

LEGG MASON, INC.  
Form 10-Q  
November 06, 2018  
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from to

Commission file number: 001-08529

LEGG MASON, INC.

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

52-1200960

(I.R.S. Employer Identification No.)

100 International Drive - Baltimore, MD

(Address of principal executive offices)

21202

(Zip code)

(410) 539-0000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. \_\_\_\_\_

Edgar Filing: LEGG MASON, INC. - Form 10-Q

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

As of November 2, 2018, there were 85,528,403 shares of the registrant's common stock outstanding.

---

Table of Contents

TABLE OF CONTENTS

	Page
<u>PART I</u>	
<u>FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited)</u>	<u>3</u>
<u>CONSOLIDATED BALANCE SHEETS</u>	
<u>CONSOLIDATED STATEMENTS OF INCOME</u>	
<u>CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME</u>	
<u>CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY</u>	
<u>CONSOLIDATED STATEMENTS OF CASH FLOWS</u>	
<u>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</u>	
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>45</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>78</u>
<u>Item 4. Controls and Procedures</u>	<u>78</u>
<u>PART II</u>	
<u>OTHER INFORMATION</u>	
<u>Item 1A. Risk Factors</u>	<u>79</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>79</u>
<u>Item 6. Exhibits</u>	<u>79</u>

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## LEGG MASON, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

(Unaudited)

	September 30, 2018	March 31, 2018
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$611,164	\$736,130
Cash and cash equivalents of consolidated investment vehicles	5,055	2,800
Restricted cash	19,579	30,428
Receivables:		
Investment advisory and related fees	446,398	475,594
Other	80,885	77,024
Investment securities	404,087	399,370
Investment securities of consolidated investment vehicles	76,412	140,133
Other	68,536	65,010
Other current assets of consolidated investment vehicles	952	1,893
Total Current Assets	1,713,068	1,928,382
Fixed assets, net	153,906	148,406
Intangible assets, net	3,766,507	3,797,659
Goodwill	1,891,306	1,932,355
Deferred income taxes	194,352	202,068
Other	147,562	134,407
Other assets of consolidated investment vehicles	9,627	9,257
<b>TOTAL ASSETS</b>	<b>\$7,876,328</b>	<b>\$8,152,534</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Current Liabilities		
Accrued compensation	\$406,640	\$476,061
Accounts payable and accrued expenses	175,861	175,583
Short-term borrowings	—	125,500
Current portion of long-term debt	250,971	—
Other	134,902	204,264
Other current liabilities of consolidated investment vehicles	1,533	634
Total Current Liabilities	969,907	982,042
Deferred compensation	101,252	92,422
Deferred income taxes	166,543	139,787
Other	125,526	132,042
Long-term debt, net	1,970,810	2,221,810
<b>TOTAL LIABILITIES</b>	<b>3,334,038</b>	<b>3,568,103</b>
Commitments and Contingencies (Note 7)	632,295	732,295
<b>REDEEMABLE NONCONTROLLING INTERESTS</b>	<b>632,295</b>	<b>732,295</b>
<b>STOCKHOLDERS' EQUITY</b>	<b>8,550</b>	<b>8,461</b>

Edgar Filing: LEGG MASON, INC. - Form 10-Q

Common stock, par value \$0.10; authorized 500,000,000 shares; issued 85,503,455 shares for September 30, 2018 and 84,606,408 shares for March 31, 2018

Additional paid-in capital	2,013,541	1,976,364
Employee stock trust	(22,117 )	(21,996 )
Deferred compensation employee stock trust	22,117	21,996
Retained earnings	1,981,939	1,894,762
Accumulated other comprehensive loss, net	(122,109 )	(55,182 )
Total stockholders' equity attributable to Legg Mason, Inc.	3,881,921	3,824,405
Nonredeemable noncontrolling interest	28,074	27,731
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>3,909,995</b>	<b>3,852,136</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$7,876,328</b>	<b>\$8,152,534</b>

See Notes to Consolidated Financial Statements

3

---

Table of Contents

LEGG MASON, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(Dollars in thousands, except per share amounts)  
(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2018	2017	2018	2017
<b>OPERATING REVENUES</b>				
Investment advisory fees:				
Separate accounts	\$261,567	\$253,128	\$521,462	\$503,174
Funds	383,923	393,035	767,487	775,263
Performance fees	31,874	40,821	55,910	122,358
Distribution and service fees	79,074	80,668	158,264	159,574
Other	1,989	686	3,209	1,811
Total Operating Revenues	758,427	768,338	1,506,332	1,562,180
<b>OPERATING EXPENSES</b>				
Compensation and benefits	364,885	367,951	726,453	781,258
Distribution and servicing	114,525	123,634	231,117	245,983
Communications and technology	57,489	51,299	114,229	101,602
Occupancy	27,352	25,171	52,256	49,579
Amortization of intangible assets	6,102	6,082	12,282	12,421
Impairment of intangible assets	—	—	—	34,000
Contingent consideration fair value adjustments	145	—	571	(16,550)
Other	52,201	49,782	108,020	102,263
Total Operating Expenses	622,699	623,919	1,244,928	1,310,556
<b>OPERATING INCOME</b>	135,728	144,419	261,404	251,624
<b>NON-OPERATING INCOME (EXPENSE)</b>				
Interest income	2,420	1,572	4,866	3,040
Interest expense	(29,860)	(29,077)	(59,777)	(58,343)
Other income, net	6,627	7,289	13,879	18,677
Non-operating income (loss) of consolidated investment vehicles, net	(3,998)	2,094	(415)	3,091
Total Non-Operating Income (Expense)	(24,811)	(18,122)	(41,447)	(33,535)
<b>INCOME BEFORE INCOME TAX PROVISION</b>	110,917	126,297	219,957	218,089
Income tax provision	29,844	38,673	60,519	66,928
<b>NET INCOME</b>	81,073	87,624	159,438	151,161
Less: Net income attributable to noncontrolling interests	8,270	11,960	20,545	24,577
<b>NET INCOME ATTRIBUTABLE TO LEGG MASON, INC.</b>	\$72,803	\$75,664	\$138,893	\$126,584
<b>NET INCOME PER SHARE ATTRIBUTABLE TO LEGG MASON, INC. STOCKHOLDERS:</b>				
Basic	\$0.82	\$0.78	\$1.57	\$1.30
Diluted	0.82	0.78	1.57	1.29
See Notes to Consolidated Financial Statements				

Table of ContentsLEGG MASON, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2018	2017	2018	2017
NET INCOME	\$81,073	\$87,624	\$159,438	\$151,161
Other comprehensive income (loss):				
Foreign currency translation adjustment	(14,658 )	21,442	(68,020 )	32,113
Changes in defined benefit pension plan	211	121	1,093	240
Total other comprehensive income (loss)	(14,447 )	21,563	(66,927 )	32,353
COMPREHENSIVE INCOME	66,626	109,187	92,511	183,514
Less: Comprehensive income attributable to noncontrolling interests	9,742	10,483	24,627	22,767
COMPREHENSIVE INCOME ATTRIBUTABLE TO LEGG MASON, INC.	\$56,884	\$98,704	\$67,884	\$160,747

See Notes to Consolidated Financial Statements

Table of Contents

LEGG MASON, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Dollars in thousands)  
(Unaudited)

	Six Months Ended September 30,	
	2018	2017
<b>STOCKHOLDERS' EQUITY ATTRIBUTABLE TO LEGG MASON, INC.</b>		
<b>COMMON STOCK</b>		
Beginning balance	\$8,461	\$9,573
Stock options exercised	16	32
Deferred compensation employee stock trust	—	1
Stock-based compensation	112	89
Employee tax withholdings by settlement of net share transactions	(39)	(34)
Shares repurchased and retired	—	(472)
Ending balance	8,550	9,189
<b>ADDITIONAL PAID-IN CAPITAL</b>		
Beginning balance	1,976,365	2,385,726
Stock options exercised	5,231	9,304
Deferred compensation employee stock trust	302	285
Stock-based compensation	34,814	38,994
Employee tax withholdings by settlement of net share transactions	(15,422)	(13,017)
Shares repurchased and retired	—	(179,177)
Redeemable noncontrolling interest reclassification for affiliate management equity plans and affiliate noncontrolling interest	12,251	—
Ending balance	2,013,541	2,242,115
<b>EMPLOYEE STOCK TRUST</b>		
Beginning balance	(21,996)	(24,057)
Shares issued to plans	(302)	(286)
Distributions and forfeitures	181	2,617
Ending balance	(22,117)	(21,726)
<b>DEFERRED COMPENSATION EMPLOYEE STOCK TRUST</b>		
Beginning balance	21,996	24,057
Shares issued to plans	302	286
Distributions and forfeitures	(181)	(2,617)
Ending balance	22,117	21,726
<b>RETAINED EARNINGS</b>		
Beginning balance	1,894,762	1,694,859
Net income attributable to Legg Mason, Inc.	138,893	126,584
Dividends declared	(61,441)	(54,177)
Reclassification to noncontrolling interest for net increase in estimated redemption value of affiliate management equity plans and affiliate noncontrolling interests	(2,538)	(2,295)
Adoption of new revenue recognition guidance	12,263	—
Adoption of new stock-based compensation guidance	—	24,327
Ending balance	1,981,939	1,789,298
<b>ACCUMULATED OTHER COMPREHENSIVE LOSS, NET</b>		
Beginning balance	(55,182)	(106,784)
Changes in defined benefit pension plan	1,093	240
Foreign currency translation adjustment	(68,020)	32,113



Edgar Filing: LEGG MASON, INC. - Form 10-Q

Ending balance	(122,109 )	(74,431 )
TOTAL STOCKHOLDERS' EQUITY ATTRIBUTABLE TO LEGG MASON, INC.	3,881,921	3,966,171
NONREDEEMABLE NONCONTROLLING INTEREST		
Beginning balance	27,731	27,798
Net income attributable to noncontrolling interests	4,937	4,291
Distributions	(4,594 )	(4,063 )
Ending balance	28,074	28,026
TOTAL STOCKHOLDERS' EQUITY	\$3,909,995	\$3,994,197
See Notes to Consolidated Financial Statements		

Table of ContentsLEGG MASON, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	Six Months Ended September 30,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income	\$ 159,438	\$ 151,161
Adjustments to reconcile Net Income to net cash provided by operations:		
Impairments of intangible assets	—	34,000
Depreciation and amortization	36,143	36,634
Accretion and amortization of securities discounts and premiums, net	1,080	1,670
Stock-based compensation	35,225	39,531
Net unrealized losses (gains) on investments	3,237	(10,800 )
Net gains and earnings on investments	(15,128 )	(7,037 )
Net losses (gains) of consolidated investment vehicles	415	(3,091 )
Deferred income taxes	41,666	51,194
Contingent consideration fair value adjustments	571	(16,550 )
Other	217	(272 )
Decrease (increase) in assets:		
Investment advisory and related fees receivable	24,621	(4,978 )
Net (purchases) sales of trading and other investments	(12,544 )	29,853
Other receivables	(15,697 )	9,207
Other assets	(14,482 )	11,456
Assets of consolidated investment vehicles	69,225	(31,100 )
Increase (decrease) in liabilities:		
Accrued compensation	(64,931 )	(96,720 )
Deferred compensation	8,831	11,386
Accounts payable and accrued expenses	2,488	(9,301 )
Other liabilities	(73,876 )	(21,237 )
Other liabilities of consolidated investment vehicles	899	(100 )
<b>CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>\$ 187,398</b>	<b>\$ 174,906</b>

Table of Contents

LEGG MASON, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)  
(Dollars in thousands)  
(Unaudited)

	Six Months Ended September 30,	
	2018	2017
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Payments for fixed assets	\$(29,831 )	\$(15,846 )
Business investments	—	(2,250 )
Contingent payment from prior sale of businesses	923	2,561
Returns of capital and proceeds from sales and maturities of investments	7,671	8,173
<b>CASH USED IN INVESTING ACTIVITIES</b>	<b>(21,237 )</b>	<b>(7,362 )</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Dividends paid	(54,719 )	(47,639 )
Distributions to affiliate noncontrolling interests	(22,004 )	(27,076 )
Payment of contingent consideration	(4,319 )	—
Net (redemptions) subscriptions attributable to noncontrolling interests	(68,856 )	19,624
Employee tax withholdings by settlement of net share transactions	(15,461 )	(13,051 )
Issuances of common stock for stock-based compensation	5,548	9,622
Decrease in short-term borrowings	(125,500 )	—
Repurchases of common stock	—	(179,649 )
<b>CASH USED IN FINANCING ACTIVITIES</b>	<b>(285,311 )</b>	<b>(238,169 )</b>
<b>EFFECT OF EXCHANGE RATES</b>	<b>(14,559 )</b>	<b>(1,245 )</b>
<b>NET DECREASE IN CASH, CASH EQUIVALENTS, AND RESTRICTED CASH</b>	<b>(133,709 )</b>	<b>(71,870 )</b>
<b>CASH, CASH EQUIVALENTS, AND RESTRICTED CASH:</b>		
<b>BEGINNING OF PERIOD</b>	<b>773,765</b>	<b>754,339</b>
<b>END OF PERIOD</b>	<b>\$640,056</b>	<b>\$682,469</b>
Supplemental Disclosures		
Cash paid for:		
Income taxes, net of refunds of \$9,505 in 2017	\$22,104	\$7,277
Interest	58,719	56,670
Reconciliation of cash, cash equivalents and restricted cash		
Cash and cash equivalents	\$611,164	\$654,234
Restricted cash:		
Corporate restricted cash	19,579	21,547
Cash and cash equivalents of consolidated investment vehicles	5,055	2,475
Affiliate employee benefit trust cash included in Other non-current assets	4,258	4,213
<b>Total cash, cash equivalents and restricted cash per consolidated statements of cash flows</b>	<b>\$640,056</b>	<b>\$682,469</b>
See Notes to Consolidated Financial Statements		

Table of Contents

LEGG MASON, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Amounts in thousands, except per share amounts or unless otherwise noted)

September 30, 2018

(Unaudited)

1. Interim Basis of Reporting

The accompanying unaudited interim consolidated financial statements of Legg Mason, Inc. and its subsidiaries (collectively "Legg Mason") have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the applicable rules and regulations of the Securities and Exchange Commission (the "SEC"). The interim consolidated financial statements have been prepared using the interim basis of reporting and, as such, reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. The preparation of interim consolidated financial statements requires management to make assumptions and estimates that affect the amounts reported in the interim consolidated financial statements and accompanying notes. Actual amounts could differ from those estimates and the differences could have a material impact on the interim consolidated financial statements. Terms such as "we," "us," "our," and "Company" refer to Legg Mason.

The nature of Legg Mason's business is such that the results of any interim period are not necessarily indicative of the results of a full year. Certain disclosures included in the Company's annual report are not required to be included on an interim basis in the Company's Quarterly Reports on Form 10-Q. The Company has condensed or omitted these disclosures. Certain amounts in prior period financial statements have been reclassified to conform to new guidance and/or the current period presentation, including the classification and presentation of restricted cash and certain distributions received from equity method investees in the Consolidated Statements of Cash Flows, as discussed below.

The information contained in the interim consolidated financial statements should be read in conjunction with Legg Mason's latest Annual Report on Form 10-K filed with the SEC.

2. Significant Accounting Policies

Consolidation

Legg Mason sponsors and manages various types of investment products. For its services, Legg Mason is entitled to receive management fees and may be eligible, under certain circumstances, to receive additional subordinated management fees or other incentive fees. Legg Mason's exposure to risk in these entities is generally limited to any equity investment it has made or is required to make, and any earned but uncollected management fees, except those for which total return swap arrangements have been executed, for which additional risks are discussed below. Legg Mason did not sell or transfer investment assets to any of these investment products. In accordance with financial accounting standards, Legg Mason consolidates certain sponsored investment products, some of which are designated and reported as consolidated investment vehicles ("CIVs"). The consolidation of sponsored investment products, including those designated as CIVs, has no impact on Net Income Attributable to Legg Mason, Inc. and does not have a material impact on Legg Mason's consolidated operating results. The change in the value of all consolidated sponsored investment products is recorded in Non-Operating Income (Expense) and reflected in Net income (loss) attributable to noncontrolling interests. The financial information of certain consolidated sponsored investment products is included in the Company's consolidated financial statements on a three-month lag based upon the availability of the investment product's financial information.

Certain of the investment products Legg Mason sponsors and manages are considered to be variable interest entities ("VIEs") (as further described below) while others are considered to be voting rights entities ("VREs") subject to traditional consolidation concepts based on ownership rights. Legg Mason may fund the initial cash investment in certain VRE investment products to generate an investment performance track record in order to attract third-party investors in the product. Legg Mason's initial investment in a new product typically represents 100% of the ownership in that product. As further discussed in Note 3, the products with "seed capital investments" are consolidated as long as Legg Mason maintains a controlling financial interest in the product, but they are not designated as CIVs by Legg Mason unless the investment is longer-term. As of September 30, 2018, March 31, 2018, and September 30, 2017, no consolidated VREs were designated as CIVs.

## Table of Contents

A VIE is an entity which does not have adequate equity to finance its activities without additional subordinated financial support; or the equity investors, as a group, do not have the normal characteristics of equity investors for a potential controlling financial interest. Legg Mason must consolidate any VIE for which it is deemed to be the primary beneficiary.

Under consolidation accounting guidance, if limited partners or similar equity holders in a sponsored investment vehicle structured as a limited partnership or a similar entity do not have either substantive investor rights to replace the manager (kick-out rights) or substantive participation rights over the general partner, the entities are VIEs. As a sponsor and manager of an investment vehicle, Legg Mason may be deemed a decision maker under the accounting guidance. If the fees paid to a decision maker are market-based, such fees are not considered variable interests in a VIE. Market-based fees are those fees which are both customary and commensurate with the level of effort required for the services provided. Additionally, if employee interests in a sponsored investment vehicle are not made to circumvent the consolidation guidance and are not financed by the sponsor, they are not included in the variable interests assessment, and are not included in the primary beneficiary determination.

A decision maker is deemed to be a primary beneficiary of a VIE if it has the power to direct activities that most significantly impact the economic performance of the VIE and the obligation to absorb losses or receive benefits from variable interests that could be significant to the VIE. In determining whether it is the primary beneficiary of a VIE, Legg Mason considers both qualitative and quantitative factors such as the voting rights of the equity holders, guarantees, and implied relationships. If a fee paid to a decision maker is not market-based, it will be considered in the primary beneficiary determination.

As of September 30, 2018, March 31, 2018 and September 30, 2017, Legg Mason concluded it was the primary beneficiary of certain VIEs, which were consolidated and designated as CIVs, because it held significant financial interests in the funds. In addition, Legg Mason has entered into various total return swap arrangements with financial intermediaries with respect to certain Legg Mason sponsored exchange traded funds ("ETFs"). Under the terms of the total return swaps, Legg Mason absorbs all of the related gains and losses on the underlying ETF investments of these financial intermediaries, and therefore has variable interests in the related funds and, if significant, may be deemed the primary beneficiary. As of September 30, 2018, March 31, 2018, and September 30, 2017, Legg Mason consolidated the ETFs with significant open total return swap arrangements, which were designated as CIVs. See Note 14 for additional information.

### Revenue Recognition

Effective April 1, 2018, Legg Mason adopted updated accounting guidance on revenue recognition which provides a single, comprehensive revenue recognition model for all contracts with customers, improves comparability and removes inconsistencies in revenue recognition practices across entities, industries, jurisdictions, and capital markets. The guidance also specifies the accounting for certain costs to obtain or fulfill a contract with a customer and revises the criteria for determining if an entity is acting as a principal or agent in certain arrangements. The adoption of the updated guidance did not result in significant changes to Legg Mason's prior revenue recognition practices, except for the timing of the recognition of certain performance and incentive fees, the capitalization and amortization of certain sales commissions for separate accounts, and the net presentation of certain fund expense reimbursements which were previously presented on a gross basis. Each of these changes to Legg Mason's previous revenue recognition practices is further discussed below.

Legg Mason adopted the updated guidance on a modified retrospective basis for any contracts that were not complete as of April 1, 2018, and recognized the cumulative effect of initially applying the updated guidance for certain sales commissions as an adjustment to the opening balance of retained earnings totaling \$12,263. There was no cumulative effect for performance and incentive fees or fund expense reimbursement accounting. The comparative information for prior periods has not been restated and continues to be reported under the prior accounting guidance in effect for those periods. A summary of the cumulative-effect changes to Legg Mason's Consolidated Balance Sheet as of April 1,

2018 is included below.

Legg Mason primarily earns revenues by providing investment management services and distribution and shareholder services for its customers, which are generally investment funds or the underlying investors in separately managed accounts. As further discussed below, revenues are calculated based on the value of the investments under management and are recognized when obligations under the terms of contracts with customers are satisfied, which is generally over time as the services are rendered.

Legg Mason also has responsibility for the valuation of assets under management ("AUM"), substantially all of which is based on observable market data from independent pricing services, fund accounting agents, custodians or brokers.

## Table of Contents

### Investment Advisory Fees

Legg Mason earns investment advisory fees on assets in separately managed accounts, investment funds, and other products managed for Legg Mason's clients. Generally, investment management services are a single performance obligation, as they include a series of distinct services that are substantially the same and are transferred to the customer over time using the same time-based measure of progress. Investment management services are satisfied over time as the customer simultaneously receives and consumes the benefits as the advisory services are performed.

### Separate Account and Funds Advisory Fees

Separate account and funds advisory fees are variable consideration which is primarily based on predetermined percentages of the daily, monthly or quarterly average market value of the AUM, as defined in the investment management agreements. The average market value of AUM is subject to change based on fluctuations and volatility in financial markets, and as such, separate account and funds advisory fees are constrained until the end of the month or quarter when the actual average market value of the AUM is known and a significant revenue reversal is no longer probable. Therefore, separate account and funds advisory fees are included in the transaction price and allocated to the investment management services performance obligation at the end of each monthly or quarterly reporting period, as specified in the investment management contract. Payment for services under investment management contracts is due once the variable consideration is allocated to the transaction price, and generally within 30 days. Recognition of separate account and funds advisory fee revenue under the updated guidance is consistent with Legg Mason's prior revenue recognition process.

### Performance and Incentive Fees

Performance and incentive fees are variable consideration that may be earned on certain investment management contracts for exceeding performance benchmarks on a relative or absolute basis or for exceeding contractual return thresholds. Performance and incentive fees are estimated at the inception of a contract; however, a range of outcomes is possible due to factors outside the control of the investment manager, particularly market conditions. Performance and incentive fees are therefore excluded from the transaction price until it becomes probable that a significant reversal in the cumulative amount of revenue recognized will not occur. A portion of Legg Mason's performance and incentive fees are earned based on 12-month performance periods that end in differing quarters during the year, with a portion also based on quarterly performance periods. Legg Mason also earns performance and incentive fees on alternative and certain other products that lock at the earlier of the investor's termination date or the liquidation of the fund or contract, in multiple-year intervals, or upon the occurrence of specific events, such as the sale of assets. For certain of these products, performance and incentive fees may be recognized as revenue earlier under the updated guidance than under prior revenue recognition practices, which deferred recognition until all contingencies were resolved. Any such performance fees recognized prior to the resolution of all contingencies are recorded as a contract asset in Other current assets or Other non-current assets in the Consolidated Balance Sheet, depending on the length of time until the contingencies are resolved.

### Fee Waivers and Fund Expense Reimbursements

Legg Mason may waive certain fees for investors or may reimburse its investment funds for certain operating expenses when such expenses exceed a certain threshold. Fee waivers continue to be reported as a reduction in advisory fee revenue under the updated guidance. Under prior accounting guidance, fund expense reimbursements in excess of recognized revenue were recorded as Other expense in the Consolidated Statements of Income. Under the updated accounting guidance, these fund expense reimbursements that exceed the recognized revenue represent a change in the transaction price and are therefore reported as a reduction of Investment advisory fees - Funds in the Consolidated Statements of Income.

### Distribution and Service Fees Revenue and Expense

Distribution and service fees represent fees earned from funds to reimburse the distributor for the costs of marketing and selling fund shares and are generally determined as a percentage of client assets. Reported amounts also include



fees earned from providing client or shareholder servicing, including record keeping or administrative services to proprietary funds, and non-discretionary advisory services for assets under advisement. Distribution and service fees earned on company-sponsored investment funds are reported as revenue. Distribution services and marketing services are considered a single performance obligation as the success of selling the underlying shares is highly dependent upon the sales and marketing efforts. Ongoing shareholder servicing is a separate performance obligation as these services are not highly interrelated and interdependent on the sale of the shares. Fees earned related to distribution and shareholder serving are considered variable consideration because they are calculated based on the average market value of the fund. The average market value of the fund is subject to change based on fluctuations and volatility in financial markets, and as such, distribution and shareholder service fees are generally constrained until the end of the month or quarter when the actual market value of the fund is known and the related revenue is no longer subject to a significant reversal. Therefore, distribution and service fees are generally included in the

## Table of Contents

transaction price at the end of each monthly or quarterly reporting period and are allocated to the two performance obligations based on the amount specified in each agreement. While distribution services are largely satisfied at the inception of an investment, the ultimate amounts of revenue are subject to the variable consideration constraint. Accordingly, a portion of distribution and service revenue will be recognized in periods subsequent to the satisfaction of the performance obligation.

Certain fund share classes only charge for distribution services at the inception of the investment based on a fixed percentage of the share price. This fixed price is allocated to the performance obligation, which is substantially satisfied at the time of the initial investment.

Recognition of distribution and service fee revenue under the updated guidance is consistent with Legg Mason's prior revenue recognition process.

When Legg Mason enters into arrangements with broker-dealers or other third parties to sell or market proprietary fund shares, distribution and servicing expense is accrued for the amounts owed to third parties, including finders' fees and referral fees paid to unaffiliated broker-dealers or introducing parties and is recorded as Distribution and servicing expense in the Consolidated Statements of Income. Distribution and servicing expense also includes payments to third parties for certain shareholder administrative services and sub-advisory fees paid to unaffiliated asset managers.

### Contract Costs and Deferred Sales Commissions

Legg Mason incurs ordinary costs to obtain investment management contracts and for services provided to customers in accordance with investment management agreements. These costs include commissions paid to wholesalers, employees and third-party broker dealers and administration and placement fees. Depending on the type of services provided, these fees may be paid at the time the contract is obtained or on an ongoing basis. Under the updated guidance, costs to obtain a contract should be capitalized if the costs are incremental and would not have been incurred if the contract had not been obtained, and costs to fulfill the contract should be capitalized if they relate directly to a contract, the costs will generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and the costs are expected to be recovered. Consistent with prior accounting procedures, fund launch costs, including organizational and underwriting costs, placement fees and commissions paid to employees, wholesalers and broker-dealers for sales of fund shares are expensed as incurred, as these costs would be incurred regardless of the investor. However, commissions paid to employees and retail wholesalers in connection with the sale of retail separate accounts are considered incremental, as these fees relate to obtaining a specific contract, are calculated based on specified rates and are recoverable through the management fees earned, and are therefore capitalized under the updated accounting guidance. Such commissions were expensed as incurred under Legg Mason's prior accounting practices. Capitalized sales commissions are amortized based on the transfer of services to which the assets relate, which averages four years. Legg Mason recorded a cumulative-effect adjustment on the Consolidated Balance Sheet as of April 1, 2018, as referenced below.

Commissions paid by Legg Mason to financial intermediaries in connection with sales of certain classes of company-sponsored mutual funds are generally capitalized as deferred sales commissions. The asset is amortized over periods not exceeding six years, which represent the periods during which commissions are generally recovered from distribution and service fee revenues and from contingent deferred sales charges ("CDSC") received from shareholders of those funds upon redemption of their shares. CDSC consideration is generally variable and is based on the timing of when investors redeem their investment. Therefore, the variable consideration is included in the transaction price once the investors redeem their shares and is satisfied at a point in time. CDSC receipts are recorded as distribution and service fee revenue when received and a reduction of the unamortized balance of deferred sales commissions, with a corresponding expense.

Management periodically tests the deferred sales commission asset for impairment by reviewing the changes in value of the related shares, the relevant market conditions and other events and circumstances that may indicate an impairment in value has occurred. If these factors indicate an impairment in value, management compares the carrying value to the estimated undiscounted cash flows expected to be generated by the asset over its remaining life. If management determines that the deferred sales commission asset is not fully recoverable, the asset will be deemed impaired and a loss will be recorded in the amount by which the recorded amount of the asset exceeds its estimated fair value. For the six months ended September 30, 2018 and 2017, no impairment charges were recorded. Deferred sales commissions, included in Other non-current assets in the Consolidated Balance Sheets, were \$1,560 and \$4,047 at September 30, 2018 and March 31, 2018, respectively.

Under the updated accounting guidance, Legg Mason has elected to expense sales commissions related to certain fund share classes with amortization periods of one year or less as incurred. Legg Mason recorded a cumulative-effect adjustment on

Table of Contents

the Consolidated Balance Sheet as of April 1, 2018, as referenced below, to reflect the expense associated with such commissions, which had previously been capitalized under Legg Mason's prior accounting practices.

## Impact of the Adoption of Updated Revenue Recognition Accounting Guidance

The cumulative effect of the changes made to Legg Mason's Consolidated Balance Sheet as of April 1, 2018 for the adoption of the updated revenue recognition accounting guidance were as follows:

Consolidated Balance Sheet	Balance as of March 31, 2018	Adjustment due to Adoption of Updated Accounting Guidance			Balance as of April 1, 2018
		Capitalized Sales Commissions	Deferred Sales Commissions	Total	
Assets					
Other, current	\$65,010	\$9,615	\$ —	\$9,615	\$74,625
Deferred income taxes	202,068	(1,148 )	—	(1,148 )	200,920
Other, non-current	134,407	10,316	(2,576 )	7,740	142,147
Liabilities					
Deferred income taxes	\$139,787	\$3,944	\$ —	\$3,944	\$143,731
Stockholders' Equity					
Retained Earnings	\$1,894,762	\$14,839	\$ (2,576 )	\$12,263	\$1,907,025

The impact of the adoption of the updated revenue recognition accounting guidance on the Consolidated Balance Sheet and the Consolidated Statements of Income was as follows:

September 30, 2018

Consolidated Balance Sheet	Balances Excluding the Adoption of Updated Accounting Guidance	Impact of the Adoption of Updated Accounting Guidance			As Reported
		Capitalized Sales Commissions	Deferred Sales Commissions	Total	
Assets					
Other, current	\$60,450	\$8,086	\$ —	\$8,086	\$68,536
Deferred income taxes	195,500	(1,148 )	—	(1,148 )	194,352
Other, non-current	138,313	10,939	(1,690 )	9,249	147,562
Liabilities					
Deferred income taxes	\$162,599	\$3,944	\$ —	\$3,944	\$166,543
Stockholders Equity					
Retained Earnings	\$1,969,696	\$13,933	\$ (1,690 )	\$12,243	\$1,981,939

Table of Contents

## Consolidated Statements of Income

Three months ended September 30, 2018  
Impact of the Adoption of Updated Accounting  
Guidance

Balances Excluding the Adoption of Updated Accounting Guidance	Capital Sales	Deferred Sales Commissions	Fund Expense Reimbursements	Total	As Reported
Operating Revenues					
Investment advisory fees:					
Funds	\$384,964	\$—	\$ —	\$ (1,041 )	\$(1,041 ) \$383,923
Operating Expenses					
Compensation and benefits	\$364,332	\$553	\$ —	\$ —	\$553 \$364,885
Distribution and servicing	115,064	—	(539 )	—	(539 ) 114,525
Other	53,242	—	—	(1,041 )	(1,041 ) 52,201

Six months ended September 30, 2018  
Impact of the Adoption of Updated Accounting  
Guidance

Balances Excluding the Adoption of Updated Accounting Guidance	Capital Sales	Deferred Sales Commissions	Fund Expense Reimbursements	Total	As Reported
Operating Revenues					
Investment advisory fees:					
Funds	\$769,811	\$—	\$ —	\$ (2,324 )	\$(2,324 ) \$767,487
Operating Expenses					
Compensation and benefits	\$725,546	\$907	\$ —	\$ —	\$907 \$726,453
Distribution and servicing	232,003	—	(886 )	—	(886 ) 231,117
Other	110,344	—	—	(2,324 )	(2,324 ) 108,020

## Cash Flow Reporting

Effective April 1, 2018, Legg Mason adopted updated accounting guidance on a retrospective basis which clarifies the classification and presentation of restricted cash, investment activity and other items in the statements of cash flows. The updated guidance requires entities to include restricted cash and restricted cash equivalents in the cash and cash equivalents balances on the consolidated statements of cash flows and to disclose a reconciliation between the balances on the consolidated statements of cash flows and the consolidated balance sheets. Legg Mason includes cash of consolidated investment vehicles and affiliate benefit trust cash in restricted cash. Legg Mason's restricted cash balances at September 30, 2018 and 2017, were \$28,892 and \$28,235, respectively. The updated guidance also clarifies how distributions from equity method investees should be classified based on either the cumulative earnings

or the nature of distribution approach. Legg Mason elected to apply the nature of distribution approach when classifying distributions received from equity method investees. As a result of adopting this aspect of the updated guidance, \$2,667 was reclassified from Cash Provided by Operating Activities to Cash Used in Investing Activities in the Consolidated Statement of Cash Flows for the six months ended September 30, 2017.

## Table of Contents

### Financial Instruments

Effective April 1, 2018, Legg Mason adopted accounting guidance on a prospective basis which requires equity investments to be measured at fair value, with changes recognized in earnings. This guidance does not apply to investments accounted for under the equity method of accounting or underlying investments of consolidated entities. The updated guidance also provides entities the option to elect to measure equity investments that do not have readily determinable fair values and do not qualify for the net asset value ("NAV") practical expedient at "adjusted cost". Under this adjusted cost method, investments are initially recorded at cost, and subsequently adjusted (increased or decreased) when there is an observable transaction involving the same investment, or similar investment from the same issuer. Adjusted cost investment carrying values are also adjusted for impairments, if any. Legg Mason has elected to measure certain investments under the adjusted cost approach. The adoption of this updated guidance did not have a material impact on Legg Mason's consolidated financial statements.

### Recent Accounting Developments

In August 2018, the Financial Accounting Standards Board ("FASB") updated the guidance to clarify accounting for implementation costs incurred for a cloud computing arrangement that is a service contract. The update conforms the requirements for capitalizing implementation costs incurred in a cloud computing arrangement that is a service contract with the accounting guidance that provides for capitalization of costs incurred to develop or obtain internal-use software. The updated guidance is effective for Legg Mason in fiscal 2021, unless adopted earlier. Legg Mason is evaluating its adoption.

In August 2018, the FASB also updated the guidance for fair value measurements. The updated guidance modifies disclosure requirements based on the revised FASB Conceptual Framework for Financial Reporting finalized in August 2018. The updated guidance will be effective in fiscal 2021, unless adopted earlier. Legg Mason is evaluating its adoption.

In August 2017, the FASB updated the guidance on accounting for derivative hedging. The updated guidance more closely aligns the results of cash flow and fair value hedging designations with risk management activities through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results in the financial statements. The new guidance also simplifies the application of hedge accounting. The updated guidance is effective for Legg Mason in fiscal 2020, unless adopted earlier. Legg Mason uses accounting hedge designation from time-to-time and would only potentially be impacted if derivative transactions were designated for hedging.

In January 2017, the FASB updated the guidance to simplify the test for goodwill impairment. The updated guidance still requires entities to perform annual goodwill impairment tests by comparing the fair value of a reporting unit with its related carrying amount, but it eliminates the requirement to potentially calculate the implied fair value of goodwill to determine the amount of impairment, if any. Under the new guidance, an entity should recognize an impairment charge if the reporting unit's carrying amount exceeds the reporting unit's fair value, in the amount of such excess. The guidance will be effective in fiscal 2020, unless adopted earlier. Legg Mason is evaluating its adoption.

In February 2016, the FASB updated the guidance on accounting for leases. The updated guidance requires that a lessee shall recognize the assets and liabilities that arise from lease transactions. A lessee will recognize a right-of-use asset to use the underlying asset and a liability representing the lease payments. The updated guidance also requires an evaluation at the inception of a service or other contract, to determine whether the contract is or contains a lease. In July 2018, the FASB further updated the lease guidance to make certain targeted improvements, including allowing for the guidance to be adopted on a modified retrospective basis. The guidance will be effective for Legg Mason in fiscal 2020. Legg Mason expects to recognize right of use assets and liabilities upon its adoption of the new standard and is continuing to evaluate the full impact of adoption, including transition method and practical expedient elections.





Table of Contents

## 3. Investments and Fair Value of Assets and Liabilities

The disclosures below include details of Legg Mason's financial assets and financial liabilities that are measured at fair value and NAV, excluding the financial assets and financial liabilities of CIVs. See Note 14, Variable Interest Entities and Consolidation of Investment Vehicles, for information related to the assets and liabilities of CIVs that are measured at fair value.

The fair values of financial assets and (liabilities) of the Company were determined using the following categories of inputs:

	As of September 30, 2018				Total
	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Investments measured at NAV	
Assets:					
Cash equivalents: <sup>(1)</sup>					
Money market funds	\$266,630	\$ —	\$ —	\$ —	\$266,630
Time deposits and other	—	9,842	—	—	9,842
Total cash equivalents	266,630	9,842	—	—	276,472
Investments of proprietary fund products and other investments: <sup>(2)</sup>					
Seed capital investments	127,448	27,307	1,394	—	156,149
Other <sup>(3)</sup>	20,642	2,049	—	—	22,691
Investments relating to long-term incentive compensation plans <sup>(4)</sup>	213,951	—	—	—	213,951
Equity method investments relating to long-term incentive compensation plans <sup>(5)</sup>	—	—	—	11,296	11,296
Total current investments <sup>(6)</sup>	362,041	29,356	1,394	11,296	404,087
Equity method investments in partnerships and LLCs: <sup>(5)(7)</sup>					
Seed capital investments <sup>(6)</sup>	—	—	1,161	13,162	14,323
Seed capital investments in real estate funds	—	—	35,859	—	35,859
Other	—	—	1,840	10,796	12,636
Adjusted cost investments: <sup>(7)</sup>					
Investments related to long-term incentive compensation plans	—	—	6,458	—	6,458
Other	—	74	4,448	—	4,522
Derivative assets <sup>(7)(8)</sup>	1,549	—	—	—	1,549
Total	\$630,220	\$39,272	\$51,160	\$35,254	\$755,906
Liabilities:					
Contingent consideration liabilities <sup>(9)</sup>	\$—	\$—	\$(1,900)	\$—	\$(1,900)
Derivative liabilities <sup>(8)</sup>	(6,296)	—	—	—	(6,296)
Total	\$(6,296)	\$—	\$(1,900)	\$—	\$(8,196)

Table of Contents

	As of March 31, 2018				
	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant nonobservable inputs (Level 3)	Investments measured at NAV	Total
Assets:					
Cash equivalents: <sup>(1)</sup>					
Money market funds	\$350,142	\$ —	\$ —	\$ —	—\$350,142
Time deposits and other	—	13,863	—	—	13,863
Total cash equivalents	350,142	13,863	—	—	364,005
Trading investments of proprietary fund products and other trading investments: <sup>(2)</sup>					
Seed capital investments	131,715	37,598	1,242	3,225	173,780
Other <sup>(3)</sup>	29,051	2,565	—	—	31,616
Trading investments relating to long-term incentive compensation plans <sup>(4)</sup>	184,639	—	—	99	184,738
Equity method investments relating to proprietary fund products and long-term incentive compensation plans: <sup>(5)</sup>	—				