other funding sources lag increasing market rates and changes in composition of funding.

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Interest Rate Sensitivity Gap Analysis

June 30, 2014

(In thousands)

	0-3 mo Balance	4-12 mo Balance	1-3 yr Balance	3+ yr Balance	Total Balance
Assets:					
Securities[1]	$ 4,000	$ 36,906	4,062	$ 4,362	$ 49,330
Total variable loans	11,230,542	54,067	5,333	25	11,289,967
Total fixed loans	790,344	409,392	205,670	211,306	1,616,712
Total loans[2]	12,020,886	463,459	211,003	211,331	12,906,679
Total interest sensitive assets	$ 12,024,886	$ 500,365	$ 215,065	$ 215,693	$ 12,956,009
Liabilities:					
Interest-bearing customer deposits	$ 5,710,622	$	$	$	$ 5,710,622
CDs & IRAs	404,001	191,538	15,170	2,830	613,539
Traditional brokered deposits	251,381				251,381
Total interest-bearing deposits	6,366,004	191,538	15,170	2,830	6,575,542
Repurchase agreements, Federal funds purchased, FHLB borrowings	1,000,548				1,000,548
Subordinated notes				286,000	286,000
Trust preferred subordinated debentures				113,406	113,406
Total borrowings	1,000,548			399,406	1,399,954
Total interest sensitive liabilities	$ 7,366,552	$ 191,538	$ 15,170	$ 402,236	$ 7,975,496
GAP	$ 4,658,334	$ 308,827	$ 199,895	$ (186,543)	$
Cumulative GAP	4,658,334	4,967,161	5,167,056	4,980,513	4,980,513
Demand deposits					$ 4,181,774
Stockholders equity					1,262,816
Total					$ 5,444,590

(1) Securities based on fair market value.
(2) Loans are stated at gross.

The table above sets forth the balances as of June 30, 2014 for interest bearing assets, interest bearing liabilities, and the total of non-interest bearing deposits and stockholders equity. While a gap interest table is useful in analyzing interest rate sensitivity, an interest rate sensitivity simulation provides a better illustration of the sensitivity of earnings

to changes in interest rates. Earnings are also affected by the effects of changing interest rates on the value of funding derived from demand deposits and stockholders equity. We perform a sensitivity analysis to identify interest rate risk exposure on net interest income. We quantify and measure interest rate risk exposure using a model to dynamically simulate the effect of changes in net interest income relative to changes in interest rates and loan and deposit account balances over the next twelve months based on three interest rate scenarios. These are a most likely rate scenario and two shock test scenarios.

The most likely rate scenario is based on the consensus forecast of future interest rates published by independent sources. These forecasts incorporate future spot rates and relevant spreads of instruments that are actively traded in the open market. The Federal Reserve s Federal funds target affects short-term borrowing; the prime lending rate and the LIBOR are the basis for most of our variable-rate loan pricing. The 10-year mortgage rate is also monitored because of its effect on prepayment speeds for mortgage-backed securities. We believe these are our primary interest rate exposures. We are not currently using derivatives to manage our interest rate exposure.

The two shock test scenarios assume a sustained parallel 100 and 200 basis point increase in interest rates. As short-term rates have remained low through 2014, we do not believe that analysis of an assumed decrease in interest rates would provide meaningful results. We will continue to evaluate these scenarios as interest rates change, until short-term rates rise above 3.0%.

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Our interest rate risk exposure model incorporates assumptions regarding the level of interest rate or balance changes on indeterminable maturity deposits (demand deposits, interest-bearing transaction accounts and savings accounts) for a given level of market rate changes. These assumptions have been developed through a combination of historical analysis and future expected pricing behavior. Changes in prepayment behavior of mortgage-backed securities, residential and commercial mortgage loans in each rate environment are captured using industry estimates of prepayment speeds for various coupon segments of the portfolio. The impact of planned growth and new business activities is factored into the simulation model. This modeling indicated interest rate sensitivity as follows (in thousands):

	Anticipated Impact Over the Next Twelve Months as Compared to Most Likely Scenario	
	100 bp Increase	200 bp Increase
	June 30, 2014	
Change in net interest income	$ 54,031	$ 119,028

The simulations used to manage market risk are based on numerous assumptions regarding the effect of changes in interest rates on the timing and extent of repricing characteristics, future cash flows, and customer behavior. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net interest income or precisely predict the impact of higher or lower interest rates on net interest income. Actual results may differ from simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies, among other factors.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the supervision and participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, we have concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to the Company s management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to various claims and legal actions related to operating activities that arise in the ordinary course of business. Management does not currently expect the ultimate disposition of these matters to have a material adverse impact on our financial statements.

ITEM 1A. RISK FACTORS

There have been no material change in the risk factors previously disclosed in the Company s 2013 Form 10-K for the fiscal year ended December 31, 2013.

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ITEM 6. EXHIBITS

on 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

on 302 of the Sarbanes-Oxley Act of 2002, filed herewith.

as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

March 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Income, (ii) Consolida

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

TEXAS CAPITAL BANCSHARES, INC.

Date: July 24, 2014

/s/ Peter B. Bartholow
Peter B. Bartholow
Chief Financial Officer
(Duly authorized officer and principal financial
officer)

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EXHIBIT INDEX

Exhibit Number	
10.1	Form of Indemnification Agreement for directors and officers of Texas Capital Bancshares, Inc. and its subsidiaries.
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.
32.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(b) of the Exchange Act and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.
101	The following materials from Texas Capital Bancshares, Inc. s Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Income, (ii) Consolidated Balance Sheets, (iii) Consolidated Statements of Cash Flows, and (iv) Notes to Consolidated Financial Statements