LEGG MASON, INC.
Form 10-Q
August 06, 2018
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 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: 1-8529
LEGG MASON, INC.
(Exact name of registrant as specified in its charter)

MARYLAND	52-1200960
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 International Drive - Baltimore, MD	21202
(Address of principal executive offices)	(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 X No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes X No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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. (Check one):

Large accelerated filer	X	Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	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. ____

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
85,451,070 shares of common stock as of the close of business on August 2, 2018.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LEGG MASON, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)
(Unaudited)

	June 30, 2018	March 31, 2018
ASSETS		
Current Assets		
Cash and cash equivalents	$590,530	$736,130
Cash and cash equivalents of consolidated investment vehicles	3,466	2,800
Restricted cash	19,004	30,428
Receivables:		
Investment advisory and related fees	435,620	475,594
Other	55,827	77,024
Investment securities	392,296	399,370
Investment securities of consolidated investment vehicles	164,468	140,133
Other	74,958	65,010
Other current assets of consolidated investment vehicles	2,609	1,893
Total Current Assets	1,738,778	1,928,382
Fixed assets, net	154,315	148,406
Intangible assets, net	3,777,315	3,797,659
Goodwill	1,901,926	1,932,355
Deferred income taxes	199,431	202,068
Other	145,063	134,407
Other assets of consolidated investment vehicles	9,413	9,257
TOTAL ASSETS	$7,926,241	$8,152,534
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Current Liabilities		
Accrued compensation	$260,089	$476,061
Accounts payable and accrued expenses	191,901	175,583
Short-term borrowings	125,500	125,500
Contingent consideration	4,174	3,707
Other	138,019	200,557
Other current liabilities of consolidated investment vehicles	629	634
Total Current Liabilities	720,312	982,042
Deferred compensation	101,258	92,422
Deferred income taxes	155,990	139,787
Contingent consideration	1,900	1,900
Other	121,572	130,142
Long-term debt, net	2,221,796	2,221,810
TOTAL LIABILITIES	3,322,828	3,568,103
Commitments and Contingencies (Note 7)		
REDEEMABLE NONCONTROLLING INTERESTS	747,697	732,295
STOCKHOLDERS' EQUITY		

Common stock, par value $.10; authorized 500,000,000 shares; issued 85,440,021 shares for June 2018 and 84,606,408 shares for March 2018	8,544	8,461
Additional paid-in capital	1,984,634	1,976,364
Employee stock trust	(21,952)	(21,996)
Deferred compensation employee stock trust	21,952	21,996
Retained earnings	1,941,988	1,894,762
Accumulated other comprehensive loss, net	(107,662)	(55,182)
Total stockholders' equity attributable to Legg Mason, Inc.	3,827,504	3,824,405
Nonredeemable noncontrolling interest	28,212	27,731
TOTAL STOCKHOLDERS' EQUITY	3,855,716	3,852,136
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$7,926,241	$8,152,534

See Notes to Consolidated Financial Statements

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

	Three Months Ended June 30,	
	2018	2017
OPERATING REVENUES		
Investment advisory fees:		
Separate accounts	$259,895	$250,046
Funds	383,564	382,228
Performance fees	24,036	81,537
Distribution and service fees	79,190	78,906
Other	1,220	1,125
Total Operating Revenues	747,905	793,842
OPERATING EXPENSES		
Compensation and benefits	361,568	413,307
Distribution and servicing	116,592	122,349
Communications and technology	56,740	50,303
Occupancy	24,904	24,408
Amortization of intangible assets	6,180	6,339
Impairment of intangible assets	—	34,000
Contingent consideration fair value adjustments	426	(16,550)
Other	55,819	52,481
Total Operating Expenses	622,229	686,637
OPERATING INCOME	125,676	107,205
NON-OPERATING INCOME (EXPENSE)		
Interest income	2,446	1,468
Interest expense	(29,917)	(29,266)
Other income, net	7,252	11,388
Non-operating income of consolidated investment vehicles, net	3,583	997
Total Non-Operating Income (Expense)	(16,636)	(15,413)
INCOME BEFORE INCOME TAX PROVISION	109,040	91,792
Income tax provision	30,675	28,255
NET INCOME	78,365	63,537
Less: Net income attributable to noncontrolling interests	12,275	12,617
NET INCOME ATTRIBUTABLE TO LEGG MASON, INC.	$66,090	$50,920
NET INCOME PER SHARE ATTRIBUTABLE TO LEGG MASON, INC. SHAREHOLDERS:		
Basic	$0.75	$0.52
Diluted	0.75	0.52
DIVIDENDS DECLARED PER SHARE	$0.34	$0.28

See Notes to Consolidated Financial Statements

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LEGG MASON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Dollars in thousands)
(Unaudited)

	Three Months Ended June 30, 2018	2017
NET INCOME	$ 78,365	$ 63,537
Other comprehensive income (loss):		
Foreign currency translation adjustment	(53,362)	10,671
Changes in defined benefit pension plan	882	119
Total other comprehensive income (loss)	(52,480)	10,790
COMPREHENSIVE INCOME	25,885	74,327
Less: Comprehensive income attributable to noncontrolling interests	14,884	12,284
COMPREHENSIVE INCOME ATTRIBUTABLE TO LEGG MASON, INC.	$ 11,001	$ 62,043

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

	Three Months Ended June 30,	
	2018	2017
STOCKHOLDERS' EQUITY ATTRIBUTABLE TO LEGG MASON, INC.		
COMMON STOCK		
Beginning balance	$8,461	$9,573
Stock options exercised	15	26
Deferred compensation employee stock trust	—	1
Stock-based compensation	107	83
Employee tax withholdings by settlement of net share transactions	(39)	(34)
Shares repurchased and retired	—	(237)
Ending balance	8,544	9,412
ADDITIONAL PAID-IN CAPITAL		
Beginning balance	1,976,364	2,385,726
Stock options exercised	4,801	7,380
Deferred compensation employee stock trust	136	125
Stock-based compensation	18,701	20,710
Employee tax withholdings by settlement of net share transactions	(15,368)	(12,777)
Shares repurchased and retired	—	(89,412)
Ending balance	1,984,634	2,311,752
EMPLOYEE STOCK TRUST		
Beginning balance	(21,996)	(24,057)
Shares issued to plans	(136)	(126)
Distributions and forfeitures	180	61
Ending balance	(21,952)	(24,122)
DEFERRED COMPENSATION EMPLOYEE STOCK TRUST		
Beginning balance	21,996	24,057
Shares issued to plans	136	126
Distributions and forfeitures	(180)	(61)
Ending balance	21,952	24,122
RETAINED EARNINGS		
Beginning balance	1,894,762	1,694,859
Net Income (Loss) Attributable to Legg Mason, Inc.	66,090	50,920
Dividends declared	(29,858)	(27,352)
Reclassification to noncontrolling interest for net increase in estimated redemption value of affiliate management equity plans and affiliate noncontrolling interests	(1,269)	(1,392)
Adoption of new revenue recognition guidance	12,263	—
Adoption of new stock-based compensation guidance	—	24,327
Ending balance	1,941,988	1,741,362
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET		
Beginning balance	(55,182)	(106,784)
Changes in defined benefit pension plan	882	119
Foreign currency translation adjustment	(53,362)	10,671
Ending balance	(107,662)	(95,994)
TOTAL STOCKHOLDERS' EQUITY ATTRIBUTABLE TO LEGG MASON, INC.	3,827,504	3,966,532

NONREDEEMABLE NONCONTROLLING INTEREST		
Beginning balance	27,731	27,798
Net income attributable to noncontrolling interests	2,214	2,261
Distributions	(1,733)	(1,818)
Ending balance	28,212	28,241
TOTAL STOCKHOLDERS' EQUITY	$3,855,716	$3,994,773

See Notes to Consolidated Financial Statements

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

	Three Months Ended June 30,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net Income (Loss)	$78,365	$63,537
Adjustments to reconcile Net Income to net cash provided by operations:		
Impairments of intangible assets	—	34,000
Depreciation and amortization	17,547	18,473
Accretion and amortization of securities discounts and premiums, net	561	936
Stock-based compensation	19,085	21,068
Net unrealized (gains) losses on investments	(350)	(5,496)
Net (gains) losses and earnings on investments	(6,792)	(5,546)
Net (gains) losses of consolidated investment vehicles	(3,583)	(997)
Deferred income taxes	21,796	22,183
Contingent consideration fair value adjustments	426	(16,550)
Other	371	(76)
Decrease (increase) in assets:		
Investment advisory and related fees receivable	36,589	(46,340)
Net sales (purchases) of trading and other investments	(4,385)	39,438
Other receivables	(4,473)	(9,778)
Other assets	(12,562)	(1,330)
Assets of consolidated investment vehicles	(14,575)	(32,775)
Increase (decrease) in liabilities:		
Accrued compensation	(213,181)	(201,486)
Deferred compensation	8,837	15,718
Accounts payable and accrued expenses	18,166	12,378
Other liabilities	(44,007)	(23,855)
Other liabilities of consolidated investment vehicles	(5)	1,014
CASH USED IN OPERATING ACTIVITIES	$(102,170)	$(115,484)

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

	Three Months Ended June 30, 2018	2017
CASH FLOWS FROM INVESTING ACTIVITIES		
Payments for fixed assets	$(17,990)	$(8,371)
Contingent payment from prior sale of businesses	—	2,561
Returns of capital and proceeds from sales and maturities of investments	3,679	2,132
CASH USED IN INVESTING ACTIVITIES	(14,311)	(3,678)
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid	(24,572)	(21,153)
Distributions to affiliate noncontrolling interests	(13,183)	(17,731)
Net subscriptions (redemptions) attributable to noncontrolling interests	18,132	10,266
Employee tax withholdings by settlement of net share transactions	(15,407)	(12,811)
Issuances of common stock for stock-based compensation	4,952	7,532
Repurchases of common stock	—	(89,649)
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	(30,078)	(123,546)
EFFECT OF EXCHANGE RATES	(10,062)	(412)
NET DECREASE IN CASH, CASH EQUIVALENTS, AND RESTRICTED CASH	(156,621)	(243,120)
CASH, CASH EQUIVALENTS, AND RESTRICTED CASH:		
BEGINNING OF PERIOD	773,765	754,339
END OF PERIOD	$617,144	$511,219
Supplemental Disclosures		
Cash paid for:		
Income taxes, net of refunds of $1,903 in 2017	$13,269	$8,132
Interest	$12,135	$11,094
Reconciliation of cash, cash equivalents and restricted cash		
Cash and cash equivalents	$590,530	$491,301
Restricted cash	19,004	15,152
Cash and cash equivalents of consolidated investment vehicles	3,466	679
Affiliate employee benefit trust cash included in Other non-current assets	4,144	4,087
Total cash, cash equivalents and restricted cash per consolidated statements of cash flows	$617,144	$511,219

See Notes to Consolidated Financial Statements

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LEGG MASON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands, except per share amounts or unless otherwise noted)
June 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 (“U.S. 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 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
In the normal course of its business, 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 June 30, 2018, March 31, 2018, and June 30, 2017, no consolidated VREs were designated as CIVs.

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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 June 30, 2018, March 31, 2018 and June 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 two Legg Mason sponsored exchange traded funds ("ETFs"). Under the terms of the total return swaps, Legg Mason absorbs all gains and losses on the underlying ETF investments of these financial intermediaries, and therefore has variable interests in each of the two related funds and is deemed to be the primary beneficiary. As of June 30, 2018 and March 31, 2018, Legg Mason consolidated each of the two ETFs, which were designated as CIVs. As of June 30, 2017, Legg Mason consolidated only one of the ETFs, which was designated as a CIVs, as the total return swaps related to the second ETF had not yet been executed.

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.

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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.

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

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 assets under management ("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.

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

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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 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 an increase to Retained earnings of $14,839, an increase to Other current assets of $9,615, an increase to Other non-current assets of $10,316, a decrease to Deferred income tax assets of $1,148 and an increase to Deferred income tax liabilities of $3,944 to reflect the capitalization of these commissions.

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 three months ended June 30,

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2018 and 2017, no impairment charges were recorded. Deferred sales commissions, included in Other non-current assets in the Consolidated Balance Sheets, were $1,625 and $4,047 at June 30, 2018 and March 31, 2018, respectively.

Under the updated accounting guidance, Legg Mason has elected to expense sales commissions related to certain share classes with amortization periods of one year or less as incurred. Legg Mason recorded a cumulative-effect adjustment of $2,576 on the Consolidated Balance Sheet as of April 1, 2018, as a reduction to Other non-current assets, with a corresponding reduction in Retained earnings 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
Assets			
Other, current	$65,010	$ 9,615	$74,625
Deferred income taxes	202,068	(1,148)	200,920
Other, non-current	134,407	7,740	142,147
Liabilities			