SERENA SOFTWARE INC
Form 10-K
May 02, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark one)

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

For the fiscal year ended January 31, 2011

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: 000-25285

SERENA SOFTWARE, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**94-2669809**

(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1900 Seaport Boulevard

Redwood City, California 94063-5587
(Address of Principal Executive Offices)

(650) 481-3400
(Registrant s telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

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 ¨ No x

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 x No ¨

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 x

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

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

Large Accelerated Filer	¨	Accelerated Filer	¨
Non-Accelerated Filer	x (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The aggregate market value of common stock held by non-affiliates of the registrant was zero as of January 31, 2010, the last business day of the registrant s most recently completed fiscal quarter. The registrant is a privately-held company and there is no public trading market for its common stock.

As of March 31, 2011, the number of shares of the registrant s common stock outstanding was 98,390,978.

DOCUMENTS INCORPORATED BY REFERENCE

List hereunder the following documents if incorporated by reference and the Part of the Form 10-K into which the document is incorporated: (1) any annual report to security holders; (2) any proxy or information statement; and (3) any prospectus filed pursuant to Rule 424(b) or (c) under the Securities Act of 1933. None.

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SERENA SOFTWARE, INC.

ANNUAL REPORT ON FORM 10-K

For the Fiscal Year Ended January 31, 2011

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PART I

ITEM 1. BUSINESS

Our fiscal year ends on January 31 and, except as otherwise provided, references to a particular fiscal year in this Annual Report on Form 10-K mean the fiscal year ended on January 31 of such year. For example, fiscal year 2011 refers to the fiscal year ended January 31, 2011.

Our Company

We are the largest global independent software company in terms of revenue focused solely on managing change across information technology, or IT, environments. Our products and services primarily address the complexity of application lifecycle management, or ALM, and are used by our customers to manage the development of, and control change in, mission critical applications within both mainframe and distributed systems environments. In addition, we provide products and services to enable customers to rapidly address business process management, or BPM, challenges through the use of visually designed process workflows. Our products and services allow customers to orchestrate and manage their application development, IT and business processes by automating and integrating disparate ALM products and processes, improving process visibility and consistency, enhancing software integrity, mitigating application development risks, supporting auditability and regulatory compliance, and boosting productivity. Our revenue is generated by software licenses, maintenance contracts and professional services. Our software products are typically installed within customer IT environments and generally accompanied by renewable annual maintenance contracts.

Our software and services are of critical importance to our customers, who make significant investments in developing applications and automating IT processes around our software solutions. We have a diversified, global customer base with a history of more than 15,000 installations of our products at customer sites worldwide. Our customers include industry leaders in the finance, telecommunications, automotive and transportation, healthcare, energy and power, equipment and machinery and technology industries, with no single customer accounting for 10% or more of our total revenue for the fiscal year ended January 31, 2011. During the same period, we generated 67%, 28%, 4% and 1% of our total revenue in North America, Europe, the Asia Pacific region and South America, respectively.

Revenue generated from software licenses, maintenance contracts and professional services accounted for 24%, 67% and 9%, respectively, of our total revenue for the fiscal year ended January 31, 2011. Software license revenue is generated by the sale of perpetual software licenses to existing and new customers, and includes both upfront licenses as well as follow-on license purchases as customers expand capacity, add additional applications or users and require additional products to satisfy a broader set of requirements. Software licenses are generally accompanied by annual maintenance contracts, which are typically priced between 17% and 21% of the price of software license. The annual maintenance contracts provide customers the right to obtain updates, bug fixes and telephone support for our applications. We typically collect maintenance fees at the time the maintenance contract is entered into and ratably recognize these fees over the term of the contract, generally one year. Professional services revenue is generated through best practices implementations to facilitate the optimal installation and usage of our software, and technical consulting and educational services.

Serena Software, Inc. was incorporated under the laws of California in 1980 and re-incorporated under the laws of Delaware in 1998. On March 10, 2006, Spyglass Merger Corp., an affiliate of Silver Lake, a private equity firm, merged with and into us, a transaction we refer to in this annual report as the merger. As a result of the merger, our common stock ceased to be traded on the NASDAQ National Market and we became a privately-held company, with approximately 56.5% of our common stock at the time of the merger on a fully diluted basis owned by investment funds affiliated with Silver Lake.

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Our Industry

Companies increasingly depend on IT tools and applications for mission critical business processes. Many of the largest commercial businesses and government entities house essential information and applications in mainframe computers located in centralized datacenters or distributed systems networks. Organizations have also increasingly opened their IT systems to customers and suppliers through their Internet and extranet sites to enhance supplier and vendor transparency, decrease data inefficiencies and reduce time to market for their products and services.

Our customers applications, systems and IT infrastructure are constantly evolving to meet changing customer, supplier and employee requirements. In addition, government and industry regulations have increased the need for governance of these applications and monitoring changes to IT environments. Changes to IT environments are increasingly becoming complicated by the tendency towards moving internal software development offshore, requiring IT managers to oversee multiple development processes across various geographies. As a result, specific functionality allowing organizations to audit, track and monitor changes, and revert back to previous versions, has become critical to managing IT systems. Organizations have an ongoing and growing need for solutions that efficiently and effectively manage change across increasingly complex IT environments.

Our products address a number of industry segments within the broader ALM market, including software change and configuration management, or SCCM, requirements management, or RM, project and portfolio management, or PPM, business process management, or BPM, and IT service management, or ITSM, markets. *SBM (Serena Business Manager)*, our BPM product, can be used to manage application development processes as well as general business processes.

We believe that several factors will continue to drive growth in the markets we serve, including:

Accelerating Software Complexity. As organizations become more dependent on complex, cross-platform IT applications, the importance of managing IT change effectively is increasingly critical. ALM tools are necessary to understand how a change in one part of the IT environment will impact the other IT systems and processes related to such change.

Regulatory Compliance. Organizations across a range of industries are increasingly required to comply with changing and new regulations that require organizations to audit, track and manage changes to their IT systems. We believe these regulatory changes and the overall regulatory environment are forcing many companies to audit their IT practices and confront change management issues with a high degree of attention directed at the potentially severe consequences of change management failures.

Business Pressures for Productivity, Quality and Faster Time to Market. Ongoing pressures on IT departments to reduce spending and improve service will continue to focus attention on process improvement in the software development life cycle. Customers will look to vendors to provide well-integrated solutions that assure the delivery of high quality applications to the market faster.

Need for Rapid and Cost Effective Human Process Management. As organizations grow, the requirement for managing and documenting human processes across multiple departments and geographies becomes mandatory. These processes often change rapidly, frequently requiring a cost effective solution to manage vital business processes.

Outsourcing. Companies continue to outsource critical IT functions by shifting software development to new geographic locations, creating the need to coordinate and communicate changes among developers in often widely dispersed locations. The outsourcing trend increases companies reliance on change management processes to allow all relevant personnel to view, approve and control changes to software applications.

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Significant Opportunity to Replace Internally Developed Solutions. A significant number of companies and government agencies currently use manual processes and internally developed software solutions to monitor their IT environments. Due to accelerating software complexity, increasing regulatory requirements and outsourcing, a growing number of organizations have begun purchasing third-party software solutions instead of relying on manual processes and internally developed software solutions.

Our Strengths

We believe our strengths in addressing the above-mentioned industry opportunities include the following:

Global Software Vendor with Leading Market Position. We are the largest global independent software company in terms of revenue focused solely on managing change across IT environments. Our products offer solutions for both distributed systems and mainframe platforms. According to Gartner s 2010 research report on worldwide software change and configuration management vendor market shares, we were the number three ranked vendor in the software change and configuration management market. We attribute our leading position to the breadth and quality of our product offerings and to our established customer relationships.

Stable, Recurring Revenue Base with Significant Visibility. The mission critical nature of our products combined with our large installed customer base have enabled us to develop a stable, recurring revenue base comprised of license, maintenance and professional services revenues. For the fiscal year ended January 31, 2011, maintenance revenue comprised 67% of our total revenue. Our maintenance revenue is generally recurring, providing us with significant visibility into our future revenue and, to a lesser extent, profitability. For the fiscal year ended January 31, 2011, our maintenance contract renewal rate was at least 90%, which we believe is higher than the industry average. We have a resilient revenue model where customers continue to enter into and renew maintenance contracts, even during significant downturns within the software industry.

Margins and Strong Cash Flow Generation. Due primarily to our broad portfolio of products, large installed customer base and leading market presence, our current business model generates positive working capital and requires minimal capital expenditure, providing us with significant free cash flow. For the fiscal year ended January 31, 2011, we had cash flows from operating activities of $46.0 million, an Adjusted EBITDA margin of 40.5% and $2.8 million in capital expenditures. A description of Adjusted EBITDA and a reconciliation of Adjusted EBITDA to comparable GAAP financial measures is included under Item 7, *Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Covenant Compliance.*

30 Year History with Diversified, Global Customer Base. We have a diversified, global customer base with a history of more than 15,000 installations of our products at customer sites worldwide. We have minimal customer concentration, with no one customer accounting for 10% or more of our total revenue for the fiscal year ended January 31, 2011. We are also continuing to expand our revenue base internationally. For the fiscal year ended January 31, 2011, we derived 33% of our total revenue from international customers.

High Switching Costs. Our software products help our customers define complex and ever-changing software environments. As such, our solutions generally become a key part of our customers application development infrastructure and are embedded deep within multiple parts of a customer s mission-critical IT environment. In addition, it typically takes our customers six to twelve months to implement our products into their systems and requires a significant investment in effort and cost. This makes it difficult for other vendors to sell competing solutions to our customer base, as there are high switching costs in terms of time, effort and expense, and the process of switching products carries the potential for significant business disruption.

Significant Equity Investments from our Founder and Silver Lake. In connection with the merger, a trust and a foundation affiliated with Douglas D. Troxel, our founder and one of our directors, exchanged equity interests

in Serena, valued for purposes of the exchange at approximately $154.1 million, for equity interests in the surviving corporation. This significant equity investment by our founder, together with the investment of $335.5 million by investment funds affiliated with or designated by Silver Lake, represented over 46% of our capitalization as of January 31, 2011.

Our Strategy

We are focused on continuing to be the leading provider of solutions that enable organizations to manage change throughout their IT environments. To pursue our objectives we have implemented the following strategies:

Develop Orchestrated ALM Solutions. We have a strategic vision to automate end-to-end application development processes from application demand through deployment. Our Orchestrated ALM strategy is to offer a suite of products that provides a unified and integrated framework for connecting people, tools and processes throughout the application lifecycle, delivering automated change processes, managing workflows and enforcing business rules within IT environments. Serena SCCM products, together with *SBM,* allow customers to quickly prioritize and deliver more of the features and applications required by their businesses, communicate changes to demand across their organizations and provide greater visibility and responsiveness by IT organizations. Serena Orchestrated ALM provides integrated capabilities for demand management, requirements management, portfolio analysis, project management, agile software development, software prototyping, and software change and configuration management. Serena Orchestrated ALM helps distributed development teams manage and track changes to requirements, software configurations and timelines.

Continued Focus on Release Management. The objective of application release management is to deploy application changes into production without disrupting the business. This process is often performed manually and is inefficiently connected to the rest of the application lifecycle, leaving a critical gap between application development and operations. Serena Release Management helps IT organizations automate the release process across platforms, environments, and application tiers. IT organizations can increase release frequency and reduce risks with *Serena Release Control*, *Serena Release Vault* and *Serena Release Automation*.

Expand into Information Technology Service Management (ITSM). We recently developed *Serena Service Manager,* a process-based IT service management solution. *Serena Service Manager* leverages the flexibility of *SBM* to automate the service delivery process, provide a simple yet powerful role-based experience to service desk users, deliver visibility into the status of issues across the service lifecycle and assist with Information Technology Infrastructure Library (ITIL) compliance. We expect to continue to develop *Serena Service Manager* and develop additional complementary solutions, such as IT service cataloguing, IT provisioning, change management and request management.

Cross-Sell and Increase Penetration into Our Large, Global Installed Customer Base. We have a large, global installed base that primarily uses our SCCM products for specific platforms. We have a significant opportunity to sell these existing customers SCCM products on additional platforms, expand their use of our products outside of SCCM (for example, RM, BPM, PPM and ITSM) and enable them to purchase and utilize our broader solution set for managing the entire application lifecycle. Moreover, we have the opportunity to sell additional licenses as customers expand capacity, add additional applications and users and develop a need for additional products to satisfy a broader set of requirements.

Maintain and Strengthen Technological Leadership of Our Products. We have assembled a global team of research and development personnel with strong industry and technical expertise in ALM, BPM and ITSM. We continue to focus on improving and upgrading our existing product portfolio and developing innovative technologies to enhance our software products. We believe such products will increase the value that we are able to deliver to our customers, enabling us to increase our revenue.

Continue to Capitalize on Regulatory Compliance Spending. Organizations across a range of industries are increasingly required to comply with regulations, from industry-specific legislation such as the Health Insurance Portability and Accountability Act, or HIPAA, and the Gramm-Leach-Bliley Act, or the GLBA, to broader legislation such as the Sarbanes-Oxley Act. We believe that the need to comply with these regulatory standards will drive additional license sales of our products, as some customers may prefer not to depend on manual or internally developed systems to satisfy these regulatory requirements. Our products support regulatory compliance by, for example, providing automatic audit trails with an audit and feedback loop that is essential for compliance with requirements imposed by the Sarbanes-Oxley Act. Our products enable easier demonstration of regulatory compliance, and also allow businesses to achieve benefits such as more reliable IT service, faster time to market and demonstrable return on investment for development initiatives.

Use Our Consulting and Services Offerings to Increase Sales of Our Software Products. We plan to use our consulting and services offerings to help drive growth in our software licenses. We provide professional services on a global basis to our customers to deploy best practices implementations to facilitate the optimal installation and usage of our software. In addition to technical consulting, education and customer support, our professional services also include process reengineering and the development of interfaces with customers databases, third party proprietary software repositories and programming languages. As customers recognize the costs and time required to meet increasing regulatory requirements, we believe our professional services organization will benefit. In addition, we believe that our consulting and service offerings will lead to greater customer satisfaction with our products, and in turn will promote increased license and maintenance revenue.

Pursue Strategic Acquisition Opportunities. We have completed a number of strategic transactions in our history, which have enabled us to broaden our product portfolio and expand into new geographies. To supplement our internal development efforts and capitalize on growth opportunities, we intend to continue to employ a disciplined and focused acquisition strategy. We seek to opportunistically acquire businesses, products and technologies in our existing or complementary vertical markets at attractive valuations.

Our Products

We develop, market and support an integrated suite of software products for managing and controlling change across distributed systems and mainframe platforms. A distributed system platform allows applications to share resources over a distributed network using operating systems such as UNIX, Linux and Windows. A mainframe platform uses a centralized system with high processing power to support high-volume applications. Our solutions improve process consistency and enhance the integrity of software that our customers create or modify. This helps protect our customers valuable application assets and improve software developer productivity, operational efficiency, application availability and return on IT investments, all of which ultimately reduce the costs of managing their IT environment. Our products serve a variety of market and customer needs and are grouped as follows:

Software Change and Configuration Management:

Dimensions® : End-to-end cross-platform, highly scalable solution for distributed development. Our *Dimensions* product family integrates application development across global sites, stakeholders, and platforms. Using *Dimensions* allows organizations to model and automatically enforce software development processes. *Dimensions* features tight integration between requirements management and change/configuration management through a common process model and a unified data store that enables IT organizations to trace, validate and implement change requests without disruption during development. The *Dimensions* product line includes *Dimensions CM* for managing the application development, change and configuration process. Customers can also purchase *Dimensions RM* for gathering, tracking and managing application requirements throughout a project s lifecycle. *Prototype Composer*, which allows customers to graphically define and model application software requirements, is fully integrated with *Dimensions*. Models, prototypes and requirements definitions created in *Prototype Composer* can be deployed to *Dimensions RM*.

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PVCS®: *PVCS Professional:* Integrated suite of issue, version and build management tools for team-based environments. *PVCS Professional* includes *SBM* and *PVCS Version Manager*, a version control product.

ChangeMan® : Software configuration management solution for mainframe systems, in particular z/OS environments. Our *ChangeMan* product family addresses the complexity of developing, deploying and maintaining mainframe software applications by providing software infrastructure to manage changes to mainframe applications in parallel, regardless of development methodology, geographic location or computing platform. The *ChangeMan* product family enables users to automate, control and synchronize those changes throughout their IT environments from a single point of control.

StarTool® and Comparex®: Application testing, data comparison, implementation and problem analysis for mainframe systems. These solutions improve mainframe application availability through file and data management, data comparison, fault analysis, application performance management, input/output optimization and application test debugging.

Application Release Management:

Serena Release Control (ARM): Manages the software release management process from requirements to deployment. Serena Release Control is a composite application that operates using *Serena Business Manager (SBM).*

Serena Release Vault (Dimensions Deploy): Manages application development, change and configuration process. *Serena Release Control* is based on *Dimensions CM*.

Serena Release Automation: Allows customers to automate and centrally manage application releases. *Serena Release Automation* consists of products that we resell and distribute on behalf of Nolio, Inc.

Application Development and Business Process Management:

Serena Business Manager, or SBM (formerly known as Serena Business Mashups and *TeamTrack)*: Enterprise process management solution to map, track, and enforce any business process, such as IT requests. Our *SBM* product line allows customers to build and deploy integrated business processes that extend to all participants in a project, including departmental users, customers, suppliers and business partners. This Web-based, secure and highly configurable process and issue management solution creates repeatable, enforceable, auditable and predictable processes, giving our customers control, insight and predictability in their management of the application lifecycle and their business processes. The *SBM* product line includes *SBM Composer* for graphically designing composite applications that include human workflow processes, orchestrated connections to other enterprise systems, and interactive web forms. Process-based applications created in *SBM Composer* are then published within *SBM* and, once deployed, are available to users from any Web browser or internet-connected device to obtain status updates, enter information and approve and route work to other participants.

IT Service Management:

Serena Service Manager: Flexible process-based IT service management. *Serena Service Manager* leverages *Serena Business Manager (SBM)* to automate the service delivery process, provide a simple yet powerful role-based experience to service desk users, deliver visibility into the status of issues across the service lifecycle and assist with Information Technology Infrastructure Library (ITIL) compliance.

Project and Portfolio Management:

Serena PPM: Portfolio, project, resource, demand and financial management for complete project and portfolio management. *Serena PPM s* project management capabilities allow for a flexible approach

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for project initiation, planning and tracking. With *Serena PPM* s portfolio management capabilities, IT can examine investment tradeoffs and track performance, and use *Serena PPM* s resource management features to analyze resource capacity and assess the impact of project changes. With *Serena PPM* s demand management tools, IT can capture all sources of demand, channeling requests through appropriate approvals. Financial management functions provide assessment of key financial indicators and management of lifecycle costs and benefits.

The following are our principal products:

Product Name	Brief Description
Dimensions® :	
Dimensions CM	Process-driven change management for heterogeneous systems.
Dimensions RM	Tracks and manages requirements through the application development lifecycle.
Prototype Composer	Graphically define and model customer application software requirements.
Serena Business Manager:	
Serena Business Manager	Create and deploy process-centric applications that may include orchestrated connections to other enterprise systems. Maps, tracks and enforces business processes. Formerly known as *Serena Business Mashups* and *TeamTrack*.
SBM Composer	Visual modeling tool for creating workflows, orchestrating connections to other enterprise systems, and design user interfaces.
PVCS® :	
PVCS Professional	An integrated suite of issue and version management tools for team-based environments.
PVCS Version Manager	Version control across all platforms and standard IDEs.
Serena PPM:	
Serena PPM	Tracks and manages portfolio, project, resource, demand and financial management. Formerly known as *Mariner PPM*.
Serena Release Management:	
Serena Release Control (ARM)	Provides an automated, process-centric approach for software release management from requirements to deployment.
Serena Release Vault (Dimensions Deploy)	Based on Dimensions CM, with use restricted to version management, build management, deployment, request management and administrative features.
Serena Release Automation:Powered by Nolio	Automates and centrally manages application releases.
ChangeMan® :	
ChangeMan ZMF	Application change management and development for mainframe systems.
StarTool® and Comparex®:	
StarTool FDM	Facilitates complex mainframe file and data management tasks.
StarTool DA	Automates mainframe dump and abend analysis and speeds application problem solving activities.
Comparex	Performs data comparison for mainframe application testing and software quality.

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Products Under Development

In the coming year, we will continue to execute on our mission to give enterprises control, predictability and insight over change from business planning to operations by enhancing existing products and releasing new solutions based on market needs and requirements. While each development project will be defined and scoped based on market analysis, taking into consideration the needs of our existing and prospective customers, trends in the market, competitive moves and technological advancements, there are a number of overarching corporate goals that will be considered as well.

As part of our strategy focused on Serena Release Management, we plan to continue to enhance the integrations between various products within our product portfolio, such as *Serena Release Control (ARM)*, *Serena Release Vault* (*Dimensions Deploy)* and *Serena Release Automation*, and with third-party vendor solutions, and management reporting tools (i.e., dashboards) within our products, to ensure that our customers have the ability to track, manage and control change in a closed loop, heterogeneous environment ensuring the effective management, traceability and auditability of application release management.

Our Orchestrated ALM strategy will use *SBM* to integrate all parts of the application lifecycle across the enterprise. The objective is to create an integrated suite of not only Serena products, but other third party and open source lifecycle management products. Newly developed dashboards will provide visibility and control across the entire application lifecycle. As part of our strategy focused on the BPM market*,* we plan to continue to develop and enhance the capabilities of the core *SBM* platform, including enhancing the rules based workflow engine and expanding the capability to rapidly change and modify existing process maps and workflows. In addition, we plan to develop process-centric solutions consisting of composite applications that will utilize *SBM* to address governance and process-related needs of our customers within horizontal and certain vertical markets.

As part of our strategy focused on the ITSM market, we plan to develop solutions based on *SBM* in addition to *Serena Service Manager*, including IT service catalogue, IT provisioning, change management and request management.

Our large and diverse customer base provides us with feedback on ways we can evolve our products to meet the needs of markets outside of the core SCCM market. Examples of markets in which our products already address identified customer problems include BPM (*SBM*), PPM (*Serena PPM*), RM (*Dimensions RM*), application release management (*Serena Release Control*, or *ARM*), and ITSM (*Serena Service Manager*). We will continue to develop our solutions to meet the needs of the markets and customers that we currently serve and those in which we can achieve a leadership position.

Professional Services and Customer Support

In connection with the licensing of our software products, we typically enter into annual maintenance contracts that provide customers the right to obtain available updates, bug fixes and telephone support for our applications. In addition, we provide professional services on a global basis to our customers to help them deploy best practices implementations and to facilitate the optimal installation and usage of our software. Our professional services offerings also include technical consulting and educational services.

Consulting. We provide a comprehensive range of consulting services to our customers. Our consultants review customers existing IT systems and applications and make recommendations for changing those systems and applications and implementing our ALM products so that customers can fully realize their benefits. In addition to helping customers install and deploy our software products, our consulting services may also include process reengineering and developing interfaces with customers databases, third party proprietary software repositories or programming languages.

We also offer customers more specialized consulting services. These specialized consulting services include our best practices consulting services, which provide customers with expertise and assistance in defining and

developing a best practice change and configuration management architecture and in identifying corresponding products, methods and procedures. Our consulting services are typically billed on a time and materials basis.

Education. We offer hands-on training courses for the implementation and administration of our products. Product training is provided on a periodic basis at our headquarters in Redwood City, California, and also at customer sites throughout the United States, Europe, and Asia. We also offer course development for certain of our products. We bill our educational services on a per class basis.

Customer Support and Product Maintenance. We have a global staff of customer support personnel who provide technical support to customers. Our support centers are located in North America, the United Kingdom and Australia. We offer technical support services 24 hours a day, seven days a week via our Internet site, toll free telephone lines and electronic mail. Customers are notified about the availability of regular maintenance and enhancement releases via the Internet site or electronic mail. Customers can gain access to online services by registering on our SOS Internet web site. Customers are entitled to receive software updates, maintenance releases and technical support for an annual maintenance fee, which is typically priced between 17% and 21% of the license price.

Technology

Some of the key technological components of our products are summarized below:

Robust and flexible technology for managing processes across multiple sites. Our products contain workflow technology that facilitates the management and monitoring of software development activity and improves the efficiency of the development process. A project to create a new software application may involve hundreds of developers working around the world on tens of thousands of software components, or pieces of code. Several developers may need to develop one component at the same time, or one developer may need to make a change to a single component that also requires changes to many other components. In these situations it is critical to coordinate and control all changes made by developers to the software applications.

With our workflow technology:

- workflows can be tailored to fit customers specific business processes, whereas competing products often impose a one-size-fits-all process on all customers;
- developers are authenticated before they can make changes to components, and a detailed audit trail is maintained, which is useful for regulatory compliance;
- managers can assign tasks to developers and track their progress; and
- managers and developers can communicate and coordinate with one another using our products.

Technologies for managing and manipulating software components. Our technology also streamlines the software development process by indexing and tracking software components across multiple servers. Specifically, our technology can:

- lock access to a file to prevent two developers from making competing changes to the same file;
- compare two versions of the same file and detect differences, using a comparison engine;

process changes made to a single file by different developers, using a merge engine, which enables parallel development teams to apply changes concurrently; and

allow developers to determine which changes have led to errors, using a fingerprinting technology that gives each file a unique token or fingerprint that changes if any bit is altered, which facilitates problem detection and resolution.

Research and Development

We plan to continue making substantial investments in research and development to maintain our leadership position. We believe that our success will continue to depend on our ability to enhance our current products and to develop new products and services that meet the needs of our customers and the market. Our commitment to research and development is reflected in our investments in this area, which were $33.9 million, $32.7 million and $31.6 million for fiscal years 2009, 2010 and 2011, respectively, representing 13%, 15% and 15% of our total revenue in those years.

We are committed to delivering products and services that consistently provide value to our customers. As part of our strategy for delivering on this commitment, we use our own products internally to automate much of our research and development operations. Our research and development staff also works very closely with our product marketing and support staff to ensure that everything we develop is mapped closely to customer and market requirements.

In the United States, research and development is primarily performed at our facilities in Redwood City, California; Hillsboro, Oregon; Colorado Springs, Colorado; and Woodland Hills, California. We also perform product development internationally in the United Kingdom, India and Ukraine.

Sales and Marketing

We market our software primarily through our direct sales organization in the United States, Canada, Brazil, France, Germany, Italy, the United Kingdom, Spain, the Benelux and Nordic regions, Australia, India, Japan and Korea.

In addition to our direct sales efforts, we have established relationships with distributors, resellers and original equipment manufacturers, or OEMs, located in North America, Latin America, Belgium, Italy, Spain, Hong Kong, Israel, Japan, Korea and South Africa. These distributors, resellers and OEMs market and sell our software as well as provide technical support, educational and consulting services.

We market our products through seminars, industry conferences, trade shows, advertising, direct marketing efforts, and third-party and our own Internet sites. In addition, we have developed programs that promote an active exchange of information between our existing customers and us. These programs include customer meetings with our senior management and focus group meetings with customers to evaluate product positioning.

Because our software license revenue in any quarter depends on orders booked and shipped in the last month, weeks or days of that quarter, at the end of each quarter, we typically have either minimal or no backlog of orders for the subsequent quarter.

Competition

The market for our products and services is highly competitive and diverse. New products are frequently introduced and existing products are continually enhanced. Competitors vary in size and in the scope and breadth of the products and services that they offer. We are focused on enhancing the features of our products and developing additional product integrations to allow our products to better operate with each other as well as with products offered by other software vendors and open source software for purposes of differentiating ourselves from the competition. We are also focused on improving our sales and marketing efforts. We believe that the principal competitive factors necessary to be successful in our industry include product functionality, interoperability and reliability, the breadth of product offerings and solutions, effective sales and marketing efforts, reputation, financial stability and customer support.

Competition. We currently face competition from a number of sources, including:

customers internal IT departments;

- providers of products that compete directly with the Serena *ChangeMan ZMF* and *Comparex* products, such as CA, Inc., IBM and smaller privately-held companies;
- providers of application development programmer productivity and system management products, such as Compuware, IBM and smaller privately-held companies;
- providers of mainframe application availability products that compete directly with Serena *Comparex* and the Serena *StarTool* product family, such as Compuware, IBM, CA, Inc. and smaller privately-held companies;
- providers of BPM solutions that compete directly with *SBM*, such as IBM, Microsoft, Pegasystems, Global360 and smaller privately-held companies; and
- providers of on-premise and software-as-a-service, or SaaS, based ITSM solutions that compete directly with *Serena Service Manager*, such as BMC, ServiceNow and smaller privately-held companies.

Competition in the Software Change and Configuration Management (SCCM) Distributed Systems Market. We face significant competition as we develop, market and sell our distributed systems products, including Serena *PVCS Professional, PVCS Version Manager* and *Dimensions CM* products. Competitors in the distributed systems market include IBM, CA, Inc., Microsoft and other smaller companies. An increasing portion of the market also uses open source or freeware tools to address their basic needs for issue/defect tracking and source code control, such as *Jira* and *Subversion*.

Future Competition. We may face competition in the future from established companies who have not previously entered the SCCM, BPM and ITSM markets and from emerging software and SaaS-based companies. Barriers to entry in the distributed systems software market are relatively low.

Intellectual Property

Our continued success depends upon proprietary technology. We rely primarily on a combination of patent, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our proprietary rights. Such laws, procedures and contracts provide only limited protection. The duration of our trademark registrations vary from country to country. In the United States, we generally are able to maintain our trademark rights and renew trademark registrations for as long as the trademarks are in use. The duration of our patents issued in the United States is typically 17 years from the date of issuance of the patent or 20 years from the date of filing of the patent application. While we believe that our ability to maintain and protect our intellectual property rights is important to our success, we also believe that our business as a whole is not materially dependent on any particular patent, trademark, license or other intellectual property right of our company.

Seasonality

We have experienced and expect to continue to experience seasonality in sales of our software products. These seasonal trends materially affect our operating results. Revenue and operating results in our quarter ended January 31 are typically higher relative to other quarters because many customers make purchase decisions based on their calendar year-end budgeting requirements. In addition, our January quarter tends to reflect the effect of the incentive compensation structure for our sales organization, which is based on satisfaction of fiscal year-end quotas. As a result, we have historically experienced a substantial decline in revenue in the first quarter of each fiscal year relative to the preceding quarter.

Employees

As of January 31, 2011, we had 579 full-time employees, 144 of whom were engaged in research and development, 197 in sales and marketing, 148 in consulting, education and customer and document support, and

90 in finance, administration and operations. Our future performance depends in significant part upon the continued service of our key technical, sales and senior management personnel. The loss of the services of one or more of our key employees could materially adversely affect our business, operating results and financial condition. Our future success also depends on our continuing ability to attract, train and retain highly qualified technical, sales and managerial personnel. Competition for such personnel is intense, and we may not be able to retain our key personnel in the future. None of our employees is represented by a labor union. We have not experienced any work stoppages and consider our relations with our employees to be good.

Financial Information

See Note 1(p) of notes to our consolidated financial statements for information regarding segment reporting and financial information about geographic areas.

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ITEM 1A. RISK FACTORS

Risks Related to Our Indebtedness

Our substantial leverage could adversely affect our ability to raise additional capital to fund our operations, limit our ability to react to changes in the economy or our industry, expose us to interest rate risk to the extent of our variable rate debt and prevent us from meeting our obligations under the senior subordinated notes.

As of January 31, 2011, our total indebtedness was $485.3 million. We are highly leveraged and our debt service costs are significant. Following the amendment of our senior secured credit agreement in March 2011, we have a $75.0 million committed source of credit available to us under the revolving credit facility of our senior secured credit agreement, of which $40.0 million is unused and available to us as of January 31, 2011.

Our high degree of leverage could have important consequences, including:

- making it more difficult for us to make payments on the senior subordinated notes;
- increasing our vulnerability to general economic and industry conditions;
- requiring a substantial portion of cash flows from operating activities to be dedicated to the payment of principal and interest on our indebtedness, therefore reducing our ability to use our cash flow to fund operations, capital expenditures and future business opportunities;
- exposing us to the risk of increased interest rates as certain of our borrowings, including borrowings under our senior secured credit agreement, are at variable rates of interest;
- restricting us from making strategic acquisitions or causing us to make non-strategic divestitures;
- limiting our ability to obtain additional financing for working capital, capital expenditures, product development, debt service requirements, acquisitions and general corporate or other purposes; and
- limiting our ability to adjust to changing market conditions and placing us at a competitive disadvantage compared to our competitors who are less highly leveraged.

We and our subsidiaries may be able to incur substantial additional indebtedness in the future, subject to the restrictions contained in our senior secured credit agreement and the indenture governing the senior subordinated notes. If new indebtedness is added to our current debt levels, the related risks that we now face could intensify.

Our senior secured credit agreement contains specified financial ratios and other financial condition tests that we must satisfy in order to avoid an event of default under our debt agreements.

Under our senior secured credit agreement, we are required to satisfy and maintain specified financial ratios and to satisfy other financial condition tests. Our ability to meet those financial ratios and tests is dependent upon our financial performance, which can be affected by events beyond our control. We have experienced declines in license and maintenance revenue in the recent past, which have been offset in part by decreases in costs. If our license or maintenance revenue continues to decline, and we are unable to grow our maintenance revenue or reduce our operating expenses, we may be unable to satisfy these ratios and tests. This would force us to seek a waiver or amendment with the lenders under our senior secured credit agreement, and no assurance can be given that we will be able to obtain any necessary waivers or amendments on satisfactory terms, if at all. The lenders would likely condition any waiver or amendment, if given, on additional consideration from us, such as a consent fee, a higher interest rate, principal repayment or more restrictive covenants and limitations on our business.

A breach of any of these covenants, if not waived by the lenders, would result in a default under our senior secured credit agreement. Upon the occurrence of an event of default under our senior secured credit agreement,

all amounts outstanding under our senior secured credit agreement could be declared to be (or could automatically become) immediately due and payable and all commitments to extend further credit could be terminated. In addition, a default under our senior secured credit agreement would result in a default under the indenture governing our senior subordinated notes, and all amounts outstanding under these notes could be declared immediately due and payable. If we were unable to repay those amounts, the lenders under our senior secured credit agreement could proceed against the collateral granted to them to secure that indebtedness. We have pledged a significant portion of our assets as collateral under our senior secured credit agreement. If the repayment of borrowings under our senior secured credit agreement is accelerated, we cannot assure you that we will have sufficient assets to repay our indebtedness under our senior secured credit agreement, as well as our unsecured indebtedness, including the senior subordinated notes.

We may not be able to generate sufficient cash to service all of our indebtedness and may be forced to take other actions to satisfy our obligations under our indebtedness, which may not be successful.

Our ability to make scheduled payments on or to refinance our debt obligations depends on our financial condition and operating performance, which are subject to prevailing economic and competitive conditions and to certain financial, business and other factors beyond our control. We cannot assure you that we will maintain a level of cash flows from operating activities sufficient to permit us to pay the principal, premium, if any, and interest on our indebtedness.

If our cash flows and capital resources are insufficient to fund our debt service obligations, we may be forced to reduce or delay investments and capital expenditures, or to sell assets, seek additional capital or restructure or refinance our indebtedness. These alternative measures may not be successful and may not permit us to meet our scheduled debt service obligations. In the absence of such operating results and resources, we could face substantial liquidity problems and might be required to dispose of material assets or operations to meet our debt service and other obligations. Our senior secured credit agreement and the indenture governing our senior subordinated notes restrict our ability to dispose of assets and use the proceeds from the disposition. We may not be able to consummate those dispositions or to obtain the proceeds that we could realize from them, and these proceeds may not be adequate to meet any debt service obligations then due.

Our debt agreements contain restrictions that limit our flexibility in operating our business.

Our senior secured credit agreement and the indenture governing our senior subordinated notes contain various covenants that limit our ability to engage in specified types of transactions. These covenants limit our and our restricted subsidiaries ability to, among other things:

- incur additional indebtedness or issue certain preferred shares;
- pay dividends on, redeem or repurchase our capital stock or make other restricted payments;
- make investments;
- make capital expenditures;
- create certain liens;
- sell certain assets;
- enter into agreements that restrict the ability of our subsidiaries to make dividend or other payments to us;

guarantee indebtedness;

engage in transactions with affiliates;

prepay, repurchase or redeem the senior subordinated notes;

create or designate unrestricted subsidiaries; and

consolidate, merge or transfer all or substantially all of our assets and the assets of our subsidiaries on a consolidated basis.

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Risks Related to Our Business

The prolonged decline and uncertainty in global economic conditions has negatively affected, and could continue to negatively affect, our business, results of operations and financial condition.

Economic conditions, both domestically and abroad, directly affect our operating results. Current and future economic conditions, including such factors as consumer demand, unemployment and inflation levels, the availability of credit, and our customers financial condition, operating results and growth prospects may adversely affect our business and the results of our operations. The prolonged weakening and uncertainty in global economic conditions present a variety of risks and uncertainties that could negatively affect our business, results of operations and financial condition, including the following:

- the demand for our products and services, and IT spending generally, may decline as businesses postpone, reduce or cancel IT and other spending in response to tighter credit, negative financial news, declines in income or asset values or economic uncertainty;
- our customers, distributors and resellers may choose to defer payments or fail to pay amounts owed to us, even though they may have no contractual right to do so;
- the prolonged uncertainty has and may continue to, increase the pricing pressure on our maintenance contract renewal business and could negatively affect our maintenance revenue in the future;
- adverse economic conditions may promote consolidation in our customers industries as has occurred in the financial services industry in which many of our customers operate. Customer consolidation may lead to such adverse effects as reduced demand for our products and services by particular customers and within their industry more generally, greater pricing pressure and pressure to renegotiate existing contracts, replacement of our products in our installed base with competing products, and cancellations and reductions of previously planned customer purchases;
- we may experience increased pricing competition for our products and services;
- significant currency fluctuations could negatively affect our revenues, specifically those derived internationally; and
- the severity or length of time these economic and financial market conditions may persist is unknown.

In addition, although we do not anticipate needing additional capital in the near term due to our current financial position, financial market disruption may make it difficult for us to raise additional capital upon acceptable terms or at all. As of January 31, 2011, we had a $30.0 million committed source of credit available to us under the revolving credit facility of our senior secured credit agreement. As of March 2, 2011, the committed source of credit available to us under the revolving credit facility increased to $40.0 million under the amended and restated credit agreement.

If adverse global economic conditions persist, the foregoing risks could result in our failure to meet the financial covenants under our senior secured credit agreement. A breach of any of these financial covenants would result in a default under our senior secured credit agreement, in which event all outstanding amounts could be declared immediately due and payable. Any such acceleration would also result in a default under the indenture governing our senior subordinated notes. If repayment under our senior secured credit agreement is accelerated, we cannot assure you that we would have sufficient assets or access to credit to repay our indebtedness or, if credit were available, that it would be upon acceptable terms.

If management is unable to effectively forecast revenues and budget operating expenses, our business could be harmed.

Management personnel regularly identify, track and forecast future revenue and trends in our business. Our sales personnel monitor the status of all qualified opportunities and proposals, such as the estimated date when a transaction will close and the potential dollar amount of the transaction. We aggregate these estimates in order to generate a sales pipeline and then evaluate the pipeline at various times to look for trends in our business. While

this pipeline analysis provides visibility to our potential customers and the associated revenue for budgeting and planning purposes, these pipeline estimates may not correlate to revenue in a particular quarter or ever. A slowdown in the economy, domestically and internationally, has caused in the past and may cause in the future customer purchasing decisions to be delayed, reduced in amount or cancelled, all of which have reduced and could reduce the rate of conversion of the pipeline into contracts. A variation in the pipeline or in the conversion of the pipeline into contracts could cause us to plan or budget improperly and thereby could adversely affect our business, operating results and financial condition. In addition, primarily due to a substantial portion of our software licenses revenue contracts closing in the latter part of a quarter, management may not be able to adjust our cost structure in response to a variation in the conversion of the pipeline into contracts in a timely manner, and thereby adversely affect our business, operating results and financial condition.

Our future revenue is substantially dependent upon our installed customer base renewing maintenance agreements for our products and licensing or upgrading additional Serena products; our future professional service and maintenance revenue is dependent on future sales of our software products and could decline.

We depend on our installed customer base for future revenue from maintenance renewal fees and licenses or upgrades of additional products. Our maintenance revenue has declined in each of the past two years. If our customers do not purchase additional products, do not upgrade existing products or cancel or fail to renew their maintenance agreements, this could materially adversely affect our business, operating results and financial condition. The terms of our standard license arrangements provide for a one-time license fee and a prepayment of one year of software maintenance and support fees. The maintenance agreements are renewable annually at the option of the customer, and there are no minimum payment obligations or obligations to license additional software. In addition, prolonged economic uncertainty has increased the pressure our customers are placing on our maintenance renewal business. Therefore, our current customers may not necessarily generate significant maintenance revenue in future periods. In addition, our customers may not necessarily purchase additional products, upgrades or professional services. Our professional service and maintenance revenue are also dependent upon the continued use of these services by our installed customer base. Any downturn in our software license sales would have a negative impact on the growth of our professional service revenue and maintenance revenue in future periods.

If our target markets do not evolve as we anticipate, our business will be adversely affected.

If we fail to properly assess and address our target markets or if our products and services fail to achieve market acceptance for any reason, our business, operating results and financial condition would be materially adversely affected. With regard to the SCCM market, IT organizations have historically addressed their SCCM requirements with solutions developed internally. As SCCM requirements have become more complex, IT organizations have begun to migrate to more sophisticated third-party SCCM products. Our future financial performance will depend in large part on the continued growth in the number of businesses adopting third-party SCCM products and the expansion of their use on a company-wide basis. In addition, we only recently began to offer products in the BPM and ITSM markets and have significantly less experience with these markets than the SCCM market. Since the markets for our products are still evolving, it is difficult to assess the competitive environment or the size of the market that may develop. Moreover, these markets may grow more slowly than we anticipate. In addition, technologies, customer requirements and industry standards may change rapidly. If we cannot improve or augment our products as rapidly as existing technologies, customer requirements and industry standards evolve, our products or services could become obsolete. The introduction of new or technologically superior products by competitors could also make our products less competitive or obsolete. As a result of any of these factors, our position in existing markets or potential markets could be eroded.

We have experienced significant turnover in our executive officers and other key management personnel, and if our new executive officers and key management personnel are unable to successfully manage our business, our business and financial results may be adversely affected.

Our success will depend on the ability of recently-hired executive officers and other key management personnel to successfully manage our business. Within the past eighteen months, we have employed a new President and Chief Executive Officer, a new Senior Vice President, Worldwide Marketing, a new Senior Vice President, SBM Business Unit, a new Vice President, North Americas Sales, a new Vice President, North America Professional Services and other sales and technical management personnel. If we are unable to successfully integrate and transition one or more of our executive officers or other key management personnel into our business, if one or more of our new executive officers are unable to successfully perform in their positions, establish and implement our business strategy or manage our business, or if one or more other key management personnel are unable to successfully perform in their positions or manage their functional areas, our business and operating results may be materially and adversely affected.

If the market for IBM and IBM-compatible mainframes decreases, it could adversely affect our business.

Our mainframe revenue is dependent upon the continued use and acceptance of IBM Corporation, or IBM, and IBM-compatible mainframes and the growth of this market. If the role of the mainframe does not increase as we anticipate, or if it in any way decreases, this may materially adversely affect our business, operating results and financial condition. Additionally, if there is a wide acceptance of other platforms or if new platforms emerge that provide enhanced enterprise server capabilities, our business, operating results and financial condition may be materially adversely affected. We expect that, for the foreseeable future, a significant portion of our software license revenue will continue to come from the sales of our mainframe products. As a result, future sales of our existing products and associated maintenance revenue and professional service revenue will depend on continued use of mainframes.

If we fail to effectively manage our sales and marketing organizations, it could adversely affect our business.

The loss of key sales or marketing employees could result in disruptions to our business and materially adversely affect our license revenue, operating results and financial condition. If we are required to hire new sales and marketing employees in the future, a substantial amount of time and training is generally required before these personnel become productive. The hiring, training and integration of additional and replacement personnel is time consuming, is expected to increase our operating expenses and may cause disruptions to our business, potentially materially adversely affecting our revenue, operating results and financial condition. If we fail to manage our sales and marketing organizations effectively, these organizations may fail to perform as we anticipate, which could materially adversely affect our license revenue and weaken our competitive position.

Any delays in our normally lengthy sales cycles could result in significant fluctuations in our operating results.

Our sales cycle typically takes three to eighteen months to complete and varies from product to product. Any delay in the sales cycle of a large license or a number of smaller licenses could result in significant fluctuations in our operating results. The length of the sales cycle may vary depending on a number of factors over which we may have little or no control, including the size and complexity of a potential transaction and the level of competition that we encounter in our selling activities. We have experienced an overall lengthening of sales cycles in the current economic environment as customers have more rigorously scrutinized potential IT purchases. Additionally, the emerging market for our products and services contributes to the lengthy sales process in that during the sales cycle we often have to educate potential customers on the use and the benefits of our products. In certain circumstances, we license our software to customers on a trial basis to assist customers in their evaluation of our products. Our sales cycle can also be further extended for product sales made through third party distributors.

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Our license revenue from products for distributed systems may fluctuate.

Our license revenue from our distributed systems products was 58% of total license revenue in both the fiscal years ended January 31, 2011 and 2010. License revenue from our distributed products may fluctuate materially and has recently declined. If we fail to successfully develop, market, sell and support our distributed systems products, our business, operating results and financial condition could be materially adversely affected. Additionally, our distributed system products may be adversely impacted by pricing pressures resulting from the current continuing adverse economic environment and increased competition.

Our industry changes rapidly due to evolving technology standards, and our future success will depend on our ability to continue to meet the sophisticated needs of our customers.

Our future success will depend on our ability to address the increasingly sophisticated needs of our customers by supporting existing and emerging hardware, software, database and networking platforms particularly for our distributed systems products. We must develop and introduce enhancements to our existing products and new products on a timely basis to keep pace with technological developments, evolving industry standards and changing customer requirements. We expect that we will have to respond quickly to rapid technological change, changing customer needs, frequent new product introductions and evolving industry standards that may render existing products and services obsolete. As a result, our position in existing markets or potential markets could be eroded rapidly by product advances. Our growth and future financial performance will depend in part upon our ability to enhance existing applications, develop and introduce new applications that keep pace with technological advances, meet changing customer requirements and respond to competitive products. We expect that our product development efforts will continue to require substantial investments, and we may not have sufficient resources to make the necessary investments. If we are unable to successfully and timely develop our products due to development constraints, such as high employee turnover, lack of management ability or lack of development resources, our products may fail to address these evolving customer requirements and become less competitive in our target markets. Any of these events could have a material adverse effect on our business, operating results and financial condition.

We are subject to intense competition in our target markets, and we expect to face increased competition in the future.

We may not be able to compete successfully against current or future competitors, and such inability would materially adversely affect our business, operating results and financial condition. The market for our products is highly competitive and diverse. Moreover, the technology for products in our target markets may change rapidly. New products are frequently introduced, and existing products are continually enhanced. Competition may also result in changes in pricing policies by us or our competitors, potentially materially adversely affecting our business, operating results and financial condition. Competitors vary in size and in the scope and breadth of the products and services that they offer. Many of our current and potential competitors have greater financial, technical, marketing and other resources than we do. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements. They may also be able to devote greater resources to the development, promotion and sale of their products than we can.

Competition in the Software Change and Configuration Management (SCCM) Distributed Systems Market. We face significant competition as we develop, market and sell our distributed systems products, including *PVCS Professional, PVCS Version Manager* and *Dimensions CM* products. Competitors in the distributed systems market include IBM, CA, Inc., Microsoft, and other smaller companies. A growing portion of the market is also using free open source tools to address their basic needs for issue/defect tracking and source code control, such as *Jira* and *Subversion*, resulting in an increased source of competition for our distributed system products, particularly *PVCS Professional, PVCS Version Manage, SBM* and, to a lesser extent, *Dimensions CM* .

Competition in the Mainframe market. We currently face competition from a number of sources, including:

customers   internal IT departments;

- providers of products that compete directly with *ChangeMan ZMF* and *Comparex*, such as CA, Inc., IBM and smaller privately-held companies;

- providers of application development programmer productivity and system management products, such as Compuware, IBM and smaller privately-held companies; and

- providers of mainframe application availability products that compete directly with Serena *Comparex* and the Serena *StarTool* product family, such as Compuware, IBM, CA, Inc. and smaller privately-held companies.

Competition in Other Markets. We currently face competition from a number of sources, including:

- providers of BPM solutions that compete directly with *SBM*, such as IBM, Microsoft, PegaSystems, Global360 and smaller privately-held companies; and

- providers of on-premise and SaaS-based ITSM solutions that compete with *Serena Service Manager*, such as BMC, ServiceNow and smaller privately-held companies.

Future Competition. We may face competition in the future from established companies who have not previously entered the mainframe or distributed systems market or from emerging software companies. Increased competition may materially adversely affect our business, operating results and financial condition due to price reductions, reduced gross margins and reduction in market share. Established companies may not only develop their own mainframe or distributed systems solutions, but they may also acquire or establish cooperative relationships with our competitors, including cooperative relationships between large, established companies and smaller privately-held companies. Because larger companies have significant financial and organizational resources available, they may be able to quickly penetrate the mainframe or distributed systems market through acquisitions or strategic relationships and may be able to leverage the technology and expertise of smaller companies and develop successful SCCM products. We expect that the software industry in general, and providers of SCCM solutions in particular, will continue to consolidate. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

Bundling or Compatibility Risks. Our ability to sell our products also depends, in part, on the compatibility of our products with other third party products, particularly those provided by IBM. Developers of these third party products may change their products so that they will no longer be compatible with our products. These third party developers may also decide to bundle their products with other SCCM products for promotional purposes. If that were to happen, our business, operating results and financial condition may be materially adversely affected as we may be priced out of the market or no longer be able to offer commercially viable products.

We may encounter problems conducting our international operations, and factors associated with international operations could adversely affect our business.

International Operations. We have sales subsidiaries in the United Kingdom, Germany, Sweden, France, Belgium, Spain, the Netherlands, Australia, Japan and Singapore. We have limited experience in marketing, selling and supporting our products in many countries, and may not be able to successfully market, sell, deliver and support our products internationally.

Risks of International Operations. International sales were 33%, 32% and 34% of our total revenue in the fiscal years ended January 31, 2011, 2010 and 2009, respectively. Our international revenue is attributable principally to our European operations. Our international operations are subject to a variety of risks associated with conducting business internationally that could materially adversely affect our business, operating results and financial condition, including the following:

- difficulties in staffing and managing international operations;

problems in collecting accounts receivable;

- longer payment cycles;
- fluctuations in currency exchange rates;
- inability to control or predict the levels of revenue produced by our international distributors;
- seasonal reductions in business activity during the summer months in Europe and certain other parts of the world;
- limitations on repatriation of earnings;
- difficulties in enforcing the terms of our agreements with customers, distributors and resellers;
- reduced protection of intellectual property rights in some countries;
- political and economic instability;
- recessionary environments in foreign economies; and
- increases in tariffs, duties, price controls or other restrictions on foreign currencies or trade barriers imposed by foreign countries.

Growing market acceptance of open source software could cause a decline in our revenue and operating margins.

Growing market acceptance of open source software has presented both benefits and challenges to the commercial software industry in recent years. Open Source software is made widely available by its authors and is licensed as is for a nominal fee or, in some cases, at no charge. As the use of open source software becomes more widespread, certain open source technology, such as *Subversion*, have become competitive with our products offering software version control capabilities, such as *PVCS Version Manager* and, to a lesser extent, *Dimensions CM*, which has caused the sale of these products to decline. In addition, *Jira*, an open source bug tracking tool, has become competitive with the use of *SBM* as an issue and defect tracking tool. Further adoption of open source software within the markets that we sell could cause further declines in the sale of our products or force us to reduce the fees we charge for our products, which could have a material adverse impact on our revenue and operating margins.

We may experience delays in developing our products which could adversely affect our business.

If we are unable, for technological or other reasons, to develop and introduce new and improved products and services in a timely manner, this could materially adversely affect our business, operating results and financial condition. We have experienced product development delays in new version and update releases in the past and may experience similar or more significant product delays in the future. Difficulties in product development could delay or prevent the successful introduction or marketing of new or improved products or the delivery of new versions of our products to our customers. Any delay in releasing our new distributed systems products, for whatever reason, could have a material adverse effect on our business, operating results and financial condition.

Acquisitions may be difficult to integrate, disrupt our business or divert the attention of our management.

Historically, we have expanded our product offerings by acquiring other companies and by acquiring specific products from third parties. We may acquire or make investments in other companies and technologies. In the event of any acquisitions or investments, we could:

incur debt;

assume liabilities;

incur charges for the impairment of the value of investments or acquired assets; or

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incur amortization expense related to intangible assets.

If we fail to achieve the financial and strategic benefits of past and future acquisitions or investments, our operating results will suffer. Acquisitions and investments involve numerous other risks, including:

- difficulties integrating the acquired operations, technologies or products with ours;
- failure to achieve targeted synergies;
- unanticipated costs and liabilities;
- diversion of management s attention from our core business;
- adverse effects on our existing business relationships with suppliers and customers or those of the acquired organization;
- difficulties entering markets in which we have no or limited prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

Fluctuations in the value of foreign currencies could result in currency transaction losses.

A majority of our international business is conducted in foreign currencies, principally the British pound and the euro. Fluctuations in the value of foreign currencies relative to the U.S. dollar will continue to cause currency transaction gains and losses. We cannot predict the effect of exchange rate fluctuations upon future operating results. We may experience currency losses in the future. To date, we have not adopted a hedging program to protect us from risks associated with foreign currency fluctuations.

Our goodwill became impaired in fiscal year 2009 and certain amortizable intangible assets became impaired in fiscal year 2010. If our goodwill or amortizable intangible assets again becomes impaired in the future, we may be required to record a significant charge to earnings.

Under generally accepted accounting principles, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include a decline in expected future cash flows and slower growth rates in our industry. We impaired $6.8 million of capitalized software development costs in fiscal year 2010 and recorded a goodwill impairment charge of $326.7 million in fiscal year 2009, and may be required to record significant charges in any future period for which impairment of our goodwill or amortizable intangible assets is determined.

Third parties in the future could assert that our products infringe their intellectual property rights, possibly adversely affecting our business.

Third parties may claim that our current or future products and services infringe their proprietary rights. Any claims of this type could affect our relationships with existing customers and may prevent future customers from licensing our products or using our services. Because we are dependent upon a limited number of products and services, any such claims, with or without merit, could be time consuming to defend, result in costly litigation, cause product shipment or service deployment delays or require us to enter into royalty or licensing agreements. Royalty or license agreements may not be available on acceptable terms or at all. We expect that software product developers will increasingly be subject to infringement claims as the number of products, services and competition in the software industry segments increase and the functionality of products and services in different industry segments overlap. As a result of these factors, infringement claims could materially adversely affect our business and operating results.

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Errors in our products or the failure of our products to conform to specifications could result in our customers demanding refunds from us or asserting claims for damages against us.

Because our software products and services are complex, they often contain errors or bugs that can be detected at any point in a product s life cycle. While we continually test our products for errors and work with customers through our customer support services to identify and correct bugs in our software, we expect that errors in our products and services will continue to be found in the future. Although many of these errors may prove to be immaterial, certain of these errors could be significant. Detection of any significant errors may result in, among other things, loss of, or delay in, market acceptance and sales of our products and services, diversion of development resources, injury to our reputation, or increased service and warranty costs. These problems could materially adversely affect our business, operating results and financial condition. In the past we have discovered errors in certain of our products and have experienced delays in the shipment of our products during the period required to correct these errors. These delays have principally related to new version and product update releases. To date, none of these delays have materially affected our business. However, product and services errors or delays in the future, including any product and services errors or delays associated with the introduction of our distributed systems products and solutions, could be material. In addition, in certain cases we have warranted that our products will operate in accordance with specified customer requirements. If our products or services fail to conform to such specifications, customers could demand a refund for the software license fees or service fees paid to us or assert claims for damages.

Product liability claims asserted against us in the future could adversely affect our business.

We may be subject to claims for damages related to product errors in the future. A material product liability claim could materially adversely affect our business. Our license agreements with our customers typically contain provisions designed to limit exposure to potential product liability claims. Our standard software licenses provide that if our products fail to perform, we will correct or replace such products. If these corrective measures fail, we may be required to refund the license fee for the non-performing products. Our standard license agreement limits our liability for non-performing products to the amount of license fee paid. Our standard license also provides that we will not be liable for indirect or consequential damages caused by the failure of our products. Such limitation of liability provisions may, however, not be effective under the laws of certain jurisdictions to the extent local laws treat certain warranty exclusions as unenforceable. Although we have not experienced any product liability claims to date, the sale and support of our products entail the risk of such claims.

Changes in accounting regulations and related interpretations and policies regarding revenue recognition could cause us to defer recognition of revenue or recognize lower revenue and profits.

Although we use standardized license agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-product or multi-year transactions. As our transactions increase in complexity with the sale of larger, multi-product, multi-year licenses, negotiation of mutually acceptable terms and conditions can extend the sales cycle and, in certain situations, may require us to defer recognition of revenue on such licenses. We believe that we are in compliance with FASB ASC Topic 985-605, Revenue Recognition ; however, these future, more complex, multi-product, multi-year license transactions may require additional accounting analysis to account for them accurately, could lead to unanticipated changes in our current revenue accounting practices and may contain terms affecting the timing of revenue recognition.

If we do not adequately manage and evolve our financial reporting and managerial systems and processes, our ability to manage and grow our business may be harmed.

Our ability to successfully implement our business plan and comply with regulations, including the Sarbanes-Oxley Act, requires an effective planning and management process. We expect that we will need to continue to improve existing, and implement new, operational and financial systems, procedures and controls to

manage our business effectively in the future. Any delay in the implementation of, or disruption in the transition to, new or enhanced systems, procedures and controls, could harm our ability to accurately forecast sales demand, manage our supply chain and record and report financial and management information on a timely and accurate basis.

Our executive officers and certain key personnel are critical to our business, and such officers and key personnel may not remain with us in the future.

Our success will depend to a significant extent on the continued service of our senior executives and certain other key employees, including certain sales, consulting, technical and marketing personnel. If we lost the services of one or more of our executives or key employees, including if one or more of our executives or key employees decided to join a competitor or otherwise compete directly or indirectly with us, this could materially adversely affect our business. We have recently experienced an increase in the attrition of our employees due to competition for employees within our markets, and if we fail to increase our revenues and profitability, this attrition may continue or increase in the future, which could materially adversely affect our business. Other than our Chief Financial Officer, none of our executive officers is party to an employment agreement with us. In addition, we do not maintain key man life insurance on our employees and have no plans to do so.

The interests of our controlling stockholder may differ from the interests of the holders of our securities.

Silver Lake and its affiliates own, in the aggregate, approximately 68.2% of our outstanding common stock as of January 31, 2011 and beneficially own the only authorized share of our series A preferred stock. In addition, Silver Lake and its affiliates, by virtue of their ownership of our common stock and their voting rights under a stockholders agreement, control the vote, in connection with substantially all matters subject to stockholder approval, of more than 99% of our outstanding common stock. As a result of this ownership and the terms of a stockholders agreement, Silver Lake is entitled to elect directors with majority voting power in our Board of Directors, to appoint new management and to approve actions requiring the approval of the holders of our outstanding voting shares as a single class, including adopting most amendments to our certificate of incorporation and approving mergers or sales of all or substantially all of our assets.

The interests of Silver Lake and its affiliates may differ from other holders of our securities in material respects. For example, if we encounter financial difficulties or are unable to pay our debts as they mature, the interests of Silver Lake and its affiliates, as equity holders, might conflict with the interests of our other holders of our securities. Silver Lake and its affiliates may also have an interest in pursuing acquisitions, divestitures, financings or other transactions that, in its judgment, could enhance its equity investments, even though such transactions might involve risks to other holders of our securities, including the incurrence of additional indebtedness. Additionally, the indenture governing our senior subordinated notes permits us to pay advisory fees, dividends or make other restricted payments under certain circumstances, and Silver Lake may have an interest in our doing so. We are party to a management advisory agreement with Silver Lake that provides for us to pay advisory and other fees to Silver Lake.

Silver Lake and its affiliates are in the business of making investments in companies and may, from time to time in the future, acquire interests in businesses that directly or indirectly compete with certain portions of our business or are suppliers or customers of ours. You should consider that the interests of Silver Lake and its affiliates may differ from other holders of our securities in material respects.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

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ITEM 2. PROPERTIES

Our principal administrative, sales, marketing, consulting, education, customer support and research and development facilities are located at our headquarters in Redwood City, California and in Hillsboro, Oregon. We currently occupy an aggregate of approximately 30,000 square feet of office space in the Redwood City facility, 33,000 square feet of office space in the Hillsboro facility, 13,000 square feet of office space in the St. Albans facility in the United Kingdom, 7,000 square feet of office space in the Woodland Hills facility, 6,900 square feet of office space in the Kiev facility in Ukraine, 5,500 square feet of office space in the Paris facility in France and 4,000 square feet of office space in the Colorado Springs facility, under leases with terms running through July 2012, November 2018, March 2021, May 2012, April 2013, March 2014 and April 2014, respectively, and 6,000 square feet of office space in the Ismaning facility in Germany under an ongoing month-to-month lease. Management believes its current facilities will be adequate to meet our needs for at least the next twelve months. We believe that suitable additional facilities will be available in the future as needed on commercially reasonable terms.

We also lease office space for sales and marketing in various locations throughout North America and in Brazil, Belgium, Spain, Germany, Italy, Sweden, Australia, Korea, Japan, Singapore and India.

ITEM 3. LEGAL PROCEEDINGS

In the ordinary course of our business, we are subject to periodic legal proceedings and claims. Although we cannot predict with certainty the ultimate outcome of these matters, we do not believe that any currently pending legal proceeding to which we are a party is likely to have a material adverse effect on our business, results of operations, cash flows or financial condition.

ITEM 4. (REMOVED AND RESERVED)

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our outstanding common stock is privately held, and there is no established public trading market for our common stock. As of the date of this filing, there were 19 holders of record of our common stock.

See Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources for a description of restrictions on our ability to pay dividends.

See Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters Equity Compensation Plan Information.

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ITEM 6. SELECTED FINANCIAL DATA

The selected historical data presented below are derived from the consolidated financial statements of Serena Software, Inc. The selected consolidated financial data set forth below is qualified in its entirety by, and should be read in conjunction with, Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements of Serena and notes thereto included elsewhere in this report.

	Aggregate (1)	Successor			
	Fiscal Year Ended January 31,				
	2007	2008	2009 (in thousands)	2010	2011
Consolidated Statement of Operations Data (1):					
Revenue:					
Software licenses	$ 86,520	$ 78,405	$ 64,578	$ 49,397	$ 51,382
Maintenance	134,605	155,465	161,626	152,464	143,974
Professional services	34,166	36,325	34,033	22,153	19,030
Total revenue	255,291	270,195	260,237	224,014	214,386
Cost of revenue:					
Software licenses	2,735	1,861	1,935	3,253	1,380
Maintenance	13,662	15,551	15,626	12,585	11,545
Professional services	31,758	33,083	31,824	21,164	18,151
Amortization of acquired technology and impairment of intangibles	37,853	35,217	35,370	41,415	33,695
Total cost of revenue	86,008	85,712	84,755	78,417	64,771
Gross profit	169,283	184,483	175,482	145,597	149,615
Operating expenses:					
Sales and marketing	72,396	78,318	76,651	57,488	55,602
Research and development	35,803	40,384	33,900	32,737	31,584
General and administrative	18,684	20,129	15,847	16,600	15,939
Amortization of intangible assets	33,639	36,813	36,812	36,813	36,813
Acquired in-process research and development	4,100				
Restructuring, acquisition and other charges	33,729	2,789	6,077	7,796	5,332
Goodwill impairment and adjustments			326,677		1,433
Total operating expenses	198,351	178,433	495,964	151,434	146,703
Operating (loss) income	(29,068)	6,050	(320,482)	(5,837)	2,912
Other income (expense):					
Interest income	3,996	1,928	1,498	437	212
Gain (loss) on early extinguishment of debt			8,707	4,602	(243)
Interest expense	(45,417)	(47,535)	(41,222)	(33,048)	(24,633)
Change in fair value of derivative instrument	(1,154)	(7,378)	2,639	4,277	1,616
Amortization and write-off of debt issuance costs	(3,563)	(1,111)	(2,070)	(2,158)	(1,857)
Total other income (expense)	(46,138)	(54,096)	(30,448)	(25,890)	(24,905)
Loss before income taxes	(75,206)	(48,046)	(350,930)	(31,727)	(21,993)
Income tax benefit	(27,994)	(20,936)	(11,424)	(18,705)	(12,437)
Net loss	$ (47,212)	$ (27,110)	$ (339,506)	$ (13,022)	$ (9,556)

Consolidated Balance Sheet Data As of January 31 (1):

Cash, cash equivalents and short-term investments	$ 68,467	$ 48,304	$ 115,044	$ 124,996	$ 126,374
Working capital (deficit)	(20,902)	(17,038)	34,279	47,013	44,185
Total assets	1,347,447	1,243,545	901,532	823,222	748,037
Convertible subordinated debentures	5	5			
Term loan	375,000	320,000	320,000	318,000	316,000
Revolving term credit facility			65,000	65,000	35,000
Senior subordinated notes	200,000	200,000	167,383	142,952	134,265
Total other long-term liabilities	169,915	141,102	105,475	74,635	50,996
Total stockholders equity	486,620	463,510	123,660	111,077	103,576

(1) For purposes of the fiscal year ended January 31, 2007 noted above, we have aggregated the Predecessor period from February 1, 2006 through March 9, 2006 and the Successor period from March 10, 2006 through January 31, 2007, without further adjustment. Upon the closing of the merger on March 10, 2006, the surviving corporation borrowed $400.0 million under a new senior secured credit facility, and issued $200.0 million in principal amount of 10 3/8% senior subordinated notes due 2016. The merger has been accounted for as an acquisition, using the purchase method of accounting, from the date of completion, March 10, 2006. This change has created many differences between reporting for Serena post-merger, as successor, and Serena pre-merger, as predecessor. The predecessor financial statements for periods ended on or before March 10, 2006, generally will not be comparable to the successor financial statements for periods after that date. Under purchase accounting, Serena s tangible assets and liabilities and intangible assets were recorded at fair value resulting in a new carrying basis for those assets and liabilities. The merger has resulted in Serena having an entirely new capital structure, and there are significant differences between the predecessor s and the successor s equity.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Consolidated Financial Statements of Serena and the notes thereto included elsewhere in this report. Our discussion contains forward-looking statements under the Private Securities Reform Act of 1995 which include, but are not limited to, statements about our plans, objectives, expectations and intentions and other statements contained in this report that are not historical facts. When used in this report, the words expects, anticipates, intends, plans, believes, seeks, estimates and similar expressions are generally intended to identify forward-looking statements. Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including those factors set forth under Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations, Business, and elsewhere in, or incorporated by reference into, this report. We assume no obligation to update the forward-looking information contained in this report.

Overview

We are the largest global independent software company in terms of revenue focused solely on managing change across information technology, or IT, environments. Our products and services primarily address the complexity of application lifecycle management, or ALM, and are used by our customers to manage the development of and control change in mission critical applications within both mainframe and distributed systems environments. In addition, we provide products and services to enable customers to rapidly address business process management, or BPM, challenges through the use of visually designed process workflows. Our products and services allow customers to orchestrate and manage their application development, IT and business processes by automating and integrating disparate ALM products and processes, improving process visibility and consistency, enhancing software integrity, mitigating application development risks, supporting auditability and regulatory compliance, and boosting productivity. Our revenue is generated by software licenses, maintenance contracts and professional services. Our software products are typically installed within customer IT environments and generally accompanied by renewable annual maintenance contracts.

In connection with our merger with Spyglass Merger Corp., an affiliate of Silver Lake, in March 2006, we entered into a senior secured credit agreement, issued senior subordinated notes, and entered into other related transactions, which we refer to collectively as the acquisition transactions. After consummation of the acquisition transactions, we are highly leveraged. As of January 31, 2011 we had outstanding $485.3 million in aggregate indebtedness, including $35.0 million of borrowing under our revolving term credit facility. Our liquidity requirements are significant, primarily due to debt service requirements.

On March 2, 2011 we entered into an amendment to our senior secured credit agreement to extend the final maturity date for the repayment of a portion of outstanding term loans, extend the commitment termination date of the commitments for a portion of the revolving credit facility and provide for additional flexibility in the financial covenants under the senior secured credit agreement. As a result of the amendment, $191.1 million of the existing term loans were extended and will mature on March 10, 2016, and $20.0 million of the existing revolving credit commitments were extended and will terminate on March 10, 2015. The $124.9 million of the existing term loans that were not extended, and the $55.0 million of the existing revolving credit commitments that were not extended will continue to mature on March 10, 2013 and March 10, 2012, respectively. As a result of the amendment, the interest rate margins were increased by 200 basis points for the extended facilities. In addition, the maximum total leverage ratio will step up to 5.50x through the test periods ending on July 31, 2012 and will step down to 5.00x thereafter for both the extended facilities and non-extended facilities. For additional information regarding the amended and restated senior secured credit agreement, see *Liquidity and Capital Resources Senior Secured Credit Agreement* below.

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We derive our revenue from software licenses, maintenance and professional services. Our distributed systems products are licensed on a per user seat basis. Customers typically purchase mainframe products under million instructions per second, or MIPS-based, perpetual licenses. Mainframe software products and applications are generally priced based on hardware computing capacity the higher the mainframe computer s MIPS capacity, the higher the cost of the software license.

We also provide ongoing maintenance, which includes technical support, version upgrades and enhancements, for an annual fee of approximately 21% of the discounted list price of the licensed product for our distributed systems products and approximately 17% to 18% of the discounted list price of the licensed product for our mainframe products. We recognize maintenance revenue over the term of the maintenance contract on a straight-line basis.

Professional services revenue is derived from technical consulting and educational services. Our professional services are typically billed on a time and materials basis and revenue is recognized as the related services are performed. Maintenance revenue and professional services revenue have lower gross profit margins than software license revenue as a result of the costs inherent in operating our customer support and professional services organizations.

Our total revenue was $260.2 million, $224.0 million and $214.4 million in the fiscal years ended January 31, 2009, 2010 and 2011, respectively, representing decreases of 14% from fiscal year 2009 to 2010 and 4% from fiscal year 2010 to 2011. The decrease in total revenues in the fiscal year ended January 31, 2010, when compared to the same period a year before, was primarily the result of continued slower software purchasing activity resulting from the world-wide economic conditions, declines in our consulting business fueled in part by the slower software purchasing activity, and pricing pressures on maintenance renewals primarily as a result of the economy and foreign currency exchange rate fluctuations negatively impacting translated foreign revenues, and certain maintenance contract cancellations. The decrease in total revenues in the fiscal year ended January 31, 2011, when compared to the same period a year ago, was primarily the result of pricing pressures on maintenance renewals as a result of the economy, foreign currency exchange rate fluctuations negatively impacting translated foreign revenues, and certain maintenance contract cancellations, and declines in our consulting business fueled in part by slower software purchasing activity.

In the fiscal years ended January 31, 2009, 2010 and 2011, 62%, 58% and 58%, respectively, of our total software license revenue came from our distributed systems products and 38%, 42% and 42%, respectively, came from our mainframe products.

Historically, our revenue has been generally attributable to sales in North America, Europe and to a lesser extent Asia Pacific and South America. Revenue attributable to sales in North America accounted for approximately 66%, 68% and 67% of our total revenue in the fiscal years ended January 31, 2009, 2010 and 2011, respectively. Our international revenue is attributable principally to our European operations and to a lesser extent Asia Pacific and South America. International revenue accounted for approximately 34%, 32% and 33% of our total revenue in the fiscal years ended January 31, 2009, 2010 and 2011, respectively.

Critical Accounting Policies and Estimates

This discussion is based upon our consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by us. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation of our financial condition or results of operations could be affected.

On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, trade accounts receivable and allowance for doubtful accounts, impairment or disposal of long-lived assets, accounting for income taxes, impairment of goodwill, valuation of our common stock, and assumptions around valuation of our options and restricted stock, among other things. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We refer to accounting estimates of this type as critical accounting policies and these are discussed further below.

In addition to these estimates and assumptions utilized in the preparation of historical financial statements, the inability to properly estimate the timing and amount of future revenue could significantly affect our future operations. We must make assumptions and estimates as to the timing and amount of future revenue. Specifically, our sales personnel monitor the status of all proposals, including the estimated closing date and potential dollar amount of such transactions. We aggregate these estimates to generate a sales pipeline and then evaluate the pipeline to identify trends in our business. This pipeline analysis and related estimates of revenue may differ significantly from actual revenue in a particular reporting period as the estimates and assumptions were made using the best available data at the time, which is subject to change. Specifically, slowdowns in the global economy and information technology spending has caused and may continue to cause customer purchasing decisions to be delayed, reduced in amount or cancelled, all of which have reduced and could continue to reduce the rate of conversion of the pipeline into contracts. A variation in the pipeline or the conversion rate of the pipeline into contracts could cause us to plan or budget inaccurately and thereby could adversely affect our business, financial condition or results of operations. In addition, because a substantial portion of our software license contracts close in the latter part of a quarter, we may not be able to adjust our cost structure to respond to a variation in the conversion of the pipeline in a timely manner, and thereby the delays may adversely and materially affect our business, financial condition or results of operations.

We believe the following are critical accounting policies and estimates used in the preparation of our consolidated financial statements.

Revenue Recognition. We recognize revenue in accordance with FASB ASC Topic 985-605 *Revenue Recognition* and recognize revenue when all of the following criteria are met as set forth in the guidance: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable and (4) collectibility is probable.

For contracts with multiple elements (e.g., license and maintenance), revenue is allocated to each component of the contract based on vendor specific objective evidence, or VSOE, of its fair value represented by the price charged when the elements are sold separately. Since VSOE of fair value has not been established for software licenses, the residual method is used to allocate revenue to the license portion of multiple-element arrangements.

Our VSOE for certain elements of an arrangement is based upon the pricing in comparable transactions when the element is sold separately. VSOE for post contract support services is primarily based upon customer renewal history where the services are sold separately. VSOE for professional services is also based upon the price charged when the services are sold separately.

For multiple element arrangements, VSOE must exist for the undelivered elements to allocate the total fee among all delivered and non-essential undelivered elements of the arrangement. If the undelivered elements of the arrangement are essential to the functionality of the product, revenue is deferred until the essential elements are delivered. If VSOE does not exist for one or more non-essential undelivered elements, revenue is deferred until such evidence does exist for the undelivered elements, or until all elements are delivered, whichever is earlier. If VSOE of all non-essential undelivered elements exists but VSOE does not exist for one or more delivered elements, revenue is recognized using the residual method. Under the residual method, the revenue for

the undelivered elements is deferred based upon VSOE and the remaining portion of the arrangement fee is recognized as revenue for the delivered elements, assuming all other criteria for revenue recognition have been met. If we could no longer establish VSOE for non-essential undelivered elements of multiple element arrangements, revenue would be deferred until all elements are delivered or VSOE is established for the undelivered elements, whichever is earlier.

We sell products to our end users and distributors under license agreements or purchase orders. Software license revenue from license agreements or purchase orders is recognized upon receipt and acceptance of a signed contract or purchase order and delivery of the software, provided the related fee is fixed or determinable and collection of the fee is probable. If an acceptance period is required, revenue is recognized upon the earlier of customer acceptance or the expiration of the acceptance period, as defined in the applicable software license agreement. Each new license includes maintenance, including the right to receive telephone support, bug fixes and unspecified upgrades and enhancements, for a specified duration of time, usually one year. The fee associated with such agreements is allocated between software license revenue and maintenance revenue based on the residual method.

We recognize maintenance revenue ratably over the life of the related maintenance contract. Maintenance contracts on perpetual licenses generally renew annually. We typically invoice and collect maintenance fees on an annual basis at the anniversary date of the license. Deferred revenue represents amounts received by us in advance of performance of the maintenance obligation. Professional services revenue includes fees derived from the delivery of training, installation, and consulting services. Revenue from training, installation, and consulting services is recognized on a time and materials basis as the related services are performed. These services have not historically involved significant production, modification or customization of the software and the services have not been essential to the functionality of the software.

Stock-based Compensation. Effective February 1, 2006, we adopted the provisions of, and accounted for stock-based compensation in accordance with FASB ASC Topic 718 *Compensation Stock Compensation.* We elected the modified prospective application method of adoption, under which prior periods are not revised for comparative purposes. The valuation provisions of FASB ASC Topic 718 apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Under the fair value recognition provisions of FASB ASC Topic 718, stock-based compensation cost is measured at the grant date based on the fair value of the award. For stock-based awards granted on or after February 1, 2006, we have elected the graded-vesting attribution method for recognizing stock-based compensation expense over the requisite service period for each separately vesting tranche of awards as though the awards were, in substance, multiple awards.

We currently use the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of stock-based awards on the date of grant using an option-pricing model is affected by our estimate of fair value for our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

Our common stock is privately held and therefore there is no public market for our common stock. To assist management in determining the estimated fair value of our common stock, we engaged an external valuation specialist to perform valuations as of July 31 and January 31 of each fiscal year. We also engaged an external valuation specialist to perform a valuation to assist management in determining the estimated fair value of our common stock in connection with our tender offer completed in the third quarter of fiscal 2010. In estimating the fair value of our common stock as of January 31, 2011, the external valuation firm employed a two-step approach that first estimated the fair value of our company as a whole, and then allocated the enterprise value to our common stock. These estimates were also used to assist management in measuring our expected stock price volatility over time.

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We estimate the expected term of options granted based on observed and expected time to post-vesting exercise or cancellations. Expected volatility is based on the combination of historical volatility of our common stock and our peer group s common stock over the period commensurate with the expected life of the options. We base the risk-free interest rate that we use in the option pricing model on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option pricing model. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use forecasted projections to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants. Existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the ultimately realized fair values of our stock-based awards. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. There currently is no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

Stock-based compensation expense is associated with employee stock options, restricted stock awards and restricted stock units and is recognized under FASB ASC Topic 718. In the fiscal year ended January 31, 2009, we recorded a stock-based compensation benefit totaling $1.6 million. The benefit was the result of our reversal in the fourth quarter of fiscal year 2009 of all previously recorded stock-based compensation expense totaling $5.1 million associated with certain performance-based options with performance conditions deemed to be improbable of achievement. In the fiscal years ended January 31, 2010 and 2011, stock-based compensation expense totaled $2.9 million and $3.6 million, respectively.

See Notes 1(o) and 6 of notes to our consolidated financial statements for further information regarding the FASB ASC Topic 718 disclosures.

Valuation of Long-Lived Assets, Including Goodwill. In accordance with FASB ASC Topic 360 *Property, Plant and Equipment,* and FASB ASC Topic 350-30 *General Intangibles Other than Goodwill,* assets such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Such events or changes in circumstances include, but are not limited to, a significant decrease in the fair value of the underlying business or asset, a significant decrease in the benefits realized from the acquired business or asset, difficulties or delays in integrating the business, or a significant change in the operations of the acquired business or use of an asset. Recoverability of long-lived assets other than goodwill is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Significant management judgment is required in identifying a triggering event that arises from a change in circumstances; forecasting future operating results; and estimating the proceeds from the disposition of long-lived or intangible assets. Material impairment charges could be necessary should different conditions prevail or

different judgments be made. Assets to be disposed of would be separately presented in the consolidated balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and would be no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the consolidated balance sheet.

In accordance with FASB ASC Topic 350-20 *Goodwill,* goodwill is tested annually for impairment in the fourth quarter of each fiscal year, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. Factors we consider important that could trigger an impairment review include, but are not limited to, significant under-performance relative to expected, historical or projected future operating results, significant changes in the manner of our use of acquired assets or the strategy for our overall business, or significant negative economic trends. An impairment loss is recognized to the extent that the carrying amount exceeds the asset s fair value. This determination is made at the reporting unit level and consists of two steps. First, we determine the fair value of a reporting unit and compare it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit s goodwill over the implied fair value of that goodwill.

We completed this test during the fourth quarters of fiscal year 2010 and fiscal year 2011 and did not record an impairment loss on goodwill in either of those fiscal years.

In the fourth quarter of fiscal year 2009, we performed our annual goodwill impairment testing on our single reporting unit. We used the two part test required by FASB ASC Topic 350-20. First, to identify potential impairment, we compared the fair value of the reporting unit to its carrying value, including goodwill. To assist management in determining the estimated fair value of our reporting unit, we engaged an external valuation specialist to perform a valuation as of January 31, 2009. In estimating the fair value of our reporting unit as of January 31, 2009, the external valuation firm employed a two-step approach that used a combination of both income and market based approaches in order to determine fair value. The income approach utilized projected future cash flows of the Company while the market approach was based on company comparables and similar transactions. This analysis resulted in a conclusion that goodwill was impaired, which required us to proceed with the second step of testing.

In the second step of testing, the amount of the goodwill impairment was determined by using an estimate of what the purchase consideration for the Company might be in a theoretical sale of the Company. We used income and market based approaches in this step, which again involved engaging an external valuation firm in a discounted cash flow analysis and a valuation analysis of intangible assets. These analyses also required management to make assumptions and estimates and review relevant industry and market data. As a result of the testing, we recorded a non-cash goodwill impairment charge in the amount of $326.7 million as of January 31, 2009.

Prior to the annual goodwill impairment testing as of January 31, 2009, we also considered whether to test goodwill in the third quarter of fiscal year 2009 as a result of the general weakening of the worldwide economy, a continued slowdown in IT spending and a decline in our license revenue which accelerated in the third quarter of fiscal year 2009. In the quarter ended October 31, 2008, we performed Step 1 of the goodwill impairment test required by FASB ASC Topic 350-20 by comparing the fair value of the reporting unit, which is the Company, to our carrying value. Because the fair value exceeded the carrying value of the reporting unit, we were not required to proceed to Step 2 for the goodwill impairment calculation. We used a combination of the market approach based on comparable company revenue and EBITDA multiples and a discounted cash flow approach to calculate the fair value of the reporting unit.

Significant assumptions and estimates are made when determining if the Company s goodwill has been impaired or if there are indicators of impairment. The Company bases its estimates on assumptions that it believes to be reasonable, but actual future results may differ from those estimates as the assumptions used by the Company are inherently unpredictable and uncertain. These estimates include estimates of future market growth and trends, forecasted revenue and costs, expected periods of asset utilization, appropriate discount rates and other variables.

Accounting for Income Taxes. Income taxes are recorded using the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. We assess the likelihood that deferred tax assets will be recoverable from future taxable income and a valuation allowance is provided if it is determined more likely than not that some portion of the deferred tax assets will not be realized.

Recent Accounting Pronouncements

Refer to Note 1(r) of notes to our consolidated financial statements for a full description of recent accounting pronouncements including the expected dates of adoption and potential effects on our financial position, results of operations and cash flows.

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Historical Results of Operations

The following table sets forth our historical results of operations expressed as a percentage of total revenue and is not necessarily indicative of the results for any future period. Historical results include the post-acquisition results of Projity Incorporated, or Projity, from September 12, 2008.

The following table sets forth our results of operations expressed as a percentage of total revenue. These operating results for the periods presented are not necessarily indicative of the results to be expected for any future period.

	Fiscal Years Ended January 31,		
	2009	**2010**	**2011**
Revenue:			
Software licenses	25%	22%	24%
Maintenance	62%	68%	67%
Professional services	13%	10%	9%
Total revenue	100%	100%	100%
Cost of revenue:			
Software licenses	1%	1%	1%
Maintenance	6%	6%	5%
Professional services	12%	10%	8%
Amortization of acquired technology and impairment of intangibles	14%	18%	16%
Total cost of revenue	33%	35%	30%
Gross profit	67%	65%	70%
Operating expenses:			
Sales and marketing	29%	26%	26%
Research and development	13%	15%	15%
General and administrative	6%	7%	7%
Amortization of intangible assets	14%	16%	17%
Restructuring, acquisition and other charges	2%	3%	3%
Goodwill impairment and adjustments	126%		1%
Total operating expenses	190%	67%	69%
Operating (loss) income	(123)%	(2)%	1%
Other income (expense):			
Interest income	1%		
Gain (loss) on early extinguishment of debt	3%	2%	
Interest expense	(15)%	(15)%	(11)%
Change in fair value of derivative instrument	1%	2%	1%
Amortization and write-off of debt issuance costs	(1)%	(1)%	(1)%
Total other income (expense)	(11)%	(12)%	(11)%
Loss before income taxes	(134)%	(14)%	(10)%
Income tax benefit	(4)%	(8)%	(6)%

Net loss	(130)%	(6)%	(4)%

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Comparison of Fiscal Years Ended January 31, 2009, 2010 and 2011

Revenue

Our total revenue was $260.2 million, $224.0 million and $214.4 million in fiscal year 2009, 2010 and 2011, respectively, representing decreases of 14% from fiscal year 2009 to 2010 and 4% from fiscal year 2010 to 2011.

The following table summarizes software licenses, maintenance and professional services revenues for the periods indicated:

	Fiscal Years Ended January 31,			Fiscal Year 2010 vs. 2009 Increase (Decrease)		Fiscal Year 2011 vs. 2010 Increase (Decrease)	
	2009	2010	2011	In Dollars	In %	In Dollars	In %
	(dollars in thousands)						
Revenue:							
Software licenses	$ 64,578	$ 49,397	$ 51,382	$ (15,181)	(24)%	$ 1,985	4%
Maintenance	161,626	152,464	143,974	(9,162)	(6)%	(8,490)	(6)%
Professional services	34,033	22,153	19,030	(11,880)	(35)%	(3,123)	(14)%
Total revenue	$ 260,237	$ 224,014	$ 214,386	$ (36,223)	(14)%	$ (9,628)	(4)%

Software Licenses. Software licenses revenue was $64.6 million, $49.4 million and $51.4 million in fiscal year 2009, 2010 and 2011, respectively, representing 25%, 22% and 24% of total revenue, respectively. Software licenses revenue decreased $15.2 million, or 24%, from fiscal year 2009 to 2010 and increased $2.0 million, or 4%, from fiscal year 2010 to 2011. The decrease in fiscal year 2010, when compared to fiscal year 2009, in both absolute dollars and as a percentage of total revenue was primarily due to the general weakening of the worldwide economy causing a significant slowdown in IT spending. The increase in fiscal year 2011, when compared to fiscal year 2010, in both absolute dollars and as a percentage of total revenue was primarily due to our hiring of additional sales representatives during the fiscal year. Our core SCCM products continue to make up a significant portion of our total software license revenue. Combined, our core SCCM products accounted for $56.8 million, $44.7 million and $46.0 million in fiscal year 2009, 2010 and 2011, representing 88%, 91% and 90% of total software license revenue, respectively. Distributed systems products accounted for $29.8 million, or 58%, of total software licenses revenue in fiscal year 2011 as compared to $28.5 million, or 58%, and $40.1 million, or 62%, in fiscal year 2010 and 2009, respectively. We expect that our *Dimensions, Professional* and *SBM* family of products will continue to account for a substantial portion of software license revenue in the future. We expect software license revenue for the fiscal quarter ending April 30, 2011 to decline sequentially when compared to the fiscal quarter ending January 31, 2011 due to seasonally stronger sales in our fiscal quarter ending January 31 and the expected continuation of adverse economic conditions.

Maintenance. Maintenance revenue was $161.6 million, $152.5 million and $144.0 million in fiscal year 2009, 2010 and 2011, respectively, representing 62%, 68% and 67% of total revenue, respectively. Maintenance revenue decreased $9.1 million, or 6%, from fiscal year 2009 to 2010 and $8.5 million, or 6%, from fiscal year 2010 to 2011. The decreases in fiscal year 2010, when compared to fiscal year 2009, and in fiscal year 2011, when compared to fiscal 2010, were primarily due to pricing pressures on maintenance renewals as a result of the weak global economy, foreign currency exchange rate fluctuations negatively impacting translated foreign revenues, and certain maintenance contract cancellations. We expect maintenance revenue to remain generally flat in the near term as maintenance contracts continue to renew at consistent rates and we continue to sell software licenses, offset by pricing pressure caused by the prolonged adverse worldwide economic conditions.

Professional Services. Professional services revenue was $34.0 million, $22.2 million and $19.0 million in fiscal year 2009, 2010 and 2011, respectively, representing 13%, 10% and 9% of total revenue, respectively. Professional services revenue decreased $11.8 million, or 35%, from fiscal year 2009 to 2010 and $3.2 million, or 14%, from fiscal year 2010 to fiscal year 2011. The decreases in fiscal year 2010, when compared to fiscal

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year 2009, and in fiscal year 2011, when compared to fiscal year 2010, were primarily due to declines in the number of consulting engagements primarily as a result of lower software license revenue and the general weakening of the worldwide economy that accelerated in the second half of fiscal year 2009 and continued in fiscal 2010 and fiscal 2011. In general, professional services revenue is attributable to consulting opportunities in our installed customer base and expanding our consulting service capabilities. We expect professional services revenue to remain generally flat in the near term as a result of the expected continuation of adverse worldwide economic conditions.

Cost of Revenue

Cost of revenue, consisting of cost of software licenses, cost of maintenance, cost of professional services and amortization of acquired technology and impairment of intangibles was $84.7 million, $78.4 million and $64.8 million in fiscal year 2009, 2010 and 2011, representing 33%, 35% and 30% of total revenue, respectively. Cost of revenue decreased $6.3 million, or 7%, from fiscal year 2009 to fiscal year 2010 and $13.6 million, or 17%, from fiscal year 2010 to fiscal year 2011. Cost of revenue decreased from fiscal year 2009 to fiscal year 2010 primarily due to a decrease in cost of professional services resulting from a decline in professional services revenue and restructuring and other cost cutting initiatives put in place in fiscal year 2010, all partially offset by an impairment charge taken in fiscal year 2010 on certain capitalized software costs related to our on-demand application services totaling $6.8 million and an increase in stock-based compensation costs. Cost of revenue decreased from fiscal year 2010 to fiscal year 2011 primarily due to the absence in 2011 of the impairment charge taken in fiscal year 2010 and decreases in cost of professional services resulting from a decline in professional services revenue, all partially offset by an increase in stock-based compensation costs.

The following table summarizes cost of revenue for the periods indicated:

	Fiscal Years Ended January 31,			Fiscal Year 2010 vs. 2009 Increase (Decrease)		Fiscal Year 2011 vs. 2010 Increase (Decrease)	
	2009	**2010**	**2011**	**In Dollars**	**In %**	**In Dollars**	**In %**
			(dollars in thousands)				
Cost of revenue:							
Software licenses	$ 1,935	$ 3,253	$ 1,380	$ 1,318	68%	$ (1,873)	(58)%
Maintenance	15,626	12,585	11,545	(3,041)	(19)%	(1,040)	(8)%
Professional services	31,824	21,164	18,151	(10,660)	(33)%	(3,013)	(14)%
Amortization of acquired technology and impairment of intangibles	35,370	41,415	33,695	6,045	17%	(7,720)	(19)%
Total cost of revenue	$ 84,755	$ 78,417	$ 64,771	$ (6,338)	(7)%	$ (13,646)	(17)%
Percentage of total revenue	33%	35%	30%				

Software Licenses. Cost of software licenses consists principally of fees associated with integrating third party technology into our *PVCS* and *Dimensions* distributed systems products and, to a lesser extent, salaries, bonuses and other costs associated with our product release organization. In fiscal 2009 and 2010 only, cost of software licenses also included amortization of certain capitalized software costs associated with our on-demand application services. Beginning in fiscal 2011, we ceased amortizing capitalized software costs because the capitalized software costs were fully impaired in the fourth quarter of fiscal 2010. Cost of software licenses was $1.9 million, $3.3 million and $1.4 million in fiscal year 2009, 2010 and 2011, respectively, representing 3%, 7% and 3% of total software licenses revenue, respectively. Cost of software licenses increased $1.3 million, or 68%, from fiscal year 2009 to fiscal year 2010 and decreased $1.9 million, or 58%, from fiscal year 2010 to fiscal year 2011. The increase in both absolute dollars and as a percentage of total software licenses revenue in fiscal year 2010, when compared to fiscal year 2009, was primarily due to amortization of certain capitalized software costs associated with our on-demand application services. The decrease in both absolute dollars and as a percentage of total software licenses revenue in fiscal year 2011, when compared to fiscal year 2010, was primarily due to the absence of the capitalized software impairment in the fourth quarter of fiscal 2010.

Maintenance. Cost of maintenance consists primarily of salaries, bonuses and other costs associated with our customer support organizations. Cost of maintenance was $15.6 million, $12.6 million and $11.5 million in fiscal year 2009, 2010 and 2011, respectively, representing 10%, 8% and 8% of total maintenance revenue, respectively. Cost of maintenance decreased $3.0 million, or 19%, from fiscal year 2009 to 2010 and $1.1 million, or 4%, from fiscal year 2010 to 2011. The decrease in both absolute dollars and as a percentage of total maintenance revenue in fiscal year 2010, when compared to fiscal year 2009, was primarily attributable to decreases in expenses associated with our customer support organization resulting from restructuring and other cost cutting initiatives, partially offset by increases in stock-based compensation expenses. The decrease in absolute dollars in fiscal year 2011, when compared to fiscal year 2010, was primarily attributable to decreases in expenses associated with our customer support organization resulting from restructuring and other cost cutting initiatives.

Professional Services. Cost of professional services consists of salaries, bonuses and other costs associated with supporting our professional services organization. Cost of professional services was $31.8 million, $21.2 million and $18.2 million in fiscal year 2009, 2010 and 2011, respectively, representing 93%, 95% and 95% of total professional services revenue, respectively. Cost of professional services decreased $10.6 million, or 33%, from fiscal year 2009 to 2010 and $3.0 million, or 14%, from fiscal year 2010 to fiscal year 2011. The absolute dollar decreases in fiscal year 2010, when compared to fiscal year 2009, and in fiscal year 2011, when compared to fiscal year 2010, were predominantly due to decreases in expenses as a result of lower professional services revenue and, to a lesser extent, restructuring and other cost cutting initiatives, all partially offset by increases in stock-based compensation expenses.

Amortization of Acquired Technology and Impairment of Intangibles. In connection with our merger in March 2006, and to a lesser extent, small technology acquisitions in March 2006, October 2006 and September 2008, we recorded $178.7 million in acquired technology, offset by amortization totaling $175.0 million as of January 31, 2011. Amortization of acquired technology was $35.4 million, $41.4 million and $33.7 million in fiscal year 2009, fiscal year 2010 and fiscal year 2011, respectively. Amortization of acquired technology in fiscal year 2010 also included an impairment charge totaling $6.8 million on certain capitalized software intangibles related to our on-demand application services. Our acquired technology intangibles will fully amortize by the first quarter of fiscal 2012 when we record $3.6 million in amortization expense.

Operating Expenses

The following table summarizes operating expenses for the periods indicated:

	Fiscal Years Ended January 31,			Fiscal Year 2010 vs. 2009 Increase (Decrease)		Fiscal Year 2011 vs. 2010 Increase (Decrease)	
	2009	2010	2011	In Dollars	In %	In Dollars	In %
	(dollars in thousands)						
Operating expenses:							
Sales & marketing	$ 76,651	$ 57,488	$ 55,602	$ (19,163)	(25)%	$ (1,886)	(3)%
Research & development	33,900	32,737	31,584	(1,163)	(3)%	(1,153)	(4)%
General & administrative	15,847	16,600	15,939	753	5%	(661)	(4)%
Amortization of intangible assets	36,812	36,813	36,813	1			
Restructuring, acquisition and other charges	6,077	7,796	5,332	1,719	28%	(2,464)	(32)%
Goodwill impairment and adjustments	326,677		1,433	(326,677)	(100)%	1,433	
Total operating expenses	$ 495,964	$ 151,434	$ 146,703	$ (344,530)	(69)%	$ (4,731)	(3)%
Percentage of total revenue	190%	67%	69%				

Sales and Marketing. Sales and marketing expenses consist primarily of salaries, commissions and bonuses, payroll taxes and employee benefits as well as travel, entertainment and marketing expenses. Sales and marketing expenses were $76.7 million, $57.5 million and $55.6 million in fiscal year 2009, 2010 and 2011, respectively, representing 29%, 26% and 26% of total revenue, respectively. Sales and marketing expenses decreased $19.2 million, or 25%, from fiscal year 2009 to 2010 and $1.9 million, or 3%, from fiscal year 2010 to 2011. In absolute dollars, the decrease in fiscal year 2010, when compared to fiscal year 2009, was the result of lower direct costs, such as travel expenses and sales commissions, associated with lower software licenses revenue, and restructuring and other cost cutting initiatives put in place in fiscal year 2010, all partially offset by increases in stock-based compensation expense. In absolute dollars, the decrease in fiscal year 2011, when compared to fiscal year 2010, was the result of restructuring and other cost cutting initiatives put in place in the second half of fiscal 2010, partially offset by higher direct costs, such as travel expenses and sales commissions, associated with higher software licenses revenue. In absolute dollar terms, we expect sales and marketing expenses to slightly increase in the near term.

Research and Development. Research and development expenses consist primarily of salaries, bonuses, payroll taxes and employee benefits and costs attributable to research and development activities. Research and development expenses were $33.9 million, $32.7 million and $31.6 million in fiscal year 2009, 2010 and 2011, respectively, representing 13%, 15% and 15% of total revenue, respectively. Research and development expenses decreased $1.2 million, or 3%, from fiscal year 2009 to 2010 and $1.1 million, or 4%, from fiscal year 2010 to 2011. In absolute dollars, the decrease in fiscal year 2010, when compared to fiscal year 2009, was primarily attributable to restructuring and other cost cutting initiatives put in place in fiscal year 2010, offset in part by increases in stock-based compensation expense. In absolute dollars, the decrease in fiscal year 2011, when compared to fiscal year 2010, was primarily attributable to restructuring and other cost cutting initiatives put in place in the second half of fiscal year 2010 and first quarter of fiscal 2011. In absolute dollar terms, we expect research and development expenses to remain generally flat or slightly increase in the near term.

General and Administrative. General and administrative expenses consist primarily of salaries, bonuses, payroll taxes and benefits and certain non-allocable administrative costs, including legal and accounting fees and bad debts. General and administrative expenses were $15.8 million, $16.6 million and $15.9 million in fiscal year 2009, 2010 and 2011, respectively, representing 6%, 7% and 7% of total revenue, respectively. General and administrative expenses increased $0.8 million, or 5%, from fiscal year 2009 to 2010 and decreased $0.7 million, or 4%, from fiscal year 2010 to 2011. In absolute dollars, the increase in general and administrative expenses in fiscal year 2010, when compared to fiscal year 2009, was primarily attributable to an increase in stock-based compensation expense and fluctuations in foreign currency exchange rates, all partially offset by restructuring and other cost cutting initiatives put in place in fiscal year 2010. In absolute dollars, the decrease in general and administrative expenses in fiscal year 2011, when compared to fiscal year 2010, was primarily attributable to restructuring and other cost cutting initiatives put in place in the second half of fiscal year 2010 and first quarter of fiscal 2011 and a decrease in bad debt expenses, all partially offset by an increase in stock-based compensation expense and fluctuations in foreign currency exchange rates. We expect general and administrative expenses to remain generally flat or slightly increase in the near term.

Amortization of Intangible Assets. In connection with our merger in March 2006, and to a lesser extent a small technology acquisition in October 2006, we have recorded $299.5 million in identifiable intangible assets, reduced by amortization totaling $185.0 million as of January 31, 2011. For each of the fiscal years ended January 31, 2009, 2010 and 2011, amortization expense was predominantly due to the identifiable intangible assets recorded in connection with the merger. Assuming there are no impairments and no acquisitions, we expect to record $9.2 million in amortization expense in each of the next five fiscal quarters, $9.1 million in amortization expense in each of the seven fiscal quarters following thereafter and $3.9 million in amortization expense in the first quarter of fiscal 2015.

Restructuring, Acquisition and Other Charges. In connection with our restructuring plans put in place in October 2008, April 2009, September 2009, December 2009, January 2010, March 2010 and February 2011, and to a lesser extent, severance and other employee related costs, sponsor fees and other charges which are not part

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of ongoing operations, we recorded $6.1 million, $7.8 million and $5.3 million in restructuring, acquisition and other charges in the fiscal years ended January 31, 2009, 2010 and 2011, respectively. Restructuring, acquisition and other charges for the fiscal years ended January 31, 2009, 2010 and 2011 are categorized as follows (in thousands):

	Fiscal Years Ended January 31,		
	2009	2010	2011
Sponsor fees, administration fees and other costs related to the Merger and the issuance of debt	$ 1,211	$ 1,226	$ 1,238
Restructuring charges consisting principally of severance, payroll taxes and other employee benefits, facilities closures and legal and other miscellaneous costs (1)	2,215	5,579	2,272
Other redundancy costs not related to our restructuring plans including severance and other employee related costs, costs to establish or liquidate entities, and other miscellaneous costs not part of ongoing operations	2,651	991	1,822
Total restructuring, acquisition and other charges	$ 6,077	$ 7,796	$ 5,332

(1) See Note 4(b) of notes to our consolidated financial statements for additional information related to our restructuring plans.

Goodwill Impairment and Adjustments. In the fourth quarter of fiscal year 2009, we performed our annual goodwill impairment testing on our single reporting unit as described in further detail in Note 3(a) of notes to our consolidated financial statements. As a result of the testing, we recorded a non-cash goodwill impairment charge of $326.7 million in fiscal year 2009. We had also completed this test during the fourth quarters of fiscal year 2010 and fiscal year 2011, and did not record an impairment loss on goodwill in either of those periods.

In the second quarter of fiscal 2011, we corrected certain immaterial errors related to acquisition purchase accounting allocations and tax reserves that resulted in recording adjustments to goodwill totaling $1.4 million. See Notes 1(c) *Correction of Immaterial Errors* and 4(a) *Goodwill* of notes to our consolidated financial statements for further details regarding the correction of immaterial errors and the resulting goodwill adjustments.

Other Income (Expense)

The following table summarizes total other income (expense) for the periods indicated:

	Fiscal Years Ended January 31,			Fiscal Year 2010 vs. 2009 Increase (Decrease)		Fiscal Year 2011 vs. 2010 Increase (Decrease)	
	2009	2010	2011	In Dollars	In %	In Dollars	In %
	(dollars in thousands)						
Other income (expense):							
Interest income	$ 1,498	$ 437	$ 212	$ (1,061)	(71)%	$ (225)	(51)%
Gain (loss) on early extinguishment of debt	8,707	4,602	(243)	(4,105)	(47)%	(4,845)	(105)%
Interest expense	(41,222)	(33,048)	(24,633)	8,174	(20)%	8,415	(25)%
Change in fair value of derivative instrument	2,639	4,277	1,616	1,638	62%	(2,661)	(62)%
Amortization and write-off of debt issuance cost	(2,070)	(2,158)	(1,857)	(88)	4%	301	(14)%
Total other income (expense)	$ (30,448)	$ (25,890)	$ (24,905)	$ 4,558	(15)%	$ 985	(4)%

Percentage of total revenue	(11)%	(12)%	(11)%

Interest Income. Interest income was $1.5 million, $0.4 million and $0.2 million in fiscal year 2009, 2010 and 2011, respectively, representing decreases of $1.1 million, or 71%, in fiscal year 2010, when compared to fiscal year 2009, and $0.2 million, or 51%, in fiscal year 2011, when compared to fiscal year 2010. The decreases in fiscal year 2010, when compared to fiscal year 2009, and in fiscal year 2011, when compared to fiscal year 2010, were principally due to lower yields on interest-bearing accounts and decreases in cash balances resulting from paying down debt, partially offset by increases in cash balances resulting from the accumulation of free cash flows from operations and $65.0 million in borrowings under the revolving term credit facility obtained late in the third quarter of fiscal 2009.

Gain (Loss) On Early Extinguishment of Debt. In the fiscal years ended January 31, 2009 and 2010, we recorded gains on the early extinguishment of debt totaling $8.7 million and $4.6 million, respectively. In the fiscal year ended January 31, 2011, we recorded a loss on the early extinguishment of debt totaling $0.2 million. All early extinguishments of debt for all periods followed authorization of our Board of Directors to repurchase our senior subordinated notes. See Note 9 of notes to our consolidated financial statements for additional information related to our debt.

Interest Expense. We recorded interest expense totaling $41.2 million, $33.0 million and $24.6 million in the fiscal years ended January 31, 2009, 2010 and 2011, respectively, in connection with the merger in the first fiscal quarter of 2007 and our borrowings of $400.0 million in a senior secured term credit facility and an additional $200.0 million in senior subordinated notes, and an additional $65.0 million in borrowings under the revolving credit facility obtained late in the third quarter of fiscal year 2009, all partially offset by principal payments on the senior secured term credit facility of $0.0 million, $2.0 million and $2.0 million, respectively, principal payments on the senior subordinated notes of $32.6 million, $24.4 million and $8.7 million, respectively, and principal payments on the revolving credit facility of $0.0 million, $0.0 million and $30.0 million, respectively. Assuming we do not paydown principal on the extended facilities, we will incur incremental interest expense of approximately $1.0 million per quarter going forward in connection with the amended and restated senior secured credit agreement effective March 2, 2011, where interest rate margins were increased by 200 basis points for the extended facilities. See Note 9 of notes to our consolidated financial statements for additional information related to our debt.

Change in Fair Value of Derivative Instrument. We used an interest rate swap as part of our interest rate risk management strategy and to comply with certain requirements of our senior secured credit agreement. In the second fiscal quarter ended July 31, 2006, we entered into an interest rate swap transaction to effectively convert the variable interest rate on a portion of the $400.0 million senior secured term loan to a fixed rate. The swap, which expired on April 10, 2010, was recorded on the balance sheet at fair value. The swap was not designated as an accounting hedge, and accordingly, changes in the fair value of the derivative were recognized in the statement of operations. The notional amount of the swap was $250.0 million initially declining over time to $126.0 million at the time the swap transaction expired on April 10, 2010. Under the terms of the swap, we made interest payments based on a fixed rate equal to 5.38% and received interest payments based on the LIBOR setting rate, set in arrears. In fiscal year 2009 and 2010, we recorded $2.6 million and $4.3 million, respectively, in income related to the changes in the fair value of the derivative. We did not enter into a similar interest rate swap during fiscal year 2011 and do not expect to enter into a similar interest rate swap in the future.

Amortization and Write-Off of Debt Issuance Costs. In connection with the merger, we recorded $16.1 million in debt issuance costs, reduced by accumulated amortization totaling $10.6 million as of January 31, 2011. In fiscal year 2009, 2010 and 2011, we recorded amortization and write-off of debt issuance costs totaling $2.1 million, $2.2 million and $1.9 million, respectively. The write-offs of unamortized debt issuance costs in fiscal year 2009, 2010 and 2011 associated with the early extinguishment of the senior subordinated notes totaled $0.7 million, $0.4 million, and $0.1 million, respectively. The write-offs were recorded as an addition to amortization of debt issuance costs. See Note 9 of notes to our consolidated financial statements for additional information related to our debt.

Income Tax Benefit

The following table summarizes total income tax benefit for the periods indicated:

	Fiscal Years Ended January 31,			Fiscal Year 2010 vs. 2009 Increase (Decrease)		Fiscal Year 2011 vs. 2010 Increase (Decrease)	
	2009	**2010**	**2011**	**In Dollars**	**In %**	**In Dollars**	**In %**
			(dollars in thousands)				
Income tax benefit:							
Total income tax benefit	$ (11,424)	$ (18,705)	$ (12,437)	$ (7,281)	64%	$ 6,268	(34)%
Percentage of total revenue	(4)%	(8)%	(6)%				

Income Taxes. Income tax benefits of $11.4 million, $18.7 million and $12.4 million were recorded in fiscal year 2009, 2010 and 2011, respectively, representing effective income tax benefit rates of 3%, 59% and 57%, respectively. The effective income tax benefit rate increased to 59% in fiscal year 2010 from 3% in fiscal year 2009 primarily as a result of the goodwill impairment charge in fiscal year 2009 (33%), and to a lesser extent, lower tax rates in non-U.S. jurisdictions (7%), the release of a reserve for uncertain tax positions (8%) and the expected benefits from U.S. research and experimentation tax credits (1%). The effective income tax benefit rate decreased to 57% in fiscal year 2011 from 59% in fiscal year 2010 primarily due to the goodwill impairment charge in fiscal 2011 (2%) as well as the impact of permanently reinvested foreign earnings (10%) offset by benefits including U.S. research and experimentation tax credits (1%), state taxes (1%), the reversal of a reserve for uncertain tax positions (3%), the domestic manufacturing deduction (3%) and other individual immaterial items (2%).

Liquidity and Capital Resources

Cash and, Cash Equivalents. Since our inception, we have financed our operations and met our capital expenditure requirements through cash flows from operations. As of January 31, 2011, we had $126.4 million in cash and cash equivalents.

Net Cash Provided by Operating Activities. Cash flows provided by operating activities were $36.5 million, $38.8 million and $46.0 million in fiscal year 2009, 2010 and 2011, respectively. In fiscal year 2009, our cash flows provided by operating activities exceeded net loss principally due to the inclusion of non-cash expenses in net loss and a decrease in trade accounts receivable, all partially offset by interest payments on the term credit facility and senior subordinated notes totaling $42.2 million, income tax payments net of refunds totaling $5.0 million and cash collections in advance of revenue recognition for maintenance contracts. In fiscal year 2010, our cash flows provided by operating activities exceeded net loss principally due to the inclusion of non-cash expenses in net loss, a decrease in trade accounts receivable and an increase in accrued expenses, all partially offset by interest payments on the term credit facility and senior subordinated notes totaling $33.5 million, income tax payments net of refunds totaling $11.3 million and cash collections in advance of revenue recognition for maintenance contracts. In fiscal year 2011, our cash flows provided by operating activities exceeded the net loss principally due to the inclusion of non-cash expenses in the net loss and a decrease in trade accounts receivable, all partially offset by interest payments on the term credit facility and senior subordinated notes totaling $25.2 million and income tax payments net of refunds totaling $11.0 million. Non-cash expenses and income included in the net loss consisted of amortization of intangible assets, amortization of deferred stock-based compensation, gains and losses on the early extinguishment of debt, net deferred income taxes, depreciation expense and fair market value adjustments on the interest rate swap for all periods, goodwill impairment in fiscal years 2009 and 2011 only, and impairment of other intangibles in fiscal year 2010 only.

Net Cash Used in Investing Activities. Net cash used in investing activities was $11.7 million, $4.7 million and $2.8 million in fiscal year 2009, 2010 and 2011, respectively. In fiscal year 2009, cash used in investing activities related principally to capitalized software totaling $5.8 million, the purchase of computer equipment

and office furniture and equipment totaling $3.9 million and acquisition related costs paid totaling $1.9 million primarily related to Projity. In fiscal year 2010, cash used in investing activities related principally to capitalized software totaling $3.6 million, the purchase of computer equipment and office furniture and equipment totaling $0.8 million and acquisition related costs paid totaling $0.4 million related to Projity. In fiscal year 2011, cash used in investing activities related principally to the purchase of computer equipment and office furniture and equipment totaling $2.4 million and capitalized software totaling $0.4 million.

Net Cash Provided by (Used in) Financing Activities. Net cash provided by (used in) financing activities was $39.6 million, $(22.7) million and $(41.3) million in fiscal year 2009, 2010 and 2011, respectively. In fiscal year 2009, net cash provided by financing activities principally related to borrowings under our revolving term credit facility totaling $65.0 million, all partially offset by the repurchase of our senior subordinated notes totaling $23.9 million, and to a lesser extent, the repurchase of option rights under our employee stock option plan totaling $1.4 million and the repurchase of common stock under stock repurchase plans totaling $0.2 million. In fiscal year 2010, net cash used in financing activities principally related to the repurchase of our senior subordinated notes totaling $19.8 million, the payment of principal on the senior secured term loan totaling $2.0 million, and to a lesser extent, the repurchase of option rights under our employee stock option plan totaling $0.7 million and the repurchase of common stock under stock repurchase plans totaling $0.2 million. In fiscal year 2011, net cash used in financing activities principally related to the payment of principal on our revolving term credit facility totaling $30.0 million, the repurchase of our senior subordinated notes totaling $8.9 million, the payment of principal on the senior secured term loan totaling $2.0 million, and to a lesser extent, the repurchase of common stock totaling $0.3 million.

Contractual Obligations and Commitments

After consummation of the acquisition transactions, we are highly leveraged. As of January 31, 2011, we had outstanding $485.3 million in aggregate indebtedness. Our liquidity requirements are significant, primarily due to debt service requirements. Our cash interest expense for the fiscal year ended January 31, 2011 was $25.2 million.

The following is a summary of our various contractual commitments as of January 31, 2011, including non-cancelable operating lease agreements for office space that expire between calendar years 2011 and 2018. All periods start from February 1, 2011.

	Payments Due by Period (2)				
	Total	Less than 1 year	1-3 years (in thousands)	3-5 years	Thereafter
Operating lease obligations	$ 7,499	$ 2,954	$ 1,694	$ 1,120	$ 1,681
Credit Facility:					
Senior secured term loan due March 10, 2013	124,899	7,500	117,399		
Senior secured term loan due March 10, 2016	191,101				191,101
Revolving term credit facility due March 10, 2012	25,667		25,667		
Revolving term credit facility due March 10, 2015	9,333			9,333	
Senior subordinated notes due March 15, 2016	134,265				134,265
Scheduled interest on debt (1)	121,876	26,094	48,253	44,760	2,769
	$ 614,590	$ 36,548	$ 193,013	$ 55,213	$ 329,816

(1) Scheduled interest on debt is calculated through the instruments due date and assumes no principal paydowns or borrowings. Scheduled interest on debt includes the seven year senior secured term loan due March 10, 2013 at an annual rate of 2.30344%, which is the rate in effect as of March 2, 2011, the seven year senior secured term loan with an extended due date of March 10, 2016 at an annual rate of 4.30344%, which is the rate in effect as of March 2, 2011, the partially drawn six year revolving term credit facility due March 10, 2012 at an annual rate of 2.30344%, which is the rate in effect as of March 2, 2011, the partially drawn six year revolving term credit facility with an extended due date of March 10, 2015 at an annual rate

of 4.30344%, which is the rate in effect as of March 2, 2011, the commitment fee on the unutilized amount of the six year revolving term credit facility due March 10, 2012 at the stated annual rate of 0.5%, and the ten year senior subordinated notes due March 15, 2016 at the stated annual rate of 10.375%.

(2) This table excludes the company s unrecognized tax benefits totaling $2.9 million as of January 31, 2011 since the company has determined that the timing of payments with respect to this liability cannot be reasonably estimated.

Acquisitions. The aggregate amount of cash paid relating to acquisitions during the fiscal year ended January 31, 2009 was $1.9 million and consisted of $1.8 million related to our acquisition of Projity, Incorporated in September 2008, net of cash received, and $0.1 million related to our acquisition of Data Scientific Corp. in March 2006. The aggregate amount of cash paid relating to acquisitions during the fiscal year ended January 31, 2010 was $0.4 million in connection with our acquisition of Projity, Incorporated in September 2008. There were no cash payments relating to acquisitions during the fiscal year ended January 31, 2011. See Notes 1(b) and 5 of notes to our consolidated financial statements for additional information related to acquisition related activities, which have affected our liquidity.

Off-Balance Sheet Arrangements. As part of our ongoing operations, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, or SPEs, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of January 31, 2011, we are not involved in any unconsolidated SPE transactions.

Senior Secured Credit Agreement

In connection with the consummation of the merger, we entered into a senior secured credit agreement pursuant to a debt commitment we obtained from affiliates of the initial purchasers of our senior subordinated notes.

General. The borrower under the senior secured credit agreement initially was Spyglass Merger Corp. and immediately following completion of the merger became Serena. The senior secured credit agreement originally provided for (1) a seven-year term loan in the amount of $400.0 million, amortizing at a rate of 1.00% per year on a quarterly basis for the first six and three-quarter years after the closing date of the acquisition transactions, with the balance payable at maturity, and (2) a six-year revolving credit facility that permits loans in an aggregate amount of up to $75.0 million, which includes a letter of credit facility and a swing line facility. In addition, subject to certain terms and conditions, the senior secured credit agreement provides for one or more uncommitted incremental term loan or revolving credit facilities in an aggregate amount not to exceed $150.0 million. Proceeds of the term loan on the initial borrowing date were used to partially finance the merger, to refinance certain indebtedness of Serena and to pay fees and expenses incurred in connection with the merger. Proceeds of the revolving credit facility have been, and any incremental facilities will be, used for working capital and general corporate purposes of the borrower and its restricted subsidiaries.

Amended and Restated Senior Secured Credit Agreement. On March 2, 2011 we entered into an amendment to our senior secured credit agreement to extend the final maturity date for the repayment of a portion of outstanding term loans, extend the commitment termination date of the commitments for a portion of the revolving credit facility and provide for additional flexibility in the financial covenants under the senior secured credit agreement. As a result of the amendment, $191.1 million of the existing term loans were extended and will mature on March 10, 2016 (the extended term loans), and $20.0 million of the existing revolving credit commitments were extended and will terminate on March 10, 2015 (the extended revolving credit commitments). The $124.9 million of the existing term loans that were not extended (the non-extended term loans), and the $55.0 million of the existing revolving credit commitments that were not extended (the non-extended revolving credit commitments) will continue to mature on March 10, 2013 and March 10, 2012, respectively. We refer to the extended term loans and extended revolving credit commitments collectively as the extended facilities, and the non-extended term loans and non-extended credit commitments collectively as the

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non-extended facilities. As a result of the amendment, the interest rate margins were increased by 200 basis points for the extended facilities. In addition, the maximum total leverage ratio will step up to 5.50x through the test periods ending on July 31, 2012 and will step down to 5.00x thereafter for both the extended facilities and non-extended facilities. After giving effect to the amendment, the aggregate principal amount outstanding under the senior secured credit agreement did not change. In connection with the amendment, Lehman Commercial Paper Inc. resigned as administrative agent, collateral agent, swingline lender and letter of credit issuer under the senior secured credit agreement and was replaced by Barclays Bank PLC.

Interest Rates and Fees. The $400.0 million term loan, of which $316.0 million was outstanding as of January 31, 2011, bears interest at a rate equal to three-month LIBOR plus 2.00%. That rate was 2.30344% as of January 31, 2011. The revolving term credit facility, of which $35.0 million was outstanding as of January 31, 2011, bears interest at a rate equal to three-month LIBOR plus 2.00%. That rate was 2.30344% as of January 31, 2011. More generally, the loans under the senior secured credit agreement bear interest, at the option of the borrower, at the following:

- a rate equal to the London Interbank Offered Rate, or LIBOR, plus an applicable margin of (1) 2.00% with respect to the term loan and (2) 2.00% with respect to the revolving credit facility or

- the alternate base rate, which is the higher of (1) the corporate base rate of interest announced by the administrative agent and (2) the Federal Funds rate plus 0.50%, plus, in each case, an applicable margin of (a) 1.25% with respect to the term loan and (b) 1.25% with respect to the revolving credit facility.

The revolving credit facility bears an annual commitment fee of 0.5% on the undrawn portion of that facility commencing on the date of execution and delivery of the senior secured credit agreement. As a result of our borrowing $65.0 million under the revolving credit facility in the fiscal quarter ended October 31, 2008 and Lehman Commercial Paper, Inc., or LCPI, becoming a defaulting lender due to its failure to fund its portion of the loan commitment, the annual commitment fee of 0.50% was not payable pursuant to the terms of the senior secured credit agreement until April 2010, when we repaid $30 million under the revolving credit facility. In connection with the amendment of our senior secured credit agreement in March 2011, Barclays Bank PLC assumed LCPI s revolving credit commitment of $10.0 million, which revived the applicable revolving credit commitment and resulted in total non-extended and extended revolving credit commitments of $75.0 million.

After our delivery of financial statements and a computation of the maximum ratio of total debt (defined in the senior secured credit agreement) to trailing four quarters of EBITDA (defined in the senior secured credit agreement), or total leverage ratio, for the first full quarter ending after the closing date of the merger, the applicable margins and the commitment fee became subject to a grid based on the most recent total leverage ratio.

Prepayments. At our option, (1) amounts outstanding under the term loan may be voluntarily prepaid and (2) the unutilized portion of the commitments under the revolving credit facility may be permanently reduced and the loans under such facility may be voluntarily repaid, in each case subject to requirements as to minimum amounts and multiples, at any time in whole or in part without premium or penalty, except that any prepayment of LIBOR rate advances other than at the end of the applicable interest periods will be made with reimbursement for any funding losses or redeployment costs of the lenders resulting from the prepayment. Loans under the term loan and under any incremental term loan facility are subject to mandatory prepayment with (a) 50% of annual excess cash flow with certain step downs to be based on the most recent total leverage ratio and agreed upon by the issuer and the lenders, (b) 100% of net cash proceeds of asset sales and other asset dispositions by the borrower or any of its restricted subsidiaries, subject to various reinvestment rights of the company and other exceptions, and (c) 100% of the net cash proceeds of the issuance or incurrence of debt by the company or any of its restricted subsidiaries, subject to various baskets and exceptions.

We have made principal payments totaling $25 million and $55 million in each of the fiscal years ended January 31, 2007 and January 31, 2008, respectively, and $2 million in the fiscal year ended January 31, 2010 on the $400 million senior secured term loan.

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In the fiscal year ended January 31, 2011, we made a mandatory principal payment totaling $2 million on the senior secured term loan and a voluntary principal payment totaling $30 million on the revolving term credit facility. In the fiscal quarter ended April 30, 2011, we made a mandatory principal payment in the amount of $7.5 million under the term loan, which was applied against the outstanding principal balance of the non-extended term loans on a pro rata basis.

Guarantors. All obligations under the senior secured credit agreement are to be guaranteed by each future direct and indirect restricted subsidiary of the company, other than foreign subsidiaries. We do not have any domestic subsidiaries and, accordingly, there are no guarantors.

Security. All obligations of the company and each guarantor (if any) under the senior secured credit agreement are secured by the following:

- a perfected lien on and pledge of (1) the capital stock and intercompany notes of each existing and future direct and indirect domestic subsidiary of the company, (2) all the intercompany notes of the company and (3) 65% of the capital stock of each existing and future direct and indirect first-tier foreign subsidiary of the company, and

- a perfected first priority lien, subject to agreed upon exceptions, on, and security interest in, substantially all of the tangible and intangible properties and assets of the company and each guarantor.

Covenants, Representations and Warranties. The senior secured credit agreement contains customary representations and warranties and customary affirmative and negative covenants, including, among other things, restrictions on indebtedness, investments, capital expenditures, sales of assets, mergers and acquisitions, liens and dividends and other distributions. There are no financial covenants included in the senior secured credit agreement, other than a minimum interest coverage ratio and a maximum total leverage ratio as discussed below under Covenant Compliance.

Events of Default. Events of default under the senior secured credit agreement include, among others, nonpayment of principal or interest, covenant defaults, a material inaccuracy of representations or warranties, bankruptcy and insolvency events, cross defaults and a change of control.

Senior Subordinated Notes

As of January 31, 2011, we have outstanding $134.3 million principal amount of senior subordinated notes, bearing interest at a rate of 10.375%, payable semi-annually on March 15 and September 15, and maturing on March 15, 2016. Each of our domestic subsidiaries that guarantees the obligations under our senior secured credit agreement will jointly, severally and unconditionally guarantee the notes on an unsecured senior subordinated basis. As of the date of this report, we do not have any domestic subsidiaries and, accordingly, there are no guarantors on such date. The notes are our unsecured, senior subordinated obligations, and the guarantees, if any, will be unsecured, senior subordinated obligations of the guarantors. The notes are subject to redemption at our option under terms and conditions specified in the indenture related to the notes, and may be redeemed at the option of the holders at 101% of their face amount, plus accrued and unpaid interest, upon certain change of control events.

In the fiscal year ended January 31, 2009, we repurchased, in eight separate privately negotiated transactions, an aggregate of $32.6 million of principal amount of our original outstanding $200.0 million senior subordinated notes. In the fiscal year ended January 31, 2010, we repurchased, in six separate privately negotiated transactions, an aggregate of $24.4 million of principal amount of our original outstanding $200.0 million senior subordinated notes. In the fiscal year ended January 31, 2011, we repurchased, in two separate privately negotiated transactions, an aggregate of $8.7 million of principal amount of our original outstanding $200.0 million senior subordinated notes. These repurchases resulted in gains of $8.7 million and $4.6 million from the extinguishment of debt in the fiscal years ended January 31, 2009 and 2010, respectively, and a loss of $0.2 million from the extinguishment of debt in the fiscal year ended January 31, 2011. We may from time to time repurchase our senior subordinated notes in open market or privately negotiated purchases or otherwise.

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Covenant Compliance

Our senior secured credit agreement and the indenture governing the senior subordinated notes contain various covenants that limit our ability to engage in specified types of transactions. These covenants limit our and our restricted subsidiaries ability to, among other things:

- incur additional indebtedness or issue certain preferred shares;
- pay dividends on, redeem or repurchase our capital stock or make other restricted payments;
- make investments;
- make capital expenditures;
- create certain liens;
- sell certain assets;
- enter into agreements that restrict the ability of our subsidiaries to make dividend or other payments to us;
- guarantee indebtedness;
- engage in transactions with affiliates;
- prepay, repurchase or redeem the notes;
- create or designate unrestricted subsidiaries; and
- consolidate, merge or transfer all or substantially all of our assets and the assets of our subsidiaries on a consolidated basis.

In addition, under our senior secured credit agreement, we are required to satisfy and maintain specified financial ratios and other financial condition tests, including minimum interest coverage ratio and a maximum total leverage ratio. We were in compliance with all of the covenants under the secured credit agreement and indenture as of January 31, 2011. Our ability to meet those financial ratios and tests can be affected by events beyond our control, and we cannot assure you that we will meet those ratios and tests in the future. A breach of any of these covenants would result in a default (which, if not cured, could mature into an event of default) and in certain cases an immediate event of default under our senior secured credit agreement. Upon the occurrence of an event of default under our senior secured credit agreement, all amounts outstanding under our senior secured credit agreement could be declared to be (or could automatically become) immediately due and payable and all commitments to extend further credit could be terminated.

Earnings before interest, taxes, depreciation and amortization, or EBITDA, is a non-GAAP financial measure used to determine our compliance with certain covenants contained in our senior secured credit agreement. Adjusted EBITDA represents EBITDA further adjusted to exclude

certain defined unusual items and other adjustments permitted in calculating covenant compliance under our senior secured credit agreement. We believe that the presentation of Adjusted EBITDA is appropriate to provide additional information to investors regarding our compliance with the financial covenants under our senior secured credit agreement.

The breach of financial covenants in our senior secured credit agreement (i.e., those that require the maintenance of ratios based on Adjusted EBITDA) would force us to seek a waiver or amendment with the lenders under our senior secured credit agreement, and no assurance can be given that we will be able to obtain any necessary waivers or amendments on satisfactory terms, if at all. The lenders would likely condition any waiver or amendment, if given, on additional consideration from us, such as a consent fee, a higher interest rate, principal repayment or more restrictive covenants and limitations on our business. Any such breach, if not waived by the lenders, would result in an event of default under that agreement, in which case the lenders could elect to declare all amounts borrowed due and payable. Any such acceleration would also result in a default under

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the indenture governing the senior subordinated notes. Additionally, under our debt agreements, our ability to engage in activities such as incurring additional indebtedness, making investments and paying dividends is also tied to ratios based on Adjusted EBITDA.

Adjusted EBITDA does not represent net income (loss) or cash flow from operations as those terms are defined by GAAP and does not necessarily indicate whether cash flows will be sufficient to fund cash needs. While Adjusted EBITDA and similar measures are frequently used as measures of operations and the ability to meet debt service requirements, these terms are not necessarily comparable to other similarly titled captions of other companies due to the potential inconsistencies in the method of calculation. Adjusted EBITDA does not reflect the impact of earnings or charges resulting from matters that we may consider not to be indicative of our ongoing operations. In particular, the definition of Adjusted EBITDA in the senior secured credit agreement allows us to add back certain defined non-cash, extraordinary, unusual or non-recurring charges that are deducted in calculating GAAP net income (loss). Our senior secured credit agreement requires that Adjusted EBITDA be calculated for the most recent four fiscal quarters. As a result, Adjusted EBITDA can be disproportionately affected by a particularly strong or weak quarter and may not be comparable to Adjusted EBITDA for any subsequent four-quarter period or any complete fiscal year.

The following is a reconciliation of net loss, a GAAP measure of our operating results, to Adjusted EBITDA as defined in our debt agreements.

	Fiscal Years Ended January 31,		
	2009	**2010**	**2011**
Net loss (1)	$ (339,506)	$ (13,022)	$ (9,556)
Interest expense (income), net (2)	30,448	25,890	24,905
Income tax benefit	(11,424)	(18,705)	(12,437)
Depreciation and amortization expense (3)	74,740	86,392	77,120
Goodwill impairment and adjustments	326,677		1,433
EBITDA	80,935	80,555	81,465
Deferred maintenance writedown (1)	759	136	92
Restructuring, acquisition and other charges (4)	6,077	7,796	5,332
Adjusted EBITDA (1)	$ 87,771	$ 88,487	$ 86,889

(1) Net loss for the periods presented includes the deferred maintenance step-down associated with the merger in the first quarter of fiscal year 2007. This unrecognized maintenance revenue is added back in calculating Adjusted EBITDA for purposes of the indenture governing the senior subordinated notes and the senior secured credit agreement.

(2) Interest expense (income), net includes interest income, interest expense, the change in the fair value of derivative instruments, amortization and write-off of debt issuance costs and gains and losses on early extinguishment of debt.

(3) Depreciation and amortization expense includes depreciation of fixed assets, amortization of leasehold improvements, amortization of acquired technologies, amortization and impairment of other intangible assets, and amortization of stock-based compensation. In the fiscal year ended January 31, 2010, stock-based compensation includes unusual and non-recurring charges associated with the repurchase of stock options in connection with the tender offer that we completed during the quarter ended October 31, 2009. See Note 6 of notes to our consolidated financial statements for additional information related to stock-based compensation.

(4) Restructuring, acquisition and other charges include employee payroll, severance and other employee related costs associated with transitional activities that are not expected to be part of our ongoing operations, and travel and other direct costs associated with our merger in March 2006. See Note 4(b) of notes to our consolidated financial statements for additional information related to acquisition-related and restructuring charges.

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Our covenant requirements and ratios for the fiscal year ended January 31, 2011 are as follows. (Note that this table is given as of January 31, 2011 and so does not reflect the March 2011 amendment and restatement of our senior secured credit agreement.)

	Covenant requirement	Serena ratio
Senior secured credit agreement (1)		
Minimum Adjusted EBITDA to consolidated interest expense ratio	2.00x	3.48x
Maximum consolidated total debt to Adjusted EBITDA ratio	5.00x	4.19x
Senior subordinated notes (2)		
Minimum Adjusted EBITDA to fixed charges ratio required to incur additional debt pursuant to ratio provisions	2.00x	3.07x

(1) Our senior secured credit agreement requires us to maintain a rolling four fiscal quarters consolidated Adjusted EBITDA to consolidated interest expense ratio of a minimum of 2.00x. Consolidated interest expense is defined in the senior secured credit agreement as consolidated cash interest expense less cash interest income and is further adjusted for certain non-cash interest expenses and other items. We are also required to maintain a rolling four fiscal quarters consolidated total debt to consolidated Adjusted EBITDA ratio of a maximum of 5.00x. Under the terms of the amended and restated senior secured credit agreement, the maximum total leverage ratio will step up to 5.50x through the test period ending on July 31, 2012 and will step down to 5.00x thereafter. Consolidated total debt is defined in the senior secured credit agreement as total debt other than certain indebtedness and is reduced by the amount of cash and cash equivalents on our consolidated balance sheet in excess of $5.0 million. As of January 31, 2011, our consolidated total debt as defined was $363.9 million, consisting of total debt other than certain indebtedness totaling $485.3 million, net of cash and cash equivalents in excess of $5.0 million totaling $121.4 million. Failure to satisfy these ratio requirements would constitute a default under the senior secured credit agreement. If our lenders failed to waive any such default, our repayment obligations under the senior secured credit agreement could be accelerated, which would also constitute a default under the indenture governing the senior subordinated notes.

(2) Our ability to incur additional debt and make certain restricted payments under the indenture governing the senior subordinated notes, subject to specified exceptions, is tied to an Adjusted EBITDA to fixed charges ratio of at least 2.0x, except that we may incur certain debt and make certain restricted payments and certain permitted investments without regard to the ratio, such as our ability to incur up to an aggregate principal amount of $541.0 million under our senior secured credit agreement (which amount represents the total amount of borrowings originally committed or available under our senior secured credit agreement less $84.0 million of principal prepayments), to acquire persons engaged in a similar business that become restricted subsidiaries and to make other investments equal to the greater of $25.0 million or 2% of our consolidated assets. Fixed charges is defined in the indenture governing the senior subordinated notes as consolidated interest expense less interest income, adjusted for acquisitions, and further adjusted for non-cash interest expense.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash and cash equivalents, trade accounts receivable, accounts payable, term loan and secured indebtedness. We consider investments in highly liquid instruments purchased with an original maturity of 90 days or less to be cash equivalents. All of our cash equivalents principally consist of money market funds, and are classified as available-for-sale as of January 31, 2011. We are subject to interest rate risk on the variable interest rate of the unhedged portion of the secured term loan. Effective with the expiration of our interest rate swap contract on April 10, 2010, no portion of our variable interest rate secured term loan is hedged and management currently does not intend to enter into any swap contract to hedge any portion of the variable interest rate secured term loan. We do not believe that a hypothetical 25% fluctuation in the variable interest rate would have a material impact on our consolidated financial position or results of operations.

Interest Rate Risk. Historically, our exposure to market risk for changes in interest rates relates primarily to our short and long-term investments and short and long-term debt obligations.

As of January 31, 2011, we had $316.0 million of debt under our senior secured credit agreement. A 1% increase in these floating rates would increase annual interest expense by $3.2 million.

Under our senior secured credit agreement, we were required, within 90 days after the closing date, to fix the interest rate of at least 50% of the aggregate principal amount of indebtedness under our term loan through swaps, caps, collars, future or option contracts or similar agreements. We were also required to maintain this interest rate protection for a minimum of two years.

Consequently, in the second fiscal quarter ended July 31, 2006, we entered into an interest rate swap transaction to effectively convert the variable interest rate on a portion of the $400.0 million senior secured term loan to a fixed rate. The swap, which expired on April 10, 2010, was recorded on the balance sheet at fair value. The swap was not designated as an accounting hedge and, accordingly, changes in the fair value of the derivative were recognized in the consolidated statement of operations. The notional amount of the swap was $250.0 million initially and amortized down over time to $126.0 million at the time the swap transaction expired on April 10, 2010. Under the terms of the swap, we made interest payments based on a fixed rate equal to 5.38% and received interest payments based on the LIBOR setting rate, set in arrears. In the fiscal years ended January 31, 2009 and 2010, we recorded income totaling $2.6 million and $4.3 million, respectively, related to the changes in the fair value of the derivative. We did not enter into a similar interest rate swap in fiscal year 2011 and do not expect to enter into a similar interest rate swap in the future.

Foreign Exchange Risk. Sales to foreign countries accounted for approximately 34%, 32% and 33% of the total sales in the fiscal years ended January 31, 2009, 2010 and 2011, respectively. Because we invoice certain foreign sales in currencies other than the United States dollar, predominantly the British pound sterling and euro, and do not hedge these transactions, fluctuations in exchange rates could adversely affect the translated results of operations of our foreign subsidiaries. Therefore, foreign exchange fluctuations could create a risk of significant balance sheet gains or losses on our consolidated financial statements. In addition, in the past several years we have benefited from the weakness of the U.S. dollar against other currencies, increasing our net revenues derived from international operations. In more recent quarters, the United States dollar appreciated against these foreign currencies, negatively affecting our net revenues. If the U.S. dollar strengthens against foreign currencies, our future net revenues could be adversely affected. However, given our foreign subsidiaries net book values as of January 31, 2011 and net cash flows for the most recent fiscal year ended January 31, 2011, we do not believe that a hypothetical 25% fluctuation in foreign currency exchange rates would have a material impact on our consolidated financial position or results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

FINANCIAL STATEMENTS

Our financial statements required by this item are submitted as a separate section of this Form 10-K. See Item 15(a)1 for a listing of financial statements provided in the section titled, Index to Consolidated Financial Statements.

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SUPPLEMENTARY DATA

Selected Quarterly Financial Data

The following tables set forth quarterly unaudited supplementary data for each of the years in the two-year period ended January 31, 2011. The tables should be read in conjunction with the Consolidated Financial Statements and Notes and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this annual report on Form 10-K.

	Fiscal 2011 Quarter Ended				
	Apr. 30,	Jul. 31, (1)	Oct. 31, (in thousands)	Jan. 31,	Year Ended Jan. 31, (1)
Revenue	$ 51,625	$ 50,264	$ 52,892	$ 59,605	$ 214,386
Cost of revenue	16,055	15,537	16,432	16,747	64,771
Gross profit	35,570	34,727	36,460	42,858	149,615
Operating expenses	37,993	34,832	35,241	38,637	146,703
Operating (loss) income	(2,423)	(105)	1,219	4,221	2,912
Loss before income taxes	(8,380)	(6,504)	(5,342)	(1,767)	(21,993)
Income tax benefit	(4,219)	(3,008)	(4,628)	(582)	(12,437)
Net loss	(4,161)	(3,496)	(714)	(1,184)	(9,556)

	Fiscal 2010 Quarter Ended				
	Apr. 30,	Jul. 31,	Oct. 31, (in thousands)	Jan. 31, (2)	Year Ended Jan. 31, (2)
Revenue	$ 52,784	$ 55,181	$ 55,929	$ 60,120	$ 224,014
Cost of revenue	18,334	18,216	17,923	23,944	78,417
Gross profit	34,450	36,965	38,006	36,176	145,597
Operating expenses	38,475	36,481	38,552	37,926	151,434
Operating (loss) income	(4,025)	484	(546)	(1,750)	(5,837)
Loss before income taxes	(9,132)	(6,576)	(7,399)	(8,620)	(31,727)
Income tax benefit	(4,317)	(5,081)	(1,730)	(7,577)	(18,705)
Net loss	(4,815)	(1,495)	(5,669)	(1,043)	(13,022)

(1) Included in operating expenses is a goodwill impairment charge in the second fiscal quarter ended July 31, 2010 totaling $1.4 million.
(2) Included in cost of revenue is an impairment charge on certain capitalized software related to our on-demand application services in the fourth fiscal quarter ended January 31, 2010 totaling $6.8 million.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, with the assistance of senior management personnel, have conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 15d-15(e) of the Securities Exchange Act of 1934, as amended (Exchange Act)) as of January 31, 2011. We perform this evaluation on a quarterly basis so that the conclusions concerning the effectiveness of our disclosure controls and procedures can be reported in our annual and quarterly reports filed under the Exchange Act. Based on this

evaluation, and subject to the limitations described below, our Chief

Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of January 31, 2011.

Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 15d-15(f) of the Exchange Act) for our company. Management, with the participation of our Chief Executive Officer and Chief Financial Officer, has conducted an evaluation of the effectiveness of our internal control over financial reporting as of January 31, 2011, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, and subject to the limitations described below, management has concluded that our internal control over financial reporting was effective as of January 31, 2011.

This annual report does not include an attestation report of the company s registered public accounting firm regarding internal control over financial reporting. Management s report was not subject to attestation by the company s registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management s report in this annual report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended January 31, 2011 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls

Our management, including our Chief Executive Officer and the Chief Financial Officer, does not expect that our disclosure controls and procedures or internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system reflects resource constraints, and the benefits of controls must be considered relative to their costs. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of error or fraud, if any, have been or will be detected.

ITEM 9B. OTHER INFORMATION

Not applicable.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Our executive officers and directors are as follows:

Name	Age	Position	Director Since
Executive Officers:			
John Nugent	54	President, Chief Executive Officer and Director	2009
Robert I. Pender, Jr.	53	Senior Vice President, Finance and Administration, and Chief Financial Officer	
David Hurwitz	50	Senior Vice President, Worldwide Marketing	
Kamran Kheirolomoom	56	Senior Vice President, SBM Business Unit	
Edward Malysz	51	Senior Vice President, General Counsel and Secretary	
Non-Executive Directors:			
John A. Swainson	56	Chairman of the Board of Directors	2011
L. Dale Crandall	69	Director	2007
Timothy Davenport	55	Director	2008
Elizabeth Hackenson	50	Director	2006
George Kadifa	52	Director	2010
Todd Morgenfeld	39	Director	2009
Douglas D. Troxel	66	Director	1980

Executive Officers

John Nugent has served as a director and our President and Chief Executive Officer since November 2009. From March 2003 to August 2008, Mr. Nugent held various executive management positions at SAP AG, a business and database software company, including Executive Vice President, Worldwide Operations of SAP Business Objects, Chief Operating Officer, Americas, Asia and Japan, and Executive Vice President of Sales and Operations, United States. From April 1986 to March 2003, Mr. Nugent held senior sales management positions with Oracle Corporation, a business and database software company, including Senior Vice President, East Sales, Senior Vice President, General Business and Vice President, Sales.

Robert I. Pender, Jr. has served as our Senior Vice President, Finance and Administration, and Chief Financial Officer since December 1997. From December 1996 until August 1997, Mr. Pender was Vice President, Finance of Mosaix, Inc., a customer interaction software company. From April 1993 until December 1996, Mr. Pender served in a variety of positions, including Chief Financial Officer, with ViewStar Corporation, a client/server workflow software company that was acquired by Mosaix, Inc. in December 1996.

David Hurwitz has served as our Senior Vice President, Worldwide Marketing since February 2010. From August 2005 until January 2010, Mr. Hurwitz served in a variety of senior marketing roles at CA, Inc., an information technology management software company, most recently as Vice President of Corporate Messaging and Solutions Marketing. From February 2003 until August 2005, Mr. Hurwitz served as Chief Marketing Officer of Niku Corporation, a project and portfolio management software company. From February 2001 until December 2002, Mr. Hurwitz served as Vice President, Marketing and Strategy at Perfect Commerce, Inc., an enterprise application software company. From March 2000 until February 2001, Mr. Hurwitz served as Interim Vice President of Marketing at Global Factory, Inc., a manufacturing operations management software company. Mr. Hurwitz previously founded ConsenSys Software Corporation, a product lifecycle management company, and served as a software development engineer at ASK Computer Systems, a manufacturing management software company.

Kamran Kheirolomoom has served as our Senior Vice President, SBM Business Unit since May 2010. From January 2006 until May 2010, Mr. Kheirolomoom served as the Managing Partner of Powershift Partners, a strategic advisory firm specializing in on-demand and services opportunities, which he co-founded in 2006. From March 2003 until March 2005, Mr. Kheirolomoom served as Chairman and Chief Executive Officer of Apptero, Inc., a business application planning software company, which was acquired by Serena in March 2005. From March 1999 to February 2002, Mr. Kheirolomoom served as President and Chief Executive Officer of Kronicle/Avinon, Inc., a web services application software company. From October 1996 to June 1997, Mr. Kheirolomoom served as President of Mosaix, Inc., a customer interaction software company. From March 1986 to May 1996, Mr. Kheirolomoom served as Chairman and Chief Executive Officer of ViewStar Corporation, a provider of business process automation software and services, until its merger with Digital Systems, which together with ViewStar Corporation, became Mosaix Inc.

Edward Malysz has served as our Senior Vice President and General Counsel since April 2006. Mr. Malysz served as Vice President, Legal of Symantec Corporation, a security and storage software company, from July 2005 to April 2006. From April 2002 to July 2005, Mr. Malysz served in various legal roles at VERITAS Software Corporation, a storage software company, including Vice President, Corporate Legal Services. From June 1999 through October 2001, Mr. Malysz served in a variety of roles with E-Stamp Corporation, an Internet postage provider, including Vice President, General Counsel, Secretary and Acting Chief Financial Officer. From July 1993 to June 1999, Mr. Malysz held various legal positions with Silicon Graphics, Inc., a computer manufacturer. Prior to July 1993, Mr. Malysz was a transactional lawyer and a certified public accountant.

Non-Executive Directors

John A. Swainson has served as our Chairman of the board of directors since March 2011. Mr. Swainson is a Senior Advisor of Silver Lake, a private equity firm, which he joined in June 2010. Prior to joining Silver Lake, Mr. Swainson served as Chief Executive Officer of CA, Inc., an information technology management software company, from February 2005 to December 2009, as President and Chief Executive Officer-elect of CA, Inc. from November 2004 to February 2005, and as a director of the board of directors of CA, Inc. from November 2004 to December 2009. Prior to joining CA, Inc., Mr. Swainson served as Vice President of Worldwide Sales and Marketing of the Software Group of IBM from July 2004 through November 2004, and as General Manager of the Application Integration and Middleware division of IBM s Software Group from 1997 to July 2004. Mr. Swainson is a member of the boards of directors of Assurant, Inc., Broadcom Corporation, Visa Inc., and Cadence Design Systems, Inc.

L. Dale Crandall is the founder and president of Piedmont Corporate Advisors, Inc., a private financial consulting firm. Mr. Crandall retired from Kaiser Health Plan and Hospitals in 2002 after serving as the President and Chief Operating Officer from 2000 to 2002 and Senior Vice President and Chief Financial Officer from 1998 to 2000, and served as a member of the board of directors from 1998 until his retirement in 2002. From 1995 to 1998, Mr. Crandall was employed by APL Limited, a global ocean transportation company, where he held the positions of Executive Vice President, Chief Financial Officer and Treasurer. From 1963 to 1995, Mr. Crandall was employed by PricewaterhouseCoopers, LLP, most recently as Southern California Group Managing Partner. Mr. Crandall is also a member of the boards of directors of Ansell Ltd., Bridgepoint Education, Coventry Health Care, Inc. and UnionBanCal Corporation, and is a trustee for Dodge & Cox Mutual Funds. During the past five years, Mr. Crandall also served as a member of the boards of directors of BEA Systems, Inc., Covad Communications, Inc. and Metavante Technologies, Inc.

Timothy Davenport is the President and Chief Executive Officer of Parature, Inc, an on-demand customer service software provider, which he joined in October 2009. From August 2007 through October 2008, Mr. Davenport served as president of Revolution Health Networks, an on-line provider of consumer-centric health care services. Prior to joining Revolution Health Networks, Mr. Davenport served as chief executive officer of Vastera Inc., a provider of international trade logistics software, from November 2003 to June 2005,

and chief executive officer of Best Software Inc., a provider of corporate resource management software solutions, from June 1995 to February 2000.

Elizabeth Hackenson is the Senior Vice President and Chief Information Officer for AES Corporation, a global power company. Prior to joining AES in October 2008, Ms. Hackenson held the position of Senior Vice President and Chief Information Officer for Alcatel Lucent, a telecommunications company. Prior to joining Alcatel Lucent in December 2006, Ms. Hackenson served as Senior Vice President and Chief Information Officer for Lucent Technologies, a telecommunications company, since April 2006. From 2001 to 2006, Ms Hackenson served in various management positions at MCI, a telecommunications company, including Executive Vice President and Chief Information Officer. From 1997 to 2001, Ms. Hackenson served in various management positions with UUNET Technologies, an Internet service and technology provider. Prior to 1997, Ms. Hackenson served in various management positions with Concert Communications, EDS, Computech, TRW and Grumman & Sperry.

George Kadifa is a Director of Silver Lake, a private equity firm, which he joined in June 2007. From March 2005 to June 2007, Mr. Kadifa held various senior management positions at IBM, most recently as Vice President of Global Delivery at IBM Global Technology Services. From August 1999 to March 2005, Mr. Kadifa held senior management positions with Corio, Inc., including Chairman and Chief Executive Officer, prior to its acquisition by IBM. From August 1992 to August 1999, Mr. Kadifa served as Senior Vice President of the Industrial Sector at Oracle Corporation. Prior to August 1992, Mr. Kadifa served as a management consultant with Booz-Allen & Hamilton and a development manager with Xerox Corporation.

Todd Morgenfeld is a Director of Silver Lake, a private equity firm. Prior to joining Silver Lake in May 2004, Mr. Morgenfeld was an investment banker in the Technology, Media and Telecommunications Group at Goldman, Sachs & Co. From May 1994 to May 1999, Mr. Morgenfeld served as an armor officer in the U.S. Army.

Douglas D. Troxel is the founder of Serena and has served on our board of directors since April 1980. He has also served as our Chief Technology Officer from April 1997 until the completion of the merger in March 2006. From June 1980 to April 1997, Mr. Troxel served as our President and Chief Executive Officer. Mr. Troxel served as chairman of our board of directors from April 1980 until the completion of the merger in March 2006. Mr. Troxel continues to serve as an employee of the company for purposes of providing technical services related to the support of our mainframe software products.

Board Composition and Governance

The composition of our board of directors is established by the terms of a stockholders agreement entered into by Spyglass Merger Corp., Silver Lake and certain investors affiliated with Silver Lake, referred to as the Silver Lake investors, and Mr. Troxel and certain investors affiliated with Mr. Troxel, referred to as the Troxel investors. Among other things, the stockholders agreement provides that, prior to any change of control event or initial public offering, our board of directors will be composed of the following persons:

- our Chief Executive Officer,
- Douglas D. Troxel and one other board member designated by the Troxel investors, who is currently Ms. Hackenson, and
- the remaining board members designated by affiliates of Silver Lake, who are currently Messrs. Swainson, Crandall, Davenport, Kadifa and Morgenfeld.

Mr. Swainson serves as chairman of the board and presides over each meeting of the board of directors. We believe that the separation of the roles of chairman of the board and principal executive officer are appropriate for our company because of our ownership structure. We have established four committees of the board of directors, consisting of an audit committee, a compensation committee, a nominating committee and a strategic

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and operations committee. Our audit committee is comprised of Messrs. Crandall (chairperson), Davenport and Morgenfeld. Our compensation committee is comprised of Messrs. Swainson (chairperson), Morgenfeld and Troxel. Our nominating committee is comprised of Messrs. Troxel (chairperson) and Swainson and Ms. Hackenson. Our strategic and operations committee is comprised of Ms. Hackenson (chairperson) and Messrs. Davenport and Kadifa.

Our board of directors has determined that Messrs. Crandall and Davenport and Ms. Hackenson qualify as independent directors within the meaning of Nasdaq Marketplace Rule 5605(a).

Our board of directors has determined that Mr. Crandall qualifies as an audit committee financial expert within the meaning of Item 407(d)(5) of Regulation S-K. For information regarding the relevant experience of Mr. Crandall, see *Non-Executive Directors* above. Our board of directors has also determined that Messrs. Crandall and Davenport qualify as independent audit committee members within the meaning of Rule 10A-3 of the Securities Exchange Act of 1934 and Nasdaq Marketplace Rule 5605(c). Mr. Morgenfeld is not an independent audit committee member because of his affiliation with the Silver Lake investors, which hold a 67.2% equity interest in our company.

In accordance with the charter of our nominating committee, to the extent consistent with the stockholders agreement, our nominating committee will identify, recommend and recruit qualified candidates to fill new positions on the board of directors and will conduct the appropriate and necessary inquiries into the backgrounds and qualifications of possible candidates. In March 2011, Mr. Swainson was elected to serve as a director in accordance with the terms of the stockholders agreement.

Our directors possess high ethical standards, act with integrity and honesty and exercise sound business judgment, and each of our directors is committed to employing his or her skills and abilities in the best interests of our stockholders. The directors designated by the Silver Lake investors possess significant experience in owning and overseeing companies similar to our company and are familiar with corporate finance, strategic and operational business planning and matters consistent with the long-term interests of our shareholders.

Our board of directors is responsible for overseeing material risks associated with our company, and exercises these responsibilities periodically as part of its meetings and through its committees. In addition, the consideration of risk is inherent in the board of directors review of our long-term strategies and other matters presented to the board of directors, including acquisitions and financial matters. The role of the board of directors in risk oversight is consistent with our leadership structure, with our President and Chief Executive Officer and other senior management personnel having responsibility for assessing and managing risks on a day-to-day basis, and the board of directors and its committees providing general oversight in connection with these efforts.

We have adopted a Financial Code of Ethics that is applicable to our chief executive officer, chief financial officer, principal accounting officer (who is currently also our chief financial officer) and other senior officers of our finance department. We have filed a copy of our Financial Code of Ethics as Exhibit 14.1 to this Annual Report on Form 10-K. A free copy of our Financial Code of Ethics may be obtained from our Investor Relations website located at *www.serena.com* or by directing a written request to Serena Software, Inc., 1900 Seaport Boulevard, Redwood City CA 94063 Attn: General Counsel and Secretary.

Director Compensation

Our board of directors has adopted a cash and equity compensation program for directors who qualify as independent directors within the meaning of Nasdaq Marketplace Rule 5605(a). The cash compensation component of the program consists of an annual retainer of $40,000, annual retainers of $10,000 for the chairperson of the audit committee and $5,000 for each chairperson of the other committees of the board of directors, and annual retainers of $5,000 for each other member of the audit committee and $2,500 for each other member of the other committees of the board of directors, payable in equal installments on a quarterly basis. The

equity compensation component of the program consists of an initial stock option grant to acquire 40,000 shares of our common stock under our 2006 Stock Incentive Plan, with an exercise price equal to the fair market value of the common stock on the date of grant and vesting over a three year period, and an initial award of 25,000 restricted stock units under our 2006 Stock Incentive Plan, with vesting in full on the third anniversary of the date of grant and formulaic vesting upon a change of control or an initial public offering. In addition, the equity compensation component of the program consists of an annual stock option grant to acquire 15,000 shares of common stock under the 2006 Stock Incentive Plan, with an exercise price equal to the fair market value of the common stock on the date of grant and vesting on the first anniversary of the date of grant. For a discussion regarding the 2006 Stock Incentive Plan and the type and terms of the equity awards under the plan, see Item 11, *Executive Compensation Compensation Discussion and Analysis Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan* below.

In addition, we compensate Mr. Troxel for technical services that he occasionally provides to us in connection with the support of our mainframe software products. Mr. Troxel is paid $25,000 per year for these services. Mr. Troxel also receives certain employee benefits, such as health care coverage and participation in our 401(k) plan, and reimbursement of premiums associated with a separate life insurance policy.

The compensation for our directors for fiscal year 2011 is shown in the table in Item 11, *Executive Compensation Director Compensation.*

ITEM 11. EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

This section discusses the principles underlying our executive compensation policies and decisions. It provides qualitative information regarding the manner in which compensation is earned by our executive officers and places in context the data presented in the tables below. In addition, we discuss the compensation paid or awarded during fiscal year 2011 to our chief executive officer (principal executive officer), our chief financial officer (principal financial officer), a former executive officer and three other executive officers who were our most highly compensated executive officers in fiscal year 2011. We refer to these six executive officers as our Named Executive Officers.

Our executive compensation program is overseen and administered by the compensation committee of our board of directors. The compensation committee operates under a written charter adopted by our board of directors and has the responsibility for discharging the responsibilities of the board of directors relating to the review of the compensation of our executive officers, making recommendations regarding the compensation of our chief executive officer to our non-executive directors for approval and approving the compensation of our other executive officers. Our compensation committee and the non-executive directors exercise their discretion in accepting, modifying or rejecting management s recommendations regarding executive compensation.

Objectives of Our Compensation Program

Our executive compensation program is intended to meet three principal objectives:

- to provide competitive compensation packages to attract and retain superior executive talent;
- to reward successful performance by the executive and the company by linking a significant portion of compensation to our financial results; and
- to align the interests of executive officers with those of our stockholders by providing long-term equity compensation and meaningful equity ownership.

To meet these objectives, our compensation program balances short-term and long-term goals and mixes fixed and at-risk compensation related to the overall financial performance of the company.

Our compensation program for executive officers, including the Named Executive Officers, is generally designed to reward the achievement of targeted financial goals. The compensation program is intended to reinforce the importance of performance and accountability at various operational levels, and a significant portion of total compensation is in both cash and stock-based compensation incentives that reward performance as measured against established corporate goals, such as EBITA in our annual operating plan. EBITA represents earnings before interest, taxes and amortization. Each element of our compensation program is reviewed individually and considered collectively with the other elements of our compensation program to ensure that it is consistent with the goals and objectives of both that particular element of compensation and our overall compensation program.

Elements of Our Executive Compensation Program

Overview

For fiscal year 2011, the principal elements of compensation for our executive officers included:

- annual cash compensation consisting of base salary and performance-based incentive bonuses
- long-term equity incentive compensation
- health and welfare benefits
- severance or change of control benefits

Annual Cash Compensation

For fiscal year 2011, our General Counsel developed recommendations regarding executive compensation based on the compensation survey data and proxy analysis described below and then reviewed the recommendations with our Chief Executive Officer. Our Chief Executive Officer, Chief Financial Officer and General Counsel presented and discussed the recommendations with our compensation committee. None of these executive officers had input into determining their own level of compensation. Our compensation committee then met in executive session to discuss management s recommendations outside of the presence of management, and communicated its recommendations to our non-executive directors for their review, discussion and approval.

In assessing compensation for our executive officers, we used compensation survey data for a broad set of companies having a comparable business, size and complexity, and then compared the survey data to publicly available compensation data for a group of companies that we consider to be our peer group. We believe that the compensation practices of these companies provide us with appropriate benchmarks because these companies provide technology products and services and compete with us for executives and other employees. The survey data was derived from the Radford Executive Benchmark Survey, and included data relative to the overall software industry and certain industry segments defined by the survey company, including software companies with revenue from $200 million to $500 million, software companies with revenue from $200 million to $1 billion, and software companies comprising our peer group. The peer group was initially selected by management based on companies that compete with us in the same markets in which we sell our products, are within the software industry and of comparable size and complexity, or compete with us in recruiting executives and employees. Our compensation committee reviewed and provided input to management regarding the companies comprising the peer group. The proxy analysis was based on companies comprising our peer group, excluding those companies for which public information is not available. Because the proxy analysis was limited to publicly available information and did not provide precise comparisons by position as offered by the more comprehensive survey data from Radford, we used the proxy analysis as a general benchmark to validate the results of the survey data. We then compared base salary and total cash compensation to survey data relative to the overall software industry and our peer group.

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The following companies comprised our peer group for fiscal year 2011:

Actuate	Equinix	SPSS
Advent Software	Informatica	Sumtotal Systems
Ariba	Kana Software	Tibco Software
Aspect Software	MSC Software	Trend Micro
Blue Coat Systems	Progress Software	Vignette
Borland Software	QAD	Websense
Digital River	Rovi (Macrovision)	Wind River Systems
Epicor Software		

Our annual cash compensation for executive officers includes base salary and performance-based cash compensation. For fiscal year 2011, we generally established annual base salaries at approximately the 50th percentile of market compensation based on survey data for the overall software industry and our peer group, and target total cash compensation (assuming 100% of the target performance-based incentive bonus is earned) at approximately the 60th percentile of market compensation based on this survey data. In order to attract our President and Chief Executive Officer to join our company in November 2009, we agreed to pay Mr. Nugent an annual base compensation and target total cash compensation that were in excess of the 50th percentile and 60th percentile, respectively, of market compensation for chief executive officers within our peer group. For fiscal year 2011, Mr. Nugent s annual base compensation was approximately 16% above the 50th percentile and his target total cash compensation was approximately 6% above the 60th percentile of market compensation for chief executive officers within our peer group. The base compensation and target total cash compensation for our other executive officers were generally at or near the 50th percentile for annual base compensation and the 60th percentile for total cash compensation for similar executive roles within our peer group. In establishing the base salary and target total cash compensation for each individual, we also considered the individual s performance, achievement of management objectives and contributions to our overall business. From a market compensation perspective, we weight cash compensation more heavily toward performance-based compensation and less toward base salary because we wish to pay for performance.

Our FY 2011 Executive Annual Incentive Plan was designed to reward our executives for the achievement of annual financial targets and management objectives. For fiscal year 2011, the executive officers were eligible to receive performance-based incentive bonuses with target bonuses based on a percentage of the participant s annual base salary, as follows: (i) with regard to our President and Chief Executive Officer, 100% of his annual target bonus; (ii) with regard to our Senior Vice President, Chief Financial Officer, 75% of his annual base salary; (iii) with regard to our Senior Vice President, SBM Business Unit, 40% of his annual base salary; and (iv) with regard to our other executive officers, 50% of their respective annual base salaries. The actual bonus amounts were subject to achievement of the following performance metrics: (i) with regard to our President and Chief Executive Officer and our Senior Vice President, Chief Financial Officer, achievement of our annual EBITA target for fiscal year 2011; (ii) with regard to our Senior Vice President, Worldwide Marketing, achievement of our semi-annual EBITA targets in fiscal year 2011 and management objectives, weighted at 66.7% and 33.3%, respectively; (iii) with regard to our Senior Vice President, SBM Business Unit, achievement of our semi-annual EBITA targets for fiscal year 2011 and an individual performance objective focused on SBM license revenue, weighted equally at 50%; and (iv) with regard to our Senior Vice President, General Counsel and Secretary, achievement of our semi-annual EBITA targets in fiscal year 2011 and management objectives, weighted equally at 50%. At the beginning of the fiscal year 2011, our board of directors established EBITA targets of $89.2 million for the fiscal year and $38.6 million for the first half of the fiscal year. The above metrics were used to align the performance of each executive officer with objectives related to the company and their respective functional areas.

The primary financial metric under each of the individual executive annual incentive plans is EBITA. EBITA was selected as the most appropriate measure upon which to base the annual incentive because it represented an important overall performance metric that our board of directors, management, investors and

lenders use to evaluate the performance and value of our company. For bonus amounts based on the achievement of EBITA and payable to our executive officers other than our Senior Vice President, SBM Business Unit, achievement of less than 85% of EBITA would result in no payout of the applicable target bonus, achievement of 85% of EBITA would result in a 25% payout of the applicable target bonus, achievement of 100% of EBITA would result in a 100% payout of the applicable target bonus and achievement of 115% of EBITA would result in a 200% payout of the applicable target bonus. For our Senior Vice President, SBM Business Unit, achievement of less than 85% of EBITA would result in no payout of the applicable target bonus, achievement of 85% of EBITA would result in a 70% payout of the applicable target bonus, achievement of 100% of EBITA would result in a 100% payout of the applicable target bonus and achievement of 115% of EBITA would result in a 235% payout of the applicable target bonus. For all of our executive officers other than our Senior Vice President, SBM Business Unit, annual payouts based on the achievement of EBITA were capped at 200% of the applicable portion of the executive officer s incentive bonus. For our Senior Vice President, SBM Business Unit, the annual payout was capped at 235% of the applicable portion of the executive officer s incentive bonus. In order to attract our Senior Vice President, SBM Business Unit to join our company in May 2010, we agreed to the payout scale described above and guaranteed his bonus payout at 50% of his prorated target bonus during the first twelve months of his employment. The incentive bonuses were paid on an annual basis for our President and Chief Executive Officer and Senior Vice President, Chief Financial Officer and on a semi-annual basis for our other executive officers.

For fiscal year 2011, we achieved 94% of our annual EBITA target, which resulted in the payout of 70% of EBITA-based target bonuses based on the payout scale described above. For fiscal year 2011, we paid our President and Chief Executive Officer, Senior Vice President, Chief Financial Officer, Senior Vice President, Worldwide Marketing, and Senior Vice President, General Counsel incentive bonuses equal to 70%, 70%, 80%, and 85%, respectively, of their annual target bonuses based on the achievement of EBITA and applicable management objectives during the fiscal year. With regard to our Senior Vice President, SBM Business Unit, the achievement of 94% of our annual EBITA target resulted in an 88% payout of the allocable portion of his target bonus, and the achievement of less than 85% of his individual performance objective related to *SBM* license revenue resulted in no payout of the allocable portion of his target bonus. Based on our agreement with our Senior Vice President, SBM Business Unit at the time of his employment, we paid out 50% of his prorated target bonus for fiscal year 2011. In addition, we paid our Senior Vice President, SBM Business Unit a discretionary bonus of $18,400 to reflect his contributions to the company during the fiscal year and an annual payout level consistent with similarly situated executive officers. The payouts for our Senior Vice President, Worldwide Marketing and Senior Vice President, SBM Business Unit were prorated based on their terms of service during fiscal year 2011.

Base salaries and performance-based incentive bonuses for the Named Executive Officers for fiscal years 2011, 2010 and 2009 are shown in the *Summary Compensation Table* below.

Long-Term Equity Compensation

We intend for our option program to be the primary vehicle for offering long-term incentives and rewarding our executive officers, managers and key employees. Because of the direct relationship between the value of an option and the value of our stock, we believe that granting options and awarding restricted stock units are methods to motivate our executive officers to manage our company in a manner that is consistent with the interests of our company and our stockholders. We also regard our option program as a key retention tool. Retention is an important factor in our determination of the number of underlying shares to grant.

Following the completion of the merger, we established a new stock incentive plan, the 2006 Stock Incentive Plan, which governed, among other things, the grant of options, restricted stock and other equity-based awards. Stock options granted under the plan included time-based options that would vest and become exercisable over a four-year period and performance-based options that would vest and become exercisable

based on the achievement of annual EBITA targets over a five-year period. We generally weight stock option grants to executive officers more heavily toward performance-based options and less toward time-based options because we wish to pay for performance.

For executive officers who joined the company after the merger, we granted stock options to these executive officers shortly after the commencement of their employment with the company. The type and amount of these options were approved by the compensation committee or, in the case of our President and Chief Executive Officer, by the non-executive directors of our board of directors. The total number of shares under these options were determined based on a number of factors, including the existing equity compensation arrangements of the executive officer with his then current employer, the amount of stock options previously granted to other executive officers of the company, the compensation practices within the industry based on recommendations of professional recruiters, the knowledge and experiences of the members of our compensation committee and non-executive directors, and our negotiations with the executive officer. We do not generally grant stock options to executive officers on an annual basis.

On October 16, 2009, we completed a tender offer permitting all eligible employees (including our executive officers) and independent directors of the company to exchange, on a one-for-one basis, stock options granted under the 2006 Stock Incentive Plan for new stock options granted under Serena s Amended and Restated 2006 Stock Incentive Plan (as amended and restated, the 2006 Stock Incentive Plan) having a lower exercise price and different vesting terms. We refer to this tender offer as our October 2009 option exchange. Recent developments in the global economy and the global software industry in which we operated had adversely affected our business and resulted in our existing stock options having a per-share exercise price significantly in excess of the then current per-share fair market value of our common stock or certain vesting terms that would be difficult to achieve. As part of a review of our executive compensation and employee benefit arrangements on behalf of and under the supervision of our board of directors, and in light of the economic conditions in which we operate, our board of directors determined that new options with different vesting terms and a lower per-share exercise price would be better suited to retain and motivate employees and better align the interests of our employees and stockholders to meet our strategic and operational objectives and maximize stockholder value. For similar reasons, our board of directors also determined to award restricted stock units to certain senior management personnel (including our executive officers). We decided to award restricted stock units to our senior management personnel because, in contrast to stock options, restricted stock units maintain economic value even if the fair market value of our common stock were to decline. As a result, restricted stock units generally have significant retention value throughout their vesting period. Restricted stock units also align senior management personnel with our stockholders and balance our compensation program design, as restricted stock units take into account both upside and downside risk in the fair market value of our common stock. We awarded fewer restricted stock units than the number of shares under stock options because the grant date fair value of each restricted stock unit was greater than the grant date fair value of each stock option on a per share basis.

Pursuant to our October 2009 option exchange, eligible employees (including our executive officers) and independent directors were entitled to exchange their existing time-based options, and eligible employees (excluding officers) were entitled to exchange their performance-based options, on a one-for-one basis for new time-based options with a vesting period of generally three years and an exercise price of $3.00 per share, which was the fair market value of our common stock after the closing of the tender offer. Officers (including our executive officers) of the company were entitled to exchange their performance-based options on a one-for-one basis for new performance-based options having a vesting period of three years and six months, with vesting based on the achievement of EBITA targets established by our board of directors and an exercise price of $3.00 per share, which was the fair market value of our common stock after the closing of the tender offer. For a discussion regarding the terms of the new time-based and performance-based options, see *Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan.*

In September 2009, we awarded restricted stock units under our 2006 Stock Incentive Plan to certain senior management personnel (including our executive officers) and key employees. In November 2009, we awarded

restricted stock units under our 2006 Stock Incentive Plan to our President and Chief Executive Officer as part of his employment agreement with us and to our independent directors as part of our independent director compensation program. Pursuant to the terms of the restricted stock unit agreements, these individuals will be entitled to receive an equivalent number of shares of our common stock upon the expiration of a three year restricted period, provided that their employment or period of service with us continues throughout the restricted period. For a discussion regarding the terms of the new time-based and performance-based options, see *Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan.*

Benefits

We offer a variety of health and welfare programs to all eligible employees, including our executive officers. Our executive officers, including our Named Executive Officers, are generally eligible for the same benefit programs on the same basis as the rest of our employees, including medical and dental care coverage, life insurance coverage, short- and long-term disability and a 401(k) plan. We discontinued our 401(k) matching contribution program for all of our employees, including our executive officers, in May 2009. We do not provide perquisites as part of our executive compensation program.

Employment Agreements and Severance and Change of Control Benefits

Employment Agreement with our Chief Executive Officer

We entered into an employment agreement with Mr. Nugent dated October 28, 2009 for Mr. Nugent to serve as our President and Chief Executive Officer. The employment agreement is for an indefinite term, and either Mr. Nugent or the company may terminate his employment for any reason and at any time with or without cause or notice. The employment agreement provides for an annual base salary of $550,000. Mr. Nugent was also eligible to receive an annual cash incentive bonus equal to 100% of his base salary pursuant to our FY 2010 Executive Annual Incentive Plan, subject to proration based on his term of service during the fiscal year. As part of his relocation to the area of our corporate headquarters in Redwood City, California, Mr. Nugent was entitled to receive reimbursement of up to $65,000 of eligible moving and relocation-related expenses. The employment agreement also provided for certain severance benefits if Mr. Nugent s employment is terminated by us without cause or by Mr. Nugent for good reason within the first twelve months of his employment with the company, which arrangement has since expired pursuant to its terms. In addition, Mr. Nugent is eligible to receive severance benefits if his employment is terminated within twelve months of a change in control of the company, the terms of which are discussed under *Change of Control Agreements* below.

Employment Agreement with our Chief Financial Officer

We entered into an employment agreement with Mr. Pender dated March 10, 2006 and effective as of the closing of the merger. The employment agreement is for an indefinite term, and either Mr. Pender or the company may terminate his employment for any reason and at any time with or without cause or notice. The employment agreement provides for an annual base salary of $290,000 per annum, subject to periodic reviews and possible increases as determined by our board of directors. We are required to provide Mr. Pender with the opportunity to earn cash performance bonuses of up to 100% of his annual base salary based upon the achievement of quarterly or annual performance targets established by our board of directors. In February 2009, we agreed with Mr. Pender to increase his annual base salary to $325,000 per year and decrease his annual incentive compensation to $243,750 so that his compensation plan was more consistent with the overall structure of our executive compensation program.

If Mr. Pender is involuntarily terminated without cause or if he resigns for good reason, Mr. Pender will be entitled to the following severance benefits: continuation of his base salary for a period of twenty-four months following termination of employment, payable over such period in accordance with the company s normal payroll practices; continued health care coverage for a period of twenty-four months following termination of

employment; and six months of additional vesting of his time-based options. These severance benefits are contingent on Mr. Pender s execution of a release of claims and compliance with certain restrictive covenants, including non-competition and non-solicitation arrangements, covering the duration of his salary continuation period.

For a discussion regarding the terms of our change of control arrangement with Mr. Pender, see *Change of Control Agreements.*

Employment Agreements with our other Executive Officers

Messrs. Hurwitz, Kheirolomoom and Malysz each entered into change of control agreements with us, the terms of which are discussed under the section entitled *Change of Control Agreements* below.

Severance Agreement with our Former Senior Vice President, Products and Worldwide Customer Service

Mr. Theobald s employment with us terminated effective as of February 2, 2011. In connection with the termination of Mr. Theobald s employment, we entered into a separation agreement providing for the payment of severance and the provision of certain benefits to Mr. Theobald in exchange for a general release of claims against us and our affiliates. The separation agreement provides for severance benefits consisting of (i) the continuation of twenty percent of Mr. Theobald s base salary for a period of six months following the termination of his employment, payable in equal installments over such period in accordance with Serena s customary payroll practices; (ii) COBRA continuation of Mr. Theobald s then-existing health coverage for a period of six months following the month in which his employment terminated, at no cost to Mr. Theobald; (iii) payment of a portion of Mr. Theobald s annual incentive bonus to the extent earned but not yet paid under Serena s FY 2011 Executive Annual Incentive Plan, calculated and paid in accordance with the terms of the plan; and (iv) the amendment of certain stock options previously granted to Mr. Theobald under Serena s Amended and Restated 1997 Stock Option and Incentive Plan for purposes of extending the post-employment exercise period to three years and allowing for the payment of the aggregate exercise price through the net exercise of the stock options. The separation agreement also provides for the payment of restrictive covenant payments that are conditioned upon Mr. Theobald s compliance with no-hire and non-competition covenants. The restrictive covenant payments consist of the continuation of eighty percent of Mr. Theobald s base salary for a period of six months following the termination of his employment, payable in equal installments over such period in accordance with Serena s customary payroll practices. Mr. Theobald executed a general release of all claims in favor of Serena and its affiliates and agreed to comply with certain restrictive covenants, including confidentiality and non-disparagement covenants of unlimited duration, and no-hire and non-competition covenants limited to the duration of the restrictive covenant payments. Mr. Theobald also agreed to the cancellation of his vested stock options under the 2006 Stock Incentive Plan as of the termination of his employment.

Restricted Stock Purchase Agreement

In connection with the closing of the merger, we entered into a restricted stock agreement with Mr. Pender dated as of March 10, 2006 and issued Mr. Pender 307,200 shares of our common stock. Pursuant to the terms of the restricted stock agreement, the restricted stock award vested in full on June 16, 2010, and Mr. Pender transferred 112,681 shares of the company s common stock to us for purposes of paying applicable income tax withholdings resulting from the vesting of the restricted stock.

2006 Stock Incentive Plan

Following the completion of the merger, we established the 2006 Stock Incentive Plan, which governs, among other things, the grant of options, restricted stock units and other equity-based awards, covering shares of the company s common stock to our employees (including officers), directors and consultants. Common stock of

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the company representing 12% of outstanding common stock on a fully diluted basis as of the date of the merger (13,515,536 shares) was reserved for issuance under the plan. Each award under the plan specifies the applicable exercise or vesting period, the applicable exercise or purchase price, and such other terms and conditions as deemed appropriate. Stock options granted under the plan were either time-based options that would vest and become exercisable over a four-year period or performance-based options that would vest based on the achievement of EBITA targets over a period of five fiscal years. Performance-based options would vest based on the achievement of minimum and maximum EBITA targets during each fiscal year over a period of five fiscal years, with 10% vesting for the achievement of the minimum EBITA target and up to 20% vesting for the achievement of the maximum EBITA target for each such fiscal year. All options granted under the plan will expire not later than ten years from the date of grant, but generally will terminate earlier upon termination of employment. In the event of a sale of substantially all of the assets of the company, or a merger or acquisition of the company, the board of directors may provide that awards granted under the plan will be cashed out, continued, replaced with new awards that substantially preserve the terms of the original awards, or terminated, with acceleration of vesting of the original awards determined at the discretion of the board of directors.

On October 16, 2009, we completed a tender offer permitting all eligible employees (including our executive officers) and independent directors of the company to exchange, on a one-for-one basis, stock options granted under the 2006 Stock Incentive Plan for new stock options granted under the 2006 Stock Incentive Plan having a lower exercise price and different vesting terms. Pursuant to the October 2009 option exchange, eligible employees (including our executive officers) and independent directors were entitled to exchange their existing time-based options on a one-for-one basis for new time-based options with a vesting period of generally three years and an exercise price of $3.00 per share, which was the fair market value of our common stock after the closing of the tender offer. Existing time-based options held by our independent directors that had a vesting period of one year were exchanged for new time-based options having a vesting period of one year. All new time-vesting options will vest in full upon a change in control. Officers (including our executive officers) of the company were entitled to exchange their performance-based options on a one-for-one basis for new performance-based options having a vesting period of three years and six months, with vesting based on the achievement of EBITA targets established by our board of directors and an exercise price of $3.00 per share, which was the fair market value of our common stock after the closing of the tender offer. These new performance-based options will vest as follows: one-seventh upon achievement of the EBITA target for the second half of fiscal year 2010, and the remainder in equal annual installments upon the achievement of EBITA targets for each of fiscal years 2011, 2012 and 2013. New performance-based options issued during fiscal year 2011 will vest as follows: equal annual installments upon the achievement of EBITA targets for each of fiscal years 2011, 2012 and 2013. The EBITA target for the second half of fiscal year 2010 was $47.4 million and the EBITA targets for each of fiscal years 2011, 2012 and 2013 are $97.3 million, $107.0 million and $113.2 million, respectively. New performance-based options are subject to catch-up vesting for previously unachieved performance criteria in the event of a change in control or an initial public offering in which the company is valued at no less than $5.00 per share of common stock (as adjusted for stock splits, reverse stock splits, reorganizations, reclassifications or similar transactions, in accordance with the 2006 Stock Incentive Plan), as if the options had vested in equal monthly installments on a time-vesting basis from the date of grant. New performance-based options will also vest in full if a change in control occurs and the optionholder s employment is terminated by us without cause, or the optionholder resigns for good reason, within twelve months after the change in control. As a result of achieving our EBITA target for the second half of fiscal year 2010, one-seventh of the shares under applicable performance-based options vested. We did not achieve our EBITA target for fiscal year 2011 and, as a result, no portion of the shares under performance-based options vested for this period.

In September and November 2009, we awarded restricted stock units to certain employees (including our executive officers) and independent directors under our 2006 Stock Incentive Plan. We have also issued restricted stock units to new officers (including new executive officers) who joined us during fiscal year 2011. Pursuant to the terms of the restricted stock unit agreements, these individuals will be entitled to receive an equivalent number of shares of our common stock upon the expiration of a three year restricted period, provided that their employment or period of service with us continues throughout the restricted period. If a change in

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control or initial public offering occurs during the restricted period, and the price per share of our common stock at the time of such event (as adjusted for stock splits, reverse stock splits, reorganizations, reclassifications or similar transactions, in accordance with the 2006 Stock Incentive Plan): (i) is greater than or equal to $4.00 but less than $4.50, then 25% of the restricted stock units will vest; (ii) is greater than or equal to $4.50 but less than $5.00, then 50% of the restricted stock units will vest, or (iii) is greater than or equal to $5.00, then 100% of the restricted stock units will vest. In addition, if the average of the closing sales prices of our common stock during any consecutive 90 calendar day period following an initial public offering satisfies a higher vesting threshold, then the restricted stock units will vest based on the achievement of the higher vesting threshold.

Rollover Options

In connection with the merger, various management participants were permitted to elect to continue some or all of their stock options that were held immediately prior to the merger and had an exercise price of less than $24.00 per share. The number of shares subject to these rollover options was adjusted to be the number of shares equal to the product of (i) the difference between $24.00 and the exercise price of the option and (ii) the quotient of the total number of shares of the company s common stock subject to such option, divided by $3.75. The exercise price of these rollover options was adjusted to $1.25 per share. The rollover options are subject to the terms of the original option agreements with the company, except that in the event of a change of control of the company, the treatment of the rollover options upon such transaction will be determined in accordance with the terms of the 2006 Stock Incentive Plan.

Change of Control Agreements

We have entered into change of control arrangements with our executive officers to provide them with economic protection in order to allow them to remain focused on our business without undue personal concern in the event that an executive officer s position is eliminated or significantly altered following a change of control.

Messrs. Nugent, Hurwitz, Kheirolomoom and Malysz each entered into change of control agreements with us. Under the terms of these agreements, in the event of a change of control of the company, if the executive officer s employment is involuntarily terminated without cause or if the executive officer resigns for good reason within twelve months after consummation of a change of control of the company, the executive officer will be entitled to receive the following severance benefits: (i) continuation of base salary for one year following termination, payable over the one-year period in accordance with the company s normal payroll practices; (ii) 100% of the executive officer s target bonus, payable within forty-five days following the applicable fiscal year; (iii) a pro-rated amount of the executive officer s target bonus based upon the number of days that have elapsed in the fiscal year as of the termination date, payable within thirty days following the executive officer s termination date; and (iv) payment of health coverage premiums for the one-year salary continuation period. In order to receive these change of control benefits, the executive must execute a general release of claims in favor of the surviving company and its affiliates and comply with various restrictive covenants during the applicable severance period, including non-disparagement, non-compete and non-solicitation covenants. The non-competition, non-solicitation and non-disparagement covenants continue for the one-year salary continuation period. The confidentiality covenant is not limited in duration.

Pursuant to the terms of Mr. Pender s employment agreement with us, in the event that Mr. Pender is involuntarily terminated without cause or if he resigns for good reason in the one-month period prior to or the thirteen-month period following a change of control of the company, Mr. Pender will be entitled to receive the following benefits: (i) continuation of his base salary for a period of twenty-four months following his termination date, payable over the salary continuation period in accordance with the company s normal payroll practices; (ii) continuation of his quarterly or annual target bonus, as the case may be, for a period of twenty-four months following his termination date, payable in accordance with the company s normal payroll practices; (iii) a pro-rated amount of his target bonus that he would have been entitled to receive for the quarter or year, as the case may be, in which such termination of employment occurs, payable at the time that the company would

ordinarily have made such bonus payment; and (iv) continued health care coverage for a period of twenty-four months following termination of employment. In order to receive these change of control benefits, Mr. Pender must execute a general release of claims in favor of the surviving company and its affiliates and comply with various restrictive covenants during the applicable severance period, including non-compete and non-solicitation covenants. The duration of the non-competition and non-solicitation covenants is twenty-four months following the termination of his employment. The confidentiality covenant is not limited in duration.

For change of control arrangements related to stock options and restricted stock units awarded to our Named Executive Officers, see *2006 Stock Incentive Plan* above.

Accounting and Tax Implications

The accounting and tax treatment of particular forms of compensation do not materially affect our compensation committee s decisions. However, we evaluate the effect of such accounting and tax treatment on an ongoing basis and will make appropriate modifications to compensation policies where appropriate.

Stock Ownership

We do not have a formal policy requiring stock ownership by management.

Equity Grant Practices

All grants of stock options under the 2006 Stock Incentive Plan have had exercise prices equal to the fair market value of our common stock on the date of grant. Because the company is a privately-held company and there is no market for our common stock, the fair market value of our common stock is determined by our compensation committee based on available information that is material to the value of our common stock. We obtain an external valuation specialist of our common stock on an annual basis and update the independent valuation on a semi-annual basis.

Our compensation committee approves stock option grants and any restricted stock unit awards at either a regularly scheduled compensation committee meeting or by a unanimous written consent signed by all of the members of our compensation committee. All stock options are granted as of the date of the meeting or upon execution of the unanimous written consent. We generally grant stock options and award any restricted stock units on a quarterly basis.

Compensation Committee Report

We have reviewed and discussed the foregoing Compensation Discussion and Analysis with management. Based on our review and discussion with management, we have recommended to our board of directors that the Compensation Discussion and Analysis be included in this annual report on Form 10-K.

John A. Swainson, Chairperson*

Todd Morgenfeld

Douglas D. Troxel

* Mr. Swainson became a member of the Compensation Committee on March 21, 2011.

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Summary Compensation Table

Name and Principal Position	Fiscal Year	Salary ($)	Bonus (1) ($)	Stock Awards (2) ($)	Option Awards (3) ($)	Non-Equity Incentive Plan Compen-sation (4) ($)	All Other Compen-sation (5) ($)	Total ($)
Executive Officers:								
John Nugent (6)	2011	$ 550,000		$	$	$ 385,000	$ 52,136	$ 987,136
President and Chief Executive Officer	2010	$ 137,500		$ 1,200,000	$ 1,901,604	$ 130,625	$ 10,971	$ 3,380,700
	2009							
Robert Pender	2011	$ 325,000		$	$	$ 170,625	$ 1,190	$ 496,815
Senior Vice President, Finance and	2010	$ 325,000		$ 1,050,000	$ 1,263,762	$ 231,563	$ 6,258	$ 2,876,583
Administration, and Chief Financial Officer	2009	$ 290,000	$ 84,100			$ 60,900	$ 7,186	$ 442,186
David Hurwitz (7)	2011	$ 267,772		$ 308,000	$ 180,185	$ 107,883	$ 880	$ 864,720
Senior Vice President, Worldwide Marketing	2010							
	2009							
Kamran Kheirolomoom (8)	2011	$ 182,782	18,400	$ 154,000	$ 131,685	$ 36,737	$ 1,258	$ 524,862
Senior Vice President, SBM Business Unit	2010							
	2009							
Edward Malysz	2011	$ 260,000		$	$	$ 110,500	$ 1,190	$ 371,690
Senior Vice President, General Counsel and	2010	$ 260,000		$ 600,000	$ 232,248	$ 126,750	$ 4,318	$ 1,223,316
Secretary	2009	$ 260,000				$ 97,435	$ 6,743	$ 364,178
Former Executive Officers:								
Carl Theobald (9)	2011	$ 300,000		$	$	$ 75,000	$ 450	$ 375,450
Senior Vice President, Products and Worldwide	2010	$ 300,000		$ 975,000	$ 557,542	$ 142,500	$ 3,443	$ 1,978,485
Customer Service	2009	$ 291,250				$ 95,923	$ 2,868	$ 390,041

(1) Amounts include discretionary bonuses paid to executive officers for purposes of recognizing their contributions to our company and adjusting their total incentive bonuses (including discretionary bonus and non-equity incentive plan compensation) to reflect payout levels consistent with similarly situated executive officers.
(2) Amounts reflect the aggregate grant date fair value of restricted stock units computed in accordance with FASB ASC Topic 718. Assumptions used in the calculation of these amounts are included in Note 6 to our Consolidated Financial Statements for the year ended January 31, 2011.
(3) Amounts reflect the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. Assumptions used in the calculation of these amounts are included in Note 6 to our Consolidated Financial Statements for the year ended January 31, 2011.
(4) Amounts reflect cash awards earned under our annual executive incentive plans for fiscal years 2011, 2010 and 2009.
(5) Amounts include supplemental life insurance premiums for each executive officer, matching 401(k) plan contributions for Messrs. Pender, Malysz and Theobald in fiscal years 2009 and 2010, and reimbursement of relocation expenses incurred by Mr. Nugent of $10,867 and $50,997 in fiscal years 2010 and 2011, respectively. We discontinued our matching 401(k) plan contribution benefit program in May 2009.
(6) Mr. Nugent commenced his employment with us on November 2, 2009.
(7) Mr. Hurwitz commenced his employment with us on February 8, 2010.
(8) Mr. Kheirolomoom commenced his employment with us on May 24, 2010.
(9) Mr. Theobald s employment terminated with us on February 2, 2011. For information regarding our severance and release agreement with Mr. Theobald, see *Employment Agreements and Severance and Change of Control Benefits Severance Agreement with our Former Senior Vice President, Products and Worldwide Customer Service*.

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Grants of Plan-Based Awards in Fiscal Year 2011

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards (1) Threshold ($)	Target ($)	Maximum ($)	Estimated Future Payouts Under Equity Incentive Plan Awards (2) Threshold (#)	Target (#)	Maximum (#)	All Other Stock Awards: Number of Shares of Stock or Units (#) (3)	All Other Option Awards: Number of Securities Underlying Options (#) (4)	Exercise or Base Price of Option Awards ($/Sh)	Grant Date Fair Value of Stock and Option Awards (5)
Executive Officers:											
John Nugent	2/23/10	$ 137,500	$ 550,000	$ 1,100,000							
Robert Pender	2/23/10	$ 60,938	$ 243,750	$ 487,500							
David Hurwitz (6)	2/23/10	$ 53,944	$ 134,863	$ 224,772							
	2/22/10							100,000			$ 308,000
	2/22/10				150,000	150,000	150,000			$ 3.08	$ 106,985
	2/22/10								100,000	$ 3.08	$ 73,200
Kamran Kheirolomoom (7)	5/24/10	$ 34,902	$ 73,474	$ 159,436							
	5/26/10							50,000			$ 154,000
	5/26/10				120,000	120,000	120,000			$ 3.08	$ 74,116
	5/26/10								80,000	$ 3.08	$ 57,569
Edward Malysz	2/23/10	$ 61,750	$ 130,000	$ 195,000							
Former Executive Officer:											
Carl Theobald	2/23/10	$ 59,775	$ 150,000	$ 250,500							

(1) The amounts in these columns represent potential payouts under the FY2011 Executive Annual Incentive Plan. The Threshold column assumes 85% achievement of performance metrics, the Target column assumes 100% achievement of all performance metrics and the Maximum column assumes 115% achievement of financial performance metrics and 100% achievement of management objectives. For a discussion of the FY2011 Executive Annual Incentive Plan, see *Elements of Our Executive Compensation Program Annual Cash Compensation.*

(2) The amounts in this column represent the number of shares vesting under performance-based options granted under the 2006 Stock Incentive Plan. The Threshold, Target and Maximum columns include the number of shares under performance-based options that would vest if the minimum EBITA targets were achieved during each fiscal period over three fiscal years. For a discussion of performance-based options, see *Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan.*

(3) The amounts in this column represent the number of shares of restricted stock units awarded to the executive officers. For a discussion of restricted stock units, see *Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan.*

(4) The amounts in this column represent the number of shares under time-based options granted under the 2006 Stock Incentive Plan. For a discussion of time-based options, see *Employment Agreements and Severance and Change of Control Benefits 2006 Stock Incentive Plan.*

(5) Amounts reflect the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. Assumptions used in the calculation of these amounts are included in Note 6 to the company s Consolidated Financial Statements for the year ended January 31, 2011.

(6) Mr. Hurwitz s employment commenced with the company on February 8, 2010. Estimated payouts under non-equity incentive plan awards have been prorated based on his term of service during fiscal year 2011.

(7) Mr. Kheirolomoom s employment commenced with the company on May 24, 2010. Estimated payouts under non-equity incentive plan awards have been prorated based on his term of service during fiscal year 2011.

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Outstanding Equity Awards at 2011 Fiscal Year-End

	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Grant Date	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($)
Executive Officers:									

&nbize:10pt;color:#000000;font-style:normal;font-weight:normal;text-decoration:none;">$34.6 million, and represents accruals for severance and retention costs related to our business streamlining initiative. Compensation and benefits, excluding transition-related compensation, decreased $30.6 million, or 2.7%, to $1.1 billion, primarily driven by a $49.8 million decrease in corporate compensation, primarily due to headcount reductions resulting from our business streamlining initiative, as well as a $43.2 million net decrease in compensation at revenue share-based affiliates. Additionally, there was a decrease in deferred compensation and revenue share-based incentive obligations of $22.5 million, primarily resulting from reduced gains on assets invested for deferred compensation plans and seed capital investments, which are offset by corresponding decreases in Other non-operating income (expense). These decreases were offset in part by an increase in incentives from changes in an expense reimbursement arrangement with Western Asset, including an increase in non-cash amortization expense associated with certain related deferred compensation awards, totaling $71.8 million, as well as additional costs of approximately $20.5 million associated with market-based compensation increases among retained staff and new employees, primarily in our global distribution group, to support on-going growth initiatives.

Compensation as a percentage of operating revenues increased to 43.0% from 42.6% in the prior fiscal year, primarily due to the impact of the change in the expense reimbursement arrangement with Western Asset and market-based compensation increases among retained staff and new employees, discussed above. These increases were offset in part by the impact of lower corporate compensation costs, primarily attributable to our business streamlining initiative, the impact of compensation decreases related

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to reduced market gains on assets invested for deferred compensation plans and seed capital investments, and the decrease in transition-related compensation.

Distribution and servicing expenses decreased 8.9% to $649.7 million, principally driven by a $41.4 million decrease due to the previously discussed disposition of liquidity AUM related to the MSSB relationship, as well as a $6.9 million decrease in servicing expenses as a result of our business streamlining initiative. A $5.8 million decline in structuring fees related to closed-end fund launches also contributed to the decrease.

Communications and technology expense increased 1.7% to $164.7 million, driven by increases, principally in data processing costs, market data costs, and consulting fees, totaling $12.2 million, primarily due to transition-related costs incurred as a result of our business streamlining initiative. These increases were offset in part by $9.3 million in cost savings as a result of our streamlining changes, including reduced depreciation of technology hardware and software and consulting fees.

Occupancy expense increased 12.3% to $154.8 million, primarily due to a $14.7 million net increase in lease reserves recorded in fiscal 2012, primarily related to permanently abandoning certain office space as part of our business streamlining initiative. In addition, there was a $10.3 million increase as a result of the acceleration of depreciation related to space permanently abandoned in fiscal 2012, also related to our business streamlining initiative. These increases were offset in part by the impact of the write-off of a $4.1 million real estate escrow deposit in the prior year and a $3.3 million reduction in depreciation on furniture and leasehold improvements, both resulting from our business streamlining initiative.

Amortization of intangibles decreased 14.6% to $19.6 million, primarily due to the full amortization of certain management contracts during fiscal 2012.

Other expenses increased $14.1 million, or 8.0%, to $190.7 million, primarily as a result of an increase in expense reimbursements paid to certain mutual funds during the current year under expense cap arrangements.

Non-Operating Income (Expense)
Interest income increased 24.2% to $11.5 million, driven by higher yields earned on investment balances.

Interest expense decreased 5.0% to $87.6 million, primarily as a result of the retirement of our Equity Units during fiscal 2012, which reduced interest expense by $4.1 million.

Other non-operating income decreased $37.5 million to $22.1 million, primarily as a result of $56.0 million in net market losses on investments in proprietary fund products, which were partially offset by corresponding compensation decreases discussed above, and $11.8 million due to reduced gains on assets invested for deferred compensation plans, which were substantially offset by corresponding compensation decreases described above. These decreases were offset in part by an $11.3 million increase in dividend income, which was partially offset by a corresponding compensation increase under revenue-sharing agreements, a gain of $8.6 million related to an assigned bankruptcy claim, and a gain of $7.5 million on the sale of a small affiliate.

Other non-operating income of consolidated investment vehicles ("CIVs") increased $16.6 million to $18.3 million, due to net market gains on investments of certain CIVs.

Income Tax Provision

The provision for income taxes was $72.1 million compared to $119.4 million in the prior year. During fiscal 2012, The U.K. Finance Act 2011 (the "Act") was enacted. The Act reduced the main U.K. corporate income tax rate from 27% to 26% effective April 1, 2011, and to 25% effective April 1, 2012. The impact of the tax rate changes on the revaluation of certain existing deferred tax liabilities resulted in a tax benefit of $18.3 million in the current year. The prior year also included a similar tax benefit of $8.9 million on the revaluation of deferred tax liabilities. In addition, the restructuring of our Australian business, partially offset by adjustments to the net value of certain deferred tax assets, resulted in a net tax benefit of $10.1 million in the current year. The effective tax rate was 23.8% compared to 32.7% in the prior year. Changes in the U.K. tax rate impacted the effective tax rate by 6.0 and 2.5 percentage points in the years ended March 31, 2012 and 2011, respectively. In addition, the restructuring of our Australian business, partially offset by adjustments to the net value of certain deferred tax assets, impacted the effective tax rate by 3.3 percentage points in the current year.

Supplemental Non-GAAP Financial Information

As supplemental information, we are providing performance measures that are based on methodologies other than generally accepted accounting principles (“non-GAAP”) for “Consolidated Statements of Income, Excluding Consolidated Investment Vehicles”, "Adjusted Income", and "Operating Margin, As Adjusted" that management uses as benchmarks in evaluating and comparing our period-to-period operating performance.

Consolidated Statements of Income, Excluding Consolidated Investment Vehicles
In accordance with financial accounting standards on consolidation, we consolidate and separately identify certain sponsored investment vehicles, the most significant of which is a CLO. In presenting our "Consolidated Statements of Income, Excluding Consolidated Investment Vehicles," we add back the investment advisory and distribution and servicing fees that are eliminated upon the consolidation of investment vehicles and exclude the operating expenses and the impact on non-operating income (expense) and noncontrolling interests of CIVs.

We believe it is important to provide the Consolidated Statements of Income, Excluding Consolidated Investment Vehicles to present the underlying economic performance of our core asset management operations, which does not include the results of the investment funds that we manage but may not own all of the equity invested. By deconsolidating the CIVs from the Consolidated Statements of Income, the investment advisory and distribution fees we earn from CIVs are added back to reflect our actual revenues. Similarly, the operating expenses and the impact on non-operating income (expense) and noncontrolling interests of CIVs are removed from the GAAP basis Consolidated Statements of Income since this activity does not actually belong to us. The deconsolidation of the investment vehicles does not have any impact on Net Income Attributable to Legg Mason, Inc. in any period presented. The Consolidated Statements of Income, Excluding Consolidated Investment Vehicles are presented in addition to our GAAP basis Consolidated Statements of Income, but are not substitutes for the GAAP basis Consolidated Statements of Income and may not be comparable to Consolidated Statements of Income presented on a non-GAAP basis of other companies.

The following table presents a reconciliation of our Consolidated Statements of Income presented on a GAAP basis to our Consolidated Statements of Income, Excluding Consolidated Investment Vehicles for the years ended March 31, 2012 and 2011 (in thousands):

	For the Years Ended March 31,					
	2012			2011		
	GAAP Basis	CIVs	Non-GAAP Basis - Excluding CIVs	GAAP Basis	CIVs	Non-GAAP Basis - Excluding CIVs
Total operating revenues	$2,662,574	$3,094	$2,665,668	$2,784,317	$4,133	$2,788,450
Total operating expenses	2,323,821	(608)	2,323,213	2,397,509	(571)	2,396,938
Operating Income	338,753	3,702	342,455	386,808	4,704	391,512
Other non-operating income (expense)	(35,670)	(13,566)	(49,236)	(21,611)	3,680	(17,931)
Income (Loss) before Income Tax Provision	303,083	(9,864)	293,219	365,197	8,384	373,581
Income tax provision	72,052	—	72,052	119,434	—	119,434
Net Income (Loss)	231,031	(9,864)	221,167	245,763	8,384	254,147
Less: Net income (loss) attributable to noncontrolling interests	10,214	(9,864)	350	(8,160)	8,384	224
	$220,817	$—	$220,817	$253,923	$—	$253,923

Net Income
Attributable to Legg
Mason, Inc.

Adjusted Income

We define "Adjusted Income" as Net Income Attributable to Legg Mason, Inc., plus amortization and deferred taxes related to intangible assets and goodwill, and imputed interest and tax benefits on contingent convertible debt less deferred income taxes on goodwill and indefinite-life intangible asset impairment, if any. We also adjust for non-core items that are not reflective of our economic performance, such as the impact of tax rate adjustments on certain deferred tax liabilities related to indefinite-life intangible assets, and net money market fund support losses (gains).

We believe that Adjusted Income provides a useful representation of our operating performance adjusted for non-cash acquisition related items and other items that facilitate comparison of our results to the results of other asset management firms that have not issued contingent convertible debt, made significant acquisitions, or engaged in money market fund support transactions. We also believe that Adjusted Income is an important metric in estimating the value of an asset management business.

Adjusted Income only considers adjustments for certain items that relate to operating performance and comparability, and therefore,

is most readily reconcilable to Net Income Attributable to Legg Mason, Inc. determined under GAAP. This measure is provided in addition to Net Income Attributable to Legg Mason, Inc., but is not a substitute for Net Income Attributable to Legg Mason, Inc. and may not be comparable to non-GAAP performance measures, including measures of adjusted earnings or adjusted income, of other companies. Further, Adjusted Income is not a liquidity measure and should not be used in place of cash flow measures determined under GAAP. We consider Adjusted Income to be useful to investors because it is an important metric in measuring the economic performance of asset management companies, as an indicator of value, and because it facilitates comparison of our operating results with the results of other asset management firms that have not issued contingent convertible debt, engaged in significant acquisitions, or engaged in money market fund support transactions.

In calculating Adjusted Income, we add the impact of the amortization of intangible assets from acquisitions, such as management contracts, to Net Income Attributable to Legg Mason, Inc. to reflect the fact that these non-cash expenses distort comparisons of our operating results with the results of other asset management firms that have not engaged in significant acquisitions. Deferred taxes on indefinite-life intangible assets and goodwill include actual tax benefits from amortization deductions that are not realized under GAAP absent an impairment charge or the disposition of the related business. Because we fully expect to realize the economic benefit of the current period tax amortization, we add this benefit to Net Income Attributable to Legg Mason, Inc. in the calculation of Adjusted Income. However, because of our net operating loss carryforward, we will receive the benefit of the current tax amortization over time. Conversely, we subtract the non-cash income tax benefits on goodwill and indefinite-life intangible asset impairment charges and United Kingdom tax rate adjustments on excess book basis on certain acquired indefinite-life intangible assets, if applicable, that have been recognized under GAAP. We also add back imputed interest on contingent convertible debt, which is a non-cash expense, as well as the actual tax benefits on the related contingent convertible debt that are not realized under GAAP. We also add (subtract) other non-core items, such as net money market fund support losses (gains) (net of losses on the sale of the underlying structured investment vehicle ("SIV") securities, if applicable). These adjustments reflect that these items distort comparisons of our operating results to prior periods and the results of other asset management firms that have not engaged in money market fund support transactions or significant acquisitions, including any related impairments.

Should a disposition, impairment charge or other non-core item occur, its impact on Adjusted Income may distort actual changes in the operating performance or value of our firm. Also, realized losses on money market fund support transactions are reflective of changes in the operating performance and value of our firm. Accordingly, we monitor these items and their related impact, including taxes, on Adjusted Income to ensure that appropriate adjustments and explanations accompany such disclosures.

Although depreciation and amortization of fixed assets are non-cash expenses, we do not add these charges in calculating Adjusted Income because these charges are related to assets that will ultimately require replacement.

A reconciliation of Net Income Attributable to Legg Mason, Inc. to Adjusted Income (in thousands except per share amounts) is as follows:

	For the Years Ended March 31,	
	2012	2011
Net Income Attributable to Legg Mason, Inc.	$220,817	$253,923
Plus (less):		
Amortization of intangible assets	19,574	22,913

Deferred income taxes on intangible assets:		
Tax amortization benefit	135,830	134,602
U.K. tax rate adjustment	(18,268)	(8,878)
Imputed interest on convertible debt	39,077	36,688
Adjusted Income	$397,030	$439,248
Net Income per diluted share attributable to Legg Mason, Inc. common shareholders	$1.54	$1.63
Plus (less):		
Amortization of intangible assets	0.14	0.15
Deferred income taxes on intangible assets:		
Tax amortization benefit	0.95	0.87
U.K. tax rate adjustment	(0.13)	(0.06)
Imputed interest on convertible debt	0.27	0.24
Adjusted Income per diluted share	$2.77	$2.83

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Operating Margin, as Adjusted

We calculate "Operating Margin, as Adjusted," by dividing (i) Operating Income, adjusted to exclude the impact on compensation expense of gains or losses on investments made to fund deferred compensation plans, the impact on compensation expense of gains or losses on seed capital investments by our affiliates under revenue sharing agreements, transition-related costs of streamlining our business model, income (loss) of CIVs, and impairment charges by (ii) our operating revenues, adjusted to add back net investment advisory fees eliminated upon consolidation of investment vehicles, less distribution and servicing expenses which we use as an approximate measure of revenues that are passed through to third parties, which we refer to as "Operating Revenues, as Adjusted." The compensation items, other than transition-related costs, are removed from Operating Income in the calculation because they are offset by an equal amount in Other non-operating income (expense), and thus have no impact on Net Income Attributable to Legg Mason, Inc. Transition-related costs and income (loss) of CIVs are removed from Operating Income in the calculation because these items are not reflective of our core asset management operations. We use Operating Revenues, as Adjusted in the calculation to show the operating margin without distribution and servicing expenses, which we use to approximate our distribution revenues that are passed through to third parties as a direct cost of selling our products, although distribution and servicing expenses may include commissions paid in connection with the launching of closed-end funds for which there is no corresponding revenue in the period. Operating Revenues, as Adjusted, also include our advisory revenues we receive from CIVs that are eliminated in consolidation under GAAP.

We believe that Operating Margin, as Adjusted, is a useful measure of our performance because it provides a measure of our core business activities excluding items that have no impact on Net Income Attributable to Legg Mason, Inc. and because it indicates what our operating margin would have been without the distribution revenues that are passed through to third parties as a direct cost of selling our products, transition-related costs, and the impact of the consolidation of certain investment vehicles described above. The consolidation of these investment vehicles does not have an impact to Net Income Attributable to Legg Mason, Inc. This measure is provided in addition to our operating margin calculated under GAAP, but is not a substitute for calculations of margins under GAAP and may not be comparable to non-GAAP performance measures, including measures of adjusted margins of other companies.

The calculation of Operating margin and Operating margin, as adjusted, is as follows (dollars in thousands):

	For the Years Ended March 31,	
	2012	2011
Operating Revenues, GAAP basis	$2,662,574	$2,784,317
Plus (less):		
Operating revenues eliminated upon consolidation of investment vehicles	3,094	4,133
Distribution and servicing expense excluding consolidated investment vehicles	(649,679)	(712,779)
Operating Revenues, as Adjusted	$2,015,989	$2,075,671
Operating Income, GAAP basis	$338,753	$386,808
Plus (less):		
Gains (losses) on deferred compensation and seed investments	13,809	36,274
Transition-related costs	73,066	54,434

Operating income and expenses of consolidated investment vehicles	3,702		4,704	
Operating Income, as Adjusted	$429,330		$482,220	
Operating margin, GAAP basis	12.7	%	13.9	%
Operating margin, as adjusted	21.3		23.2	

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FISCAL 2011 COMPARED WITH FISCAL 2010

Financial Overview

Net income attributable to Legg Mason, Inc. for the year ended March 31, 2011, totaled $253.9 million, or $1.63 per diluted share, compared to $204.4 million, or $1.32 per diluted share, in the prior year. The increase in Net Income was primarily due to the net impact of increased operating revenues, reflecting a more favorable asset mix and increased performance fees, reduced interest expense, and a change in the U.K. tax rate. These increases were offset in part by the impact of transition-related compensation, the impact of gains on fund support recognized in the prior year, and an increase in costs associated with closed-end fund launches. These items are further discussed in "Results of Operations" below. Adjusted Income (see Supplemental Non-GAAP Financial Information) was $439.2 million, or $2.83 per diluted share, compared to $381.3 million, or $2.45 per diluted share, in the prior year. This increase was primarily due to the increase in Net Income, as previously discussed, excluding the impact of the current year U.K. tax rate change and fund support gains in the prior year. Operating margin increased to 13.9% from 12.2% in the prior year. Operating margin, as adjusted (see Supplemental Non-GAAP Financial Information) increased to 23.2% from 20.7% in the prior year.

Assets Under Management

The components of the changes in our AUM (in billions) for the years ended March 31 were as follows:

	2011	2010
Beginning of period	$684.5	$632.4
Investment funds, excluding liquidity funds [1]		
Subscriptions	49.5	38.8
Redemptions	(44.3)	(40.2)
Separate account flows, net	(52.1)	(76.5)
Liquidity fund flows, net	(14.2)	(4.1)
Net client cash flows	(61.1)	(82.0)
Market performance and other [2]	56.3	134.1
Dispositions	(2.1)	—
End of period	$677.6	$684.5

(1)

Subscriptions and redemptions reflect the gross activity in the funds and include assets transferred between funds and between share classes.

(2)

Includes impact of foreign exchange, reinvestment of dividends, and other.

AUM at March 31, 2011, was $678 billion, a decrease of $7 billion or 1% from March 31, 2010. The decrease in AUM was attributable to net client outflows of $61 billion, which were partially offset by market appreciation of $56 billion, of which approximately 17% resulted from the impact of foreign currency exchange fluctuation, and dispositions of $2 billion, relating to the sale of a Singapore-based Asian equity manager. The majority of outflows were in fixed income with $37 billion, or 61% of the outflows, followed by liquidity outflows and equity outflows of $16 billion and $8 billion, respectively. The majority of fixed income outflows were in products managed by Western Asset. Equity outflows were primarily experienced by products managed at ClearBridge and LMCM, while Permal and Royce had net inflows.

AUM by Asset Class

AUM by asset class (in billions) as of March 31 were as follows:

	2011	% of Total		2010	% of Total		% Change	
Equity	$189.6	28	%	$173.8	26	%	9	%
Fixed income	356.6	53		364.3	53		(2	)
Liquidity	131.4	19		146.4	21		(10	)
Total	$677.6	100	%	$684.5	100	%	(1	)%

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The component changes in our AUM by asset class (in billions) for the fiscal year ended March 31, 2011, were as follows:

	Equity	Fixed Income	Liquidity	Total
March 31, 2010	$173.8	$364.3	$146.4	$684.5
Investment funds, excluding liquidity funds				
Subscriptions	23.4	26.1	—	49.5
Redemptions	(24.7)	(19.6)	—	(44.3)
Separate account flows, net	(6.9)	(43.5)	(1.7)	(52.1)
Liquidity fund flows, net	—	—	(14.2)	(14.2)
Net client cash flows	(8.2)	(37.0)	(15.9)	(61.1)
Market performance and other	24.0	29.3	0.9	54.2
March 31, 2011	$189.6	$356.6	$131.4	$677.6

Average AUM by asset class (in billions) for the year ended March 31 were as follows:

	2011	% of Total	2010	% of Total	% Change
Equity	$173.8	26 %	$155.7	23 %	12 %
Fixed Income	361.6	54	370.7	55	(2)
Liquidity	133.8	20	149.1	22	(10)
Total	$669.2	100 %	$675.5	100 %	(1)%

Investment Performance[(1)]

Investment performance of our assets under management in the year ended March 31, 2011, was mixed compared to relevant benchmarks from the prior year.

The equity markets worked through a difficult year with political upheaval in the Middle East late in the fiscal year driving a significant increase in oil prices and the earthquake in Japan and subsequent nuclear crisis raising questions about the future of the nuclear power industry. Despite these global concerns, most U.S. indices produced positive returns for our full fiscal year driven by corporate earnings growth resulting in increases in dividends, share buybacks, and mergers and acquisitions activity.

In the fixed income markets, relatively strong economic data, combined with continued accommodative monetary and fiscal policy, continued to alleviate fears of a double-dip recession and caused U.S. Treasury yields to rise across the yield curve.

The yield curve slightly flattened over the year as the Federal Reserve kept its funds rate at 0.25% and reiterated that rates would be kept low for an extended period. The worst performing fixed income sector for the year was Government bonds as measured by the Barclays U.S. Government Bond Index returning 4.28%, in contrast to High Yield Bonds, as measured by the Barclays High Yield Bond Index, which returned 14.31% followed by U.S. TIPS, as measured by the Barclays U.S. TIPS Index, which returned 7.91% for the year.

The following table presents a summary of the percentage of our marketed composite assets[(2)] that outpaced their benchmarks as of March 31, 2011 and 2010, for the trailing 1-year, 3-year, 5-year, and 10-year periods:

As of March 31, 2011				As of March 31, 2010			
1-year	3-year	5-year	10-year	1-year	3-year	5-year	10-year

Total (includes liquidity)	75 %	78 %	74 %	84 %	81 %	60 %	67 %	91 %
Equity	42 %	57 %	61 %	77 %	49 %	61 %	72 %	86 %
Fixed income	82 %	80 %	70 %	81 %	88 %	40 %	50 %	88 %

The following table presents a summary of the percentage of our U.S. mutual fund assets[3] that outpaced their Lipper category as of March 31, 2011 and 2010, for the trailing 1-year, 3-year, 5-year, and 10-year periods:

	As of March 31, 2011				As of March 31, 2010			
	1-year	3-year	5-year	10-year	1-year	3-year	5-year	10-year
Total long-term (excludes liquidity)	56 %	74 %	70 %	67 %	62 %	68 %	70 %	80 %
Equity	58 %	70 %	68 %	60 %	51 %	63 %	65 %	78 %
Fixed income	52 %	83 %	78 %	85 %	81 %	78 %	83 %	87 %

(1)

Index performance in this section includes reinvestment of dividends and capital gains.

(2) As of March 31, 2011 and 2010, 89% and 87% of our equity assets under management, respectively, in each period, and 89% and 82% of our fixed income assets under management, respectively, were in marketed composites.

(3) Source: Lipper Inc. includes open-end, closed-end, and variable annuity funds. As of March 31, 2011 and 2010, the U.S. long-term mutual fund assets represented in the data accounted for 17% and 16%, respectively, of our total assets under management. The performance of our U.S. long-term mutual fund assets is included in the marketed composites.

RESULTS OF OPERATIONS

Operating Revenues

Total operating revenues for the year ended March 31, 2011, were $2.8 billion, an increase of 6% from $2.6 billion in the prior year, despite a 1% decrease in average AUM, reflecting increased revenue yields due to a more favorable asset mix and higher performance fees. These increases were offset in part by an increase in fee waivers on certain liquidity funds in order to maintain certain yields to investors.

Investment advisory fees from separate accounts were relatively flat at $815.6 million, as a decrease of $25.4 million, resulting from lower average fixed income assets at Western Asset, was offset by an $18.6 million increase due to higher average equity assets managed by Batterymarch and Royce, a $5.1 million increase due to higher average fixed income assets managed by Brandywine, and a $2.2 million increase due to subordinate fees received from certain CLOs managed by Western Asset.

Investment advisory fees from funds increased $119.3 million, or 9%, to $1.5 billion. Of this increase, $111.5 million was the result of higher average equity assets managed at Royce, Permal, and ClearBridge, and $84.4 million was the result of higher average fixed income assets managed at Western Asset. These increases were offset in part by a $45.7 million decrease due to lower average liquidity assets managed at Western Asset and a $36.0 million decrease as a result of fee waivers on liquidity funds managed by Western Asset, primarily to maintain certain yields to investors.

Performance fees increased 35%, or $25.2 million, to $96.7 million during fiscal 2011, driven by fees earned on assets managed at Western Asset, Permal and Brandywine.

Distribution and service fees increased 1% to $379.2 million, primarily as a result of an increase in average mutual fund AUM subject to distribution and servicing fees offset in part by the impact of increased fee waivers related to liquidity funds managed by Western Asset.

Operating Expenses
Total compensation and benefits increased $74.1 million to $1.2 billion. Compensation and benefits, excluding transition-related compensation of $45.0 million, which represents severance and retention incentive costs, increased $29.0 million, or 3%, to $1.1 billion. This increase was driven by a $68.6 million increase in revenue share-based compensation resulting from higher revenues and a reduction in operating expenses at revenue share-based affiliates in fiscal 2011, and a $7.5 million increase in incentive compensation for non-revenue share-based affiliates and administrative and sales personnel. These increases were offset in part by a $45.7 million reduction in deferred compensation obligations due to the impact of reduced market gains on assets invested for deferred compensation plans, which are recorded in Other non-operating income (expense), as well as, a $6.1 million reduction in deferred compensation expense at non-revenue share-based affiliates. The impact of reduced headcount, primarily related to our business streamlining initiatives, also reduced compensation and benefits by $6.0 million. Compensation as a percentage of operating revenues increased to 42.6% from 42.2% in the prior fiscal year primarily due to the impact of increased revenues at revenue share-based affiliates that retain a higher percentage of revenues as compensation, and transition-related compensation. These increases were substantially offset by the impact of compensation decreases related to reduced market gains on assets invested for deferred compensation plans and seed capital investments and the impact of lower corporate compensation on increased revenues.

Distribution and servicing expenses increased 3% to $712.8 million, primarily as a result of an increase in average AUM in certain products for which we pay fees to third-party distributors and an increase of $14.5 million in structuring fees related to closed-

end fund launches offset in part by the impact of liquidity fund fee waivers that reduce the amounts paid to our distributors.

Communications and technology expense decreased 1% to $162.0 million, of which $9.2 million resulted from the full depreciation of certain assets prior to or during fiscal 2011, offset in part by a $6.6 million increase in technology consulting and outsourcing fees, primarily related to our business streamlining initiatives.

Occupancy expense decreased 12% to $137.9 million, primarily due to the impact of a $19.3 million charge in the prior year as a result of subleasing space in our corporate headquarters in fiscal 2010.

Amortization of intangibles remained relatively flat at $22.9 million.

Other expenses increased $8.9 million to $176.6 million, primarily as a result of a $10.3 million increase in travel and entertainment and advertising costs, a $5.6 million increase in state franchise taxes, a $4.2 million increase in professional fees, and a $5.4 million increase in charges related to trading errors and expense reimbursements paid to certain mutual funds. These increases were offset in part by the impact of a $19.0 million investor settlement in the prior year.

Non-Operating Income (Expense)
Interest income increased 26% to $9.2 million driven by higher average interest rates, offset in part by a $0.9 million decrease due to lower average investment balances.

Interest expense decreased 27% to $92.2 million, primarily as a result of the exchange of our Equity Units in August 2009 and the repayment of the $550 million outstanding term loan balance in January 2010, which reduced interest expense by $14.8 million and $12.2 million, respectively.

As of March 31, 2010, all fund support arrangements had expired or were terminated in accordance with their terms. Fund support gains were $23.2 million in the prior year. The gains primarily represent the reversal of unrealized, non-cash losses recorded in fiscal 2009 on liquidity fund support arrangements for our offshore funds.

Other non-operating income (expense) decreased $27.3 million, primarily as a result of a $46.7 million reduction in unrealized market gains on assets invested for deferred compensation plans, which were substantially offset by corresponding compensation decreases discussed above, and a $4.3 million reduction in unrealized market gains on investments in proprietary fund products. These decreases were offset in part by the impact of $22.0 million in charges related to the exchange of our Equity Units in the prior year.

Other non-operating income (expense) of CIVs decreased $15.6 million, to a gain of $1.7 million, due to losses associated with an increase in fair value of the debt related to a CIV.

Income Tax Provision
The provision for income taxes was $119.4 million compared to $118.7 million in the prior year. During fiscal 2011, the U.K. Finance (No. 2) Act of 2010 was enacted, which reduced the corporate tax rate from 28% to 27% for periods beginning after April 1, 2011. The impact of the tax rate change on certain existing deferred tax liabilities resulted in a tax benefit of approximately $8.9 million.

The effective tax rate was 32.7% compared to 36.0% in the prior year. This decrease was primarily driven by the revaluation of certain deferred tax assets and liabilities as a result of the enactment of the U.K. tax rate reduction and adjustments to state tax rates impacted by apportionment changes. In addition, the current period benefited from adjustments resulting from the finalization of prior period tax positions.

Supplemental Non-GAAP Financial Information

Consolidated Statements of Income, Excluding Consolidated Investment Vehicles

The following table presents a reconciliation of our Consolidated Statements of Income presented on a GAAP basis to our Consolidated Statements of Income, Excluding Consolidated Investment Vehicles for the years ended March 31, 2011 and 2010 (in thousands):

	For the Years Ended March 31,					
	2011			2010		
	GAAP Basis	CIVs	Non-GAAP Basis - Excluding CIVs	GAAP Basis	CIVs	Non-GAAP Basis - Excluding CIVs
Total operating revenues	$2,784,317	$4,133	$2,788,450	$2,634,879	$2,779	$2,637,658
Total operating expenses	2,397,509	(571)	2,396,938	2,313,696	680	2,314,376
Operating Income	386,808	4,704	391,512	321,183	2,099	323,282
Other non-operating income (expense)	(21,611)	3,680	(17,931)	8,473	(8,520)	(47)
Income (Loss) before Income Tax Provision	365,197	8,384	373,581	329,656	(6,421)	323,235
Income tax provision	119,434	—	119,434	118,676	—	118,676
Net Income (Loss)	245,763	8,384	254,147	210,980	(6,421)	204,559
Less: Net income (loss) attributable to noncontrolling interests	(8,160)	8,384	224	6,623	(6,421)	202
Net Income Attributable to Legg Mason, Inc.	$253,923	$—	$253,923	$204,357	$—	$204,357

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Adjusted Income

A reconciliation of Net Income Attributable to Legg Mason, Inc. to Adjusted Income (in thousands except per share amounts) is as follows:

	For the Years Ended March 31,	
	2011	2010
Net Income Attributable to Legg Mason, Inc.	$253,923	$204,357
Plus (less):		
Amortization of intangible assets	22,913	22,769
Deferred income taxes on intangible assets:		
Tax amortization benefit	134,602	136,252
U.K. tax rate adjustment	(8,878)	—
Imputed interest on convertible debt	36,688	34,445
Net money market fund support gains [1]	—	(16,565)
Adjusted Income	$439,248	$381,258
Net Income per diluted share attributable to Legg Mason, Inc. common shareholders	$1.63	$1.32
Plus (less):		
Amortization of intangible assets	0.15	0.14
Deferred income taxes on intangible assets:		
Tax amortization benefit	0.87	0.88
U.K. tax rate adjustment	(0.06)	—
Imputed interest on convertible debt	0.24	0.22
Net money market fund support gains [1]	—	(0.11)
Adjusted Income per diluted share	$2.83	$2.45

(1) Net of income taxes.

Operating Margin, as Adjusted

The calculation of Operating margin and Operating margin, as adjusted, is as follows (dollars in thousands):

	For the Years Ended March 31,	
	2011	2010
Operating Revenues, GAAP basis	$2,784,317	$2,634,879
Plus (less):		
Operating revenues eliminated upon consolidation of investment vehicles	4,133	2,779
Distribution and servicing expense excluding consolidated investment vehicles	(712,779)	(691,868)
Operating Revenues, as Adjusted	$2,075,671	$1,945,790
Operating Income, GAAP basis	$386,808	$321,183
Plus (less):		
Gains (losses) on deferred compensation and seed investments	36,274	79,316
Transition-related costs	54,434	—
Operating income and expenses of consolidated investment vehicles	4,704	2,099
Operating Income, as Adjusted	$482,220	$402,598
Operating margin, GAAP basis	13.9 %	12.2 %
Operating margin, as adjusted	23.2	20.7

Liquidity and Capital Resources

The primary objective of our capital structure is to appropriately support our business strategies and to provide needed liquidity at all times, including maintaining required capital in certain subsidiaries. Liquidity and the access to liquidity is important to the success of our ongoing operations. Our overall funding needs and capital base are continually reviewed to determine if the capital base meets the expected needs of our businesses. We intend to continue to explore potential acquisition opportunities as a means of diversifying and strengthening our asset management business. These opportunities may from time-to-time involve acquisitions that are material in size and may require, among other things, and, subject to existing covenants, the raising of additional equity capital and/or the issuance of additional debt.

The consolidation of variable interest entities discussed above does not impact our liquidity and capital resources. We have no rights to the benefits from, nor do we bear the risks associated with, the assets and liabilities of the CIVs beyond our investments in and investment advisory fees generated from these vehicles, which are eliminated in consolidation. Additionally, creditors of the CIVs have no recourse to our general credit beyond the level of our investment, if any, so we do not consider these liabilities to be our obligations.

Our assets consist primarily of intangible assets, cash and cash equivalents, goodwill, investment securities, and investment advisory and related fee receivables. Our assets have been principally funded by equity capital, long-term debt and the results of our operations. At March 31, 2012, our cash and cash equivalents, total assets, long-term debt and stockholders' equity were $1.4 billion, $8.2 billion, $1.1 billion and $5.7 billion, respectively. Total assets and total liabilities of the CIVs at March 31, 2012, were $354 million and $280 million, respectively.

The following table summarizes our Consolidated Statements of Cash Flows for the years ended March 31 (in millions):

	2012	2011	2010
Cash flows provided by operating activities	$496.8	$412.1	$1,413.1
Cash flows provided by/(used in) investing activities	2.3	(44.4)	(276.7)
Cash flows used in financing activities	(481.8)	(468.5)	(746.7)
Effect of exchange rate changes	(10.9)	10.8	19.5
Net change in cash and cash equivalents	6.4	(90.0)	409.2
Cash and cash equivalents, beginning of period	1,375.9	1,465.9	1,056.7
Cash and cash equivalents, end of period	$1,382.3	$1,375.9	$1,465.9

Cash inflows provided by operating activities during fiscal 2012, were $496.8 million, primarily related to Net Income, adjusted for non-cash items. Cash inflows provided by investing activities during fiscal 2012, were $2.3 million, primarily related to $20.2 million of net activity related to CIVs and a release of restricted cash required for market hedge arrangements, offset in part by payments made for fixed assets. Cash outflows used in financing activities during fiscal 2012, were $481.8 million, primarily due to the repurchase of 13.6 million shares of our common stock for $400.3 million and dividends paid of $43.6 million. There remains $155 million under the current Board of Directors authorization to repurchase up to $1 billion of our common stock announced in May 2010, which we intend to utilize in fiscal 2013, subject to market conditions and our performance, actual cash flows, and other capital needs.

Cash inflows provided by operating activities during fiscal 2011 were $412.1 million, primarily attributable to Net Income, adjusted for non-cash items. Cash outflows used in investing activities during fiscal 2011 were $44.4 million, primarily attributable to payments made for fixed assets. Cash outflows used in financing activities during fiscal 2011 were $468.5 million, primarily attributable to the repurchase of 14.6 million of our common shares for $445 million.

During fiscal 2010, cash inflows provided by operating activities were $1.4 billion, of which $1.0 billion reflects the receipt of income tax refunds resulting from net operating loss carrybacks. The remainder was primarily attributable to Net Income, adjusted for non-cash items. Cash outflows used in investing activities during fiscal 2010 were $276.7 million, primarily attributable to cash payments of $180 million made in connection with the acquisition of Permal, and payments for fixed assets of $84.1 million, principally associated with the relocation of our corporate headquarters, partially offset by fund support collateral received of $38.9 million due to the amendment, termination and expiration of certain capital support arrangements. Cash outflows used in financing activities were $746.7 million, primarily due to the repayment in January 2010 of the remaining $550 million outstanding balance on our $700 million five-year term loan, $135.0 million of cash consideration paid in the exchange offer for our outstanding Equity Units and the payment of cash dividends.

Financing Transactions

The table below reflects our primary sources of financing (in thousands) as of March 31, 2012:

Type	Total at March 31, 2012	Amount Outstanding at March 31, 2012	2011	Interest Rate	Maturity
2.5% Convertible Senior Notes	$1,250,000	$1,127,009	$1,087,932	2.50%	January 2015
	—	—	103,039	5.60%	

5.6% Senior Notes from Equity Units					Retired June 2011
Revolving Credit Agreement	500,000	250,000	250,000	LIBOR + 2.625%	February 2013

During January 2008, we increased our capital base by $1.25 billion through the sale of 2.5% convertible senior notes. The proceeds strengthened our balance sheet and provided additional liquidity that has been used for general corporate purposes, including the purchase of SIV securities from our liquidity funds. The senior notes bear interest at 2.5%, payable semi-annually in cash. We are accreting the carrying value to the principal amount at maturity using an imputed interest rate of 6.5% (the effective borrowing rate for non-convertible debt at the time of issuance) over its expected life of seven years, resulting in additional interest expense for fiscal 2012, 2011 and 2010, of approximately $39.1 million, $36.7 million and $34.4 million, respectively. In connection with this financing, we entered into economic hedging transactions that increase the effective conversion price of the notes. These hedging transactions had a net cost to us of $83 million, which we paid from the proceeds of the notes. These transactions closed on January 31, 2008.

In May 2008, we issued 23 million Equity Units for $1.15 billion, of which $50 million was used to pay issuance costs. Each unit consisted of a 5% interest in $1,000 principal amount of 5.6% Senior Notes due June 30, 2021 and a purchase contract to purchase a varying number of shares of our common stock by June 30, 2011. During the September 2009 quarter, we completed an exchange offer for our Equity Units in the form of Corporate Units in order to increase our equity capital levels and reduce the amount of our outstanding debt and related interest expense. We exchanged 91% of our outstanding Corporate Units, each for 0.8881 of a share of our common stock and $6.25 in cash per Corporate Unit, equating to 18.6 million shares of Legg Mason common stock and $135.0 million of cash, including cash paid in lieu of fractional shares and transaction costs. In connection with this transaction, we incurred transaction costs of approximately $22 million, of which $15.7 million was in cash. In June 2011, the $103.0 million of outstanding debt on the remaining 5.6% senior notes from Equity Units was retired, as part of a remarketing. Concurrently, we issued 1.8 million shares of Legg Mason common stock upon the exercise of the purchase contracts from Equity Units.

During November 2007, we borrowed an aggregate of $500 million under our unsecured revolving credit facility for general corporate purposes. In March 2009, we repaid $250 million of the outstanding borrowings under this credit facility. The facility may be prepaid at any time and contains customary covenants and default provisions. The facility matures on February 11, 2013.

In October 2005, we borrowed $700 million through a syndicated five-year unsecured floating-rate term loan agreement to primarily fund the cash portion of the purchase price of the Citigroup transaction. During fiscal 2010, we repaid the remaining $550 million outstanding balance of the debt.

The agreements entered into as part of our January 2008 issuance of $1.25 billion in 2.5% convertible senior notes prevent us from incurring additional debt, with a few exceptions, if our gross debt to EBITDA ratio (as defined in the documents) exceeds 2.5 to 1. As of March 31, 2012, our gross debt to EBITDA ratio was 2.7 to 1, and thus the covenant prohibits us from borrowing additional amounts as of that date. The 2.5% convertible senior notes were extinguished in May 2012, as further described in Note 20 of Notes to Consolidated Financial Statements.

The financial covenants under our bank agreements include: maximum net debt to EBITDA ratio of 2.5 to 1 and minimum EBITDA to interest expense ratio of 4.0 to 1. Debt is defined to include all obligations for borrowed money, excluding non-recourse debt, and under capital leases. Under these net debt covenants, our debt is reduced by the amount of our unrestricted cash in excess of the greater of subsidiary cash or $375 million. EBITDA is defined as consolidated net income plus/minus tax expense, interest expense, depreciation and amortization, amortization of intangibles, any extraordinary expenses or losses, and any non-cash charges, as defined. As of March 31, 2012, our net debt to EBITDA ratio was 1.1 to 1 and EBITDA to interest expense ratio was 13.8 to 1. We have maintained compliance with our covenants at all times during fiscal 2012.

If our net income significantly declines, or if we spend our available cash, it may impact our ability to maintain compliance with these covenants. If we determine that our compliance with these covenants may be under pressure, we may elect to take a number of actions, including reducing our expenses in order to increase our EBITDA, using available cash to repay all or a portion of our $250 million outstanding debt subject to these covenants or seeking to negotiate with our lenders to modify the terms or to restructure our debt. We anticipate that we will have available cash to repay our bank debt, should it be necessary. Using available cash to repay indebtedness would make the cash unavailable for other uses and might affect the liquidity discussions and conclusions above. Entering into any modification or restructuring of our debt would likely result in additional fees or interest payments.

Certain of our outstanding debt is currently impacted by the ratings of two rating agencies. The interest rate on our revolving line of credit is based on the higher credit rating of the two rating agencies. In June 2011, our rating by one of these agencies was downgraded one notch below the other. Should the other agency downgrade our rating, absent an upgrade from the former agency, our interest costs will rise modestly.

Other Transactions

During fiscal 2010, in connection with the acquisition of Permal, we paid an aggregate of $171 million in cash to acquire the remaining 62.5% of the outstanding preference shares issued by Permal and held by Permal's pre-acquisition owners. We also elected to purchase, for $9 million, the rights of the sellers of the preference shares to receive an earnout payment of up to $149 million in two years. As a result of this transaction, there will be no further payments for the Permal acquisition. In addition, during fiscal 2010, we paid an aggregate amount of $7.5 million in dividends on the preference shares. All payments for preference shares, including dividends, were recognized as additional goodwill.

In May 2010, we terminated the exchangeable share arrangement related to the acquisition of Legg Mason Canada Inc., in accordance with its terms. In this transaction, 1.1 million shares, representing all remaining outstanding exchangeable shares, were exchanged for shares of our common stock on a one-for-one basis.

Certain of our asset management affiliates maintain various credit facilities for general operating purposes. Certain affiliates are

also subject to the capital requirements of various regulatory agencies. All such affiliates met their respective capital adequacy requirements during the periods presented.

See Notes 6, 7 and 20 of Notes to Consolidated Financial Statements for additional information related to our financing transactions.

Liquidity Fund Support
During fiscal 2010, four capital support agreements to provide up to $42 million in support to two liquidity funds were terminated or expired in accordance with their terms. No amounts were drawn thereunder prior to termination and $42 million of collateral was returned.

Future Outlook
We expect that over the next 12 months our operating activities will be adequate to support our operating cash needs. We currently intend to utilize our other available resources for any number of potential activities, including seed capital investments in new products, repurchase of shares of our common stock, repayment of outstanding debt, payment of increased dividends, or acquisitions.

During fiscal 2012, we completed the business model streamlining initiative that began in May 2010. We incurred transition-related costs of approximately $128 million through March 31, 2012, of which approximately 25% were non-cash charges. Approximately $80 million of these costs have been paid to date, and substantially all of the $16.8 million remaining costs represent lease obligations to be paid over the lease terms. The initiative resulted in annual cost savings of over $140 million, which will be fully realized on an annual basis, beginning in fiscal 2013. See Note 16 of Notes to Consolidated Financial Statements for information regarding transition-related costs recorded in fiscal 2012 and 2011.

As described above, we currently project that our cash flows from operating activities will be sufficient to fund our liquidity needs. As of March 31, 2012, we had over $1 billion in cash and cash equivalents in excess of our working capital requirements, a portion of which we intend to utilize to repurchase up to $155 million of our common stock during fiscal 2013, as previously discussed. We do not currently expect to raise additional debt or equity financing over the next 12 months, other than to refinance existing facilities. However, there can be no assurances of these expectations as our projections could prove to be incorrect, events may occur that require additional liquidity, such as an acquisition opportunity or an opportunity to refinance indebtedness, or market conditions might significantly worsen, affecting our results of operations and generation of available cash. If these events result in our operations and available cash being insufficient to fund liquidity needs, we would likely seek to manage our available resources by taking actions such as reducing future share repurchases, additional cost-cutting, reducing our expected expenditures on investments, selling assets (such as investment securities), repatriating earnings from foreign affiliates, or modifying arrangements with our affiliates and/or employees. Should these types of actions prove insufficient, or should a large acquisition or refinancing opportunity arise, we may seek to raise additional equity or debt.

At March 31, 2012, our total cash and cash equivalents of $1.4 billion included $600 million held by foreign subsidiaries. Some of the amounts held by foreign subsidiaries may be subject to material repatriation tax effects. In a prior year, we initiated plans to repatriate accumulated earnings of approximately $225 million, of which approximately $100 million had been repatriated as of March 31, 2012. Under current plans, we intend to repatriate $100 million to $150 million of foreign earnings in order to utilize foreign tax credits that may otherwise expire unutilized and to make the cash available in the U.S. All amounts planned for repatriation have been adequately provided for. No further

repatriation of accumulated prior period foreign earnings beyond the above range is currently planned. However, we may repatriate future earnings to the extent required to fund domestic operations and, if tax has not previously been provided, we would provide for and pay additional U.S. taxes in connection with repatriation of these funds. It is not practical at this time to determine the income tax liability that would result from any further repatriation of foreign earnings beyond that currently planned.

See Note 20 of Notes to Consolidated Financial Statements for subsequent events related to our new capital plan, including $650 million issuance of 5.5% senior notes and $1.25 billion repayment of 2.5% convertible senior notes.

Credit and Liquidity Risk

Cash and cash equivalent deposits involve certain credit and liquidity risks. We maintain our cash and cash equivalents with a limited number of high quality financial institutions and from time to time may have concentrations with one or more of these institutions. The balances with these financial institutions and their credit quality are monitored on an ongoing basis.

Off-Balance Sheet Arrangements

Off-balance sheet arrangements, as defined by the Securities and Exchange Commission ("SEC"), include certain contractual arrangements pursuant to which a company has an obligation, such as certain contingent obligations, certain guarantee contracts, retained or contingent interest in assets transferred to an unconsolidated entity, certain derivative instruments classified as equity

or material variable interests in unconsolidated entities that provide financing, liquidity, market risk or credit risk support. Disclosure is required for any off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on our financial condition, results of operations, liquidity or capital resources. We generally do not enter into off-balance sheet arrangements, as defined, other than those described in the Contractual Obligations section that follows and Consolidation discussed in Critical Accounting Policies and Notes 1 and 18 of Notes to Consolidated Financial Statements.

In January 2008, we entered into hedge and warrant transactions on the convertible notes with certain financial institution counterparties to increase the effective conversion price of the convertible senior notes. See Note 7 of Notes to Consolidated Financial Statements.

Contractual Obligations and Contingent Payments
We have contractual obligations to make future payments, principally in connection with our short and long-term debt, non-cancelable lease agreements, and service agreements. See Notes 6, 7, and 9 of Notes to Consolidated Financial Statements for additional disclosures related to our commitments.

The following table sets forth these contractual obligations (in millions) by fiscal year, and excludes contractual obligations of CIVs, as we are not responsible or liable for these obligations:

	2013	2014	2015	2016	2017	Thereafter	Total
Contractual Obligations							
Short-term borrowings(1)	$250.0	$—	$—	$—	$—	$—	$250.0
Long-term borrowings by contract maturity(2)	1.3	1.3	1,251.4	5.9	—	—	1,259.9
Interest on short-term and long-term borrowings(2)(3)	38.1	31.7	31.6	0.3	—	—	101.7
Minimum rental and service commitments	148.2	118.1	107.9	96.4	87.7	489.3	1,047.6
Total Contractual Obligations(4)(5)(6)	$437.6	$151.1	$1,390.9	$102.6	$87.7	$489.3	$2,659.2

(1) Represents borrowing under our revolving line of credit which does not expire until February 2013. However, we may elect to repay this debt sooner if management elects to utilize a portion of our available cash for this purpose.
(2) Excludes long-term borrowings of the consolidated CLO of $271.7 million and interest on these long-term borrowings, as applicable.
(3) Interest on floating rate short-term debt is based on rates at March 31, 2012.
(4) The table above does not include approximately $36.7 million in capital commitments to investment partnerships in which Legg Mason is a limited partner. These obligations will be funded, as required, through the end of the commitment periods through fiscal 2018.
(5) The table above does not include amounts for uncertain tax positions of $69.1 million (net of the federal benefit for state tax liabilities), because the timing of any related cash outflows cannot be reliably estimated.
(6) The table above does not include redeemable noncontrolling interests of $24.0 million, because the timing of any related cash outflows cannot be reliably estimated.

MARKET RISK
We maintain an enterprise risk management program to oversee and coordinate risk management activities of Legg Mason and its subsidiaries. Under the program, certain risk activities are managed at

the subsidiary level. The following describes certain aspects of our business that are sensitive to market risk.

Revenues and Net Income

The majority of our revenue is calculated from the market value of our AUM. Accordingly, a decline in the value of securities will cause our AUM, and thus our revenues, to decrease. In addition, our fixed income and liquidity AUM are subject to the impact of interest rate fluctuations, as rising interest rates may tend to reduce the market value of bonds held in various mutual fund portfolios or separately managed accounts. In the ordinary course of our business, we may also reduce or waive investment management fees, or limit total expenses, on certain products or services for particular time periods to manage fund expenses, or for other reasons, and to help retain or increase managed assets. Performance fees may be earned on certain investment advisory contracts for exceeding performance benchmarks. Declines in market values of AUM will result in reduced fee revenues and net income. We generally earn higher fees on equity assets than fees charged for fixed income and liquidity assets. Declines in market values of AUM in this asset class will disproportionately impact our revenues. In addition, under revenue sharing agreements, certain of our affiliates retain different percentages of revenues to cover their costs, including compensation. Our net income, profit margin and compensation as a percentage of operating revenues are impacted based on which affiliates generate our revenues, and a change in AUM at one subsidiary can have a dramatically different effect on our revenues and earnings than an equal change at another subsidiary.

Trading and Non-Trading Assets
Our trading and non-trading assets are comprised of investment securities, including seed capital in sponsored mutual funds and products, limited partnerships, limited liability companies and certain other investment products.

Trading and other current investments, excluding CIVs, at March 31, 2012 and 2011, subject to risk of security price fluctuations are summarized (in thousands) below.

	2012	2011
Investment securities, excluding CIVs:		
Trading investments relating to long-term incentive compensation plans	$111,257	$120,107
Trading proprietary fund products and other investments	222,585	204,063
Equity method investments relating to long-term incentive compensation plans, proprietary fund products and other investments	78,277	76,340
Total current investments, excluding CIVs	$412,119	$400,510

Approximately $80.0 million and $96.0 million of trading and other current investments related to long-term incentive compensation plans as of March 31, 2012 and 2011, respectively, have offsetting liabilities such that fluctuation in the market value of these assets and the related liabilities will not have a material effect on our net income or liquidity. However, it will have an impact on our compensation expense with a corresponding offset in other non-operating income (expense). Trading and other current investments of $86.2 million and $72.6 million at March 31, 2012 and 2011, respectively, relate to other long-term incentive plans for which the related liabilities do not completely offset due to vesting provisions. Therefore, fluctuations in the market value of these trading investments will impact our compensation expense, non-operating income (expense) and net income.

Approximately $245.9 million and $231.9 million of trading and other current investments at March 31, 2012 and 2011, respectively, are investments in proprietary fund products and other investments for which fluctuations in market value will impact our non-operating income. Of these amounts, the fluctuations in market value of approximately $12.6 million and $30.9 million of proprietary fund products as of March 31, 2012 and 2011, respectively, have offsetting compensation expense under revenue share agreements. The fluctuations in market value of approximately $11.8 million and $39.8 million in proprietary fund products as of March 31, 2012 and 2011, respectively, are substantially offset by gains (losses) on market hedges and therefore do not materially impact Net Income Attributable to Legg Mason, Inc. Investments in proprietary fund products are not liquidated until the related fund establishes a track record, has other investors, or a decision is made to no longer pursue the strategy.

Non-trading assets, excluding CIVs, at March 31, 2012 and 2011, subject to risk of security price fluctuations are summarized (in thousands) below.

	2012	2011
Investment securities, excluding CIVs:		
Available-for-sale	$11,913	$11,300
Investments in partnerships, LLCs and other	34,965	22,167
Equity method investments in partnerships and LLCs	169,201	155,351
Other investments	112	270
Total non-trading assets, excluding CIVs	$216,191	$189,088

Equity method investments in partnerships and LLCs at March 31, 2012 and 2011, includes approximately $89.3 million and $91.9 million, respectively, of investments related to our involvement

with the U.S. Treasury's Public Private Investment Program. Fluctuations in the market value of these investments have offsetting compensation expense under revenue-sharing agreements.

Investment securities of CIVs totaled $31.6 million and $82.8 million as of March 31, 2012 and 2011, respectively, and investments of CIVs totaled $294.9 million and $312.8 million as of March 31, 2012 and 2011, respectively. As of March 31, 2012 and 2011, we held equity investments in the CIVs of $38.9 million and $53.7 million, respectively. Fluctuations in the market value of investments of CIVs in excess of our equity investment will not impact Net Income Attributable to Legg Mason, Inc. However, it may have an impact on other non-operating income (expense) of CIVs with a corresponding offset in net income (loss) attributable to non-controlling interests.

Valuation of trading and non-trading investments is described below within Critical Accounting Policies under the heading "Valuation of Financial Instruments." See Notes 1 and 15 of Notes to Consolidated Financial Statements for further discussion

of derivatives.

The following is a summary of the effect of a 20% increase or decrease in the market values of our financial instruments subject to market valuation risks at March 31, 2012:

	Carrying Value	Fair Value Assuming a 20% Increase[(1)]	Fair Value Assuming a 20% Decrease[(1)]
Investment securities, excluding CIVs:			
Trading investments relating to long-term incentive compensation plans	$111,257	$133,508	$89,006
Trading proprietary fund products and other investments	222,585	267,102	178,068
Equity method investments relating to long-term incentive compensation plans, proprietary fund products and other investments	78,277	93,932	62,622
Total current investments, excluding CIVs	412,119	494,542	329,696
Investments in CIVs	38,919	46,703	31,135
Available-for-sale investments	11,913	14,296	9,530
Investments in partnerships, LLCs and other	34,965	41,958	27,972
Equity method investments in partnerships and LLCs	169,201	203,041	135,361
Other investments	112	134	90
Total investments subject to market risk	$667,229	$800,674	$533,784

(1) Gains and losses related to certain investments in deferred compensation plans and proprietary fund products are directly offset by a corresponding adjustment to compensation expense and related liability. In addition, investments in proprietary fund products of approximately $11.8 million have been economically hedged to limit market risk. As a result, a 20% increase or decrease in the unrealized market value of our financial instruments subject to market valuation risks would result in a $81.5 million increase or decrease in our pre-tax earnings as of March 31, 2012.

Foreign Exchange Sensitivity

We operate primarily in the United States, but provide services, earn revenues and incur expenses outside the United States. Accordingly, fluctuations in foreign exchange rates for currencies, principally in Brazil, Poland, Australia, Canada and the United Kingdom may impact our comprehensive income and net income. Certain of our affiliates have entered into forward contracts to manage the impact of fluctuations in foreign exchange rates on their results of operations. We do not expect foreign currency fluctuations to have a material effect on our net income or liquidity.

Interest Rate Risk

Exposure to interest rate changes on our outstanding debt is mitigated as substantially all of our debt is at fixed interest rates. At March 31, 2012 and 2011, approximately $250.0 million of our outstanding floating rate debt is subject to fluctuations in interest rates and will have an impact on our non-operating income and net income. As of March 31, 2012, we estimate that a 1% change in interest rates would result in a net annual change to interest expense of $2.5 million. See Notes 6 and 7 of Notes to Consolidated Financial Statements for additional disclosures regarding debt.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Accounting policies are an integral part of the preparation of our financial statements in accordance with accounting principles generally accepted in the United States of America. Understanding these policies, therefore, is a key factor in understanding our reported results of operations and financial position. See Note 1 of Notes to Consolidated Financial Statements for a discussion of our significant accounting policies and other information. Certain critical accounting policies require us to make estimates and assumptions that affect the amounts of assets, liabilities, revenues and expenses reported in the financial statements. Due to their nature, estimates involve judgment based upon available information. Therefore, actual results or amounts could differ from estimates and the difference could have a material impact on the consolidated financial statements.

We consider the following to be our critical accounting policies that involve significant estimates or judgments.

Consolidation

Effective April 1, 2010, we adopted revised accounting guidance, Accounting Standards Codification ("ASC") Topic 810, "Consolidation," (Statement of Financial Accounting Standards No. 167, "Amendments to Financial Accounting Standards Board Interpretation No. 46(R)") ("SFAS No. 167"), relating to the consolidation of variable interest entities ("VIEs") which includes a

new approach for determining who should consolidate a VIE, changes to when it is necessary to reassess who should consolidate a VIE, and changes in the assessment of which entities are VIEs. The application of the revised accounting guidance has been deferred for certain investment funds, including money market funds. Investment funds that qualify for the deferral continue to be assessed for consolidation under prior guidance, Financial Accounting Standards Board Interpretation No. 46(R), "Consolidation of Variable Interest Entities — an interpretation of ARB No. 51" ("FIN 46(R)").

In the normal course of our business, we sponsor and are the manager of various types of investment vehicles. Certain of these investment vehicles are considered to be VIEs while others are considered to be voting rights entities ("VREs") subject to traditional consolidation concepts based on ownership rights. For our services, we are entitled to receive management fees and may be eligible, under certain circumstances, to receive additional subordinate management fees or other incentive fees. Our exposure to risk in these entities is generally limited to any equity investment we have made or are required to make and any earned but uncollected management fees. Uncollected management fees from these VIEs were not material at March 31, 2012. We have not issued any investment performance guarantees to these VIEs, VREs or their investors. Investment vehicles that are considered VREs are consolidated if we have a controlling financial interest in the investment vehicle.

Financial Accounting Standards Board Interpretation No. 46(R) (Accounting Standards Update 2010-10, "Amendments to Statement 167 for Certain Investment Funds")
For most sponsored investment funds, including money market funds, we determine whether we are the primary beneficiary of a VIE if we absorb a majority of the VIE's expected losses, or receive a majority of the VIE's expected residual returns, if any. Our determination of expected residual returns excludes gross fees paid to a decision maker if certain criteria are met. In determining whether we are the primary beneficiary of a VIE, we consider both qualitative and quantitative factors such as the voting rights of the equity holders, economic participation of all parties, including how fees are earned and paid to us, related party ownership, guarantees and implied relationships. In determining the primary beneficiary, we must make assumptions and estimates about, among other things, the future performance of the underlying assets held by the VIE, including investment returns, cash flows, and credit and interest rate risks. In determining whether a VIE is significant for disclosure purposes, we consider the same factors used for determination of the primary beneficiary.

Statement of Financial Accounting Standards No. 167 (Accounting Standards Codification Topic 810, "Consolidation")
We sponsor and are the manager for collateralized debt obligation entities ("CDOs") and CLOs that do not qualify for the deferral, and are assessed under the revised accounting guidance, as follows. We determine whether we have a variable interest in a VIE by considering if, among other things, we have the obligation to absorb losses, or the right to receive benefits, that are expected to be significant to the VIE. We consider the management fee structure, including the seniority level of our fees, the current and expected economic performance of the entity, as well as other provisions included in the governing documents that might restrict or guarantee an expected loss or residual return. If we have a significant variable interest, we determine whether we are the primary beneficiary of the VIE if we have both the power to direct the activities of the VIE that most significantly impact the entity's economic performance and the obligation to absorb losses, or the right to receive benefits, that potentially could be significant to the VIE.

In evaluating whether we have the obligation to absorb losses, or the right to receive benefits, that could potentially be significant to the VIE, we consider factors regarding the design, terms, and characteristics of the investment vehicles, including the following qualitative factors: if we have involvement with the

investment vehicle beyond providing management services; if we hold equity or debt interests in the investment vehicle; if we have transferred any assets to the investment vehicle; if the potential aggregate fees in future periods are insignificant relative to the potential cash flows of the investment vehicle; and if the variability of the expected fees in relation to the potential cash flows of the investment vehicle is more than insignificant.

Legg Mason must consolidate VIEs for which it is deemed to be the primary beneficiary.

See Note 18 of Notes to Consolidated Financial Statements for additional discussion of CIVs and other VIEs.

Revenue Recognition

The vast majority of our revenues are calculated as a percentage of the fair value of our AUM. The underlying securities within the portfolios we manage, which are not reflected within our consolidated financial statements, are generally valued as follows: (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith.

For most of our mutual funds and other pooled products, the boards of directors or similar bodies are responsible for establishing policies and procedures related to the pricing of securities. Each board of directors generally delegates the execution of the various functions related to pricing to a fund valuation committee which, in turn, may rely on information from various parties in pricing securities such as independent pricing services, the fund accounting agent, the fund manager, broker-dealers, and others (or a

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combination thereof). The funds have controls reasonably designed to ensure that the prices assigned to securities they hold are accurate. Management has established policies to ensure consistency in the application of revenue recognition.

As manager and advisor for separate accounts, we are generally responsible for the pricing of securities held in client accounts (or may share this responsibility with others) and have established policies to govern valuation processes similar to those discussed above for mutual funds that are reasonably designed to ensure consistency in the application of revenue recognition. Management relies extensively on the data provided by independent pricing services and the custodians in the pricing of separate account AUM. Separate account customers typically select the custodian.

Valuation processes for AUM are dependent on the nature of the assets and any contractual provisions with our clients. Equity securities under management for which market quotations are available are usually valued at the last reported sales price or official closing price on the primary market or exchange on which they trade. Debt securities under management are usually valued at bid, or the mean between the last quoted bid and asked prices, provided by independent pricing services that are based on transactions in debt obligations, quotations from bond dealers, market transactions in comparable securities and various other relationships between securities. Short-term debt obligations are generally valued at amortized cost, which is designed to approximate fair value. The vast majority of our AUM is valued based on data from third parties such as independent pricing services, fund accounting agents, custodians and brokers. This varies slightly from time to time based upon the underlying composition of the asset class (equity, fixed income and liquidity) as well as the actual underlying securities in the portfolio within each asset class. Regardless of the valuation process or pricing source, we have established controls reasonably designed to assess the reasonableness of the prices provided. Where market prices are not readily available, or are determined not to reflect fair value, value may be determined in accordance with established valuation procedures based on, among other things, unobservable inputs. Management fees on AUM where fair values are based on unobservable inputs are not material. As of March 31, 2012, equity, fixed income and liquidity AUM values aggregated $163.4 billion, $356.1 billion and $123.8 billion, respectively.

As the vast majority of our AUM is valued by independent pricing services based upon observable market prices or inputs, we believe market risk is the most significant risk underlying valuation of our AUM. Economic events and financial market turmoil have increased market price volatility; however, the valuation of the vast majority of the securities held by our funds and in separate accounts continues to be derived from readily available market price quotations. As of March 31, 2012, less than 1% of total AUM is valued based on unobservable inputs.

Valuation of Financial Instruments
Substantially all financial instruments are reflected in the financial statements at fair value or amounts that approximate fair value, except our long-term debt. Trading investments, investment securities and derivative assets and liabilities included in the Consolidated Balance Sheets include forms of financial instruments. Unrealized gains and losses related to these financial instruments are reflected in net income or other comprehensive income, depending on the underlying purpose of the instrument.

For equity investments where we do not control the investee, and where we are not the primary beneficiary of a variable interest entity, but can exert significant influence over the financial and operating policies of the investee, we follow the equity method of accounting. The evaluation of whether we exert control or significant influence over the financial and operational policies of its investees requires significant judgment based on the facts and circumstances surrounding each

individual investment. Factors considered in these evaluations may include investor voting or other rights, any influence we may have on the governing board of the investee, the legal rights of other investors in the entity pursuant to the fund's operating documents and the relationship between us and other investors in the entity. Substantially all of our equity method investees are investment companies which record their underlying investments at fair value. Therefore, under the equity method of accounting, our share of the investee's underlying net income or loss predominantly represents fair value adjustments in the investments held by the equity method investee. Our share of the investee's net income or loss is based on the most current information available and is recorded as a net gain (loss) on investments within non-operating income (expense).

For investments, we value equity and fixed income securities using closing market prices for listed instruments or broker or dealer price quotations, when available. Fixed income securities may also be valued using valuation models and estimates based on spreads to actively traded benchmark debt instruments with readily available market prices. We evaluate our non-trading Investment securities for "other than temporary" impairment. Impairment may exist when the fair value of an investment security has been below the adjusted cost for an extended period of time. If an "other than temporary" impairment is determined to exist, the difference between the adjusted cost of the investment security and its current fair value is recognized as a charge to earnings in the period in which the impairment is determined.

For investments in illiquid or privately-held securities for which market prices or quotations are not readily available, the determination of fair value requires us to estimate the value of the securities using a variety of methods and resources, including the most current available financial information for the investment and the industry. As of March 31, 2012 and 2011, excluding

investments in CIVs, we owned approximately $11.9 million and $23.8 million, respectively, of financial investments that were valued on our assumptions or estimates and unobservable inputs.

At March 31, 2012 and 2011, we also have approximately $204.2 million and $177.5 million, respectively, of other investments, such as investment partnerships, that are included in Other noncurrent assets on the Consolidated Balance Sheets, of which approximately $169.2 million and $155.4 million, respectively, are accounted for under the equity method. The remainder is accounted for under the cost method, which considers if factors indicate there may be an impairment in the value of these investments. In addition, as of March 31, 2012 and 2011, we had $78.3 million and $76.3 million, respectively, of equity method investments that are included in Investment securities on the Consolidated Balance Sheets.

The accounting guidance for fair value measurements and disclosures defines fair value and establishes a framework for measuring fair value. The accounting guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value measurement should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of non-performance.

The accounting guidance for fair value measurements establishes a hierarchy that prioritizes the inputs for valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

Our financial instruments measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 — Financial instruments for which prices are quoted in active markets, which, for us, include investments in publicly traded mutual funds with quoted market prices and equities listed in active markets.

Level 2 — Financial instruments for which prices are quoted for similar assets and liabilities in active markets; prices are quoted for identical or similar assets in inactive markets; or prices are based on observable inputs, other than quoted prices, such as models or other valuation methodologies. For us, this category may include repurchase agreements, fixed income securities and certain proprietary fund products. This category also includes CLO loans and liabilities of a CIV, and previously included certain derivative assets and liabilities of CIVs.

Level 3 — Financial instruments for which values are based on unobservable inputs, including those for which there is little or no market activity. This category includes investments in partnerships, limited liability companies and private equity funds. This category may also include certain proprietary fund products with redemption restrictions and CLO debt of a CIV.

The valuation of an asset or liability may involve inputs from more than one level of the hierarchy. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Proprietary fund products and certain investments held by CIVs are valued at net asset value ("NAV") determined by the fund administrator. These funds are typically invested in exchange traded investments with observable market prices. Their valuations may be classified as Level 1, Level 2 or Level 3 based on whether the fund is exchange traded, the frequency of the related NAV determinations and the impact of redemption restrictions. For investments in illiquid and privately-held securities (private equity and investment partnerships) for which market prices or quotations may not be readily available, including certain investments held by CIVs, management must estimate the value of the securities using a variety of methods and resources, including the most current available financial information for the investment and the industry to which it applies in order to determine fair value. These valuation processes for illiquid and privately-held securities inherently require management's judgment and are therefore classified in Level 3.

The fair values of CLO loans and bonds are determined based on prices from well-recognized third-party pricing services that utilize available market data and are therefore classified as Level 2. Legg Mason has established controls designed to assess the reasonableness of the prices provided. The fair value of CLO debt is valued using a discounted cash flow methodology. Inputs used to determine the expected cash flows include assumptions about forecasted default and recovery rates that a market participant would use in determining the fair value of the CLO's underlying collateral assets. Given the significance of the unobservable inputs to the fair value measurement, the CLO debt valuation is classified as Level 3.

Exchange traded options are valued using the last sale price or in the absence of a sale, the last offering price. Options traded over

the counter are valued using dealer supplied valuations. Options are classified as Level 1. Futures contracts are valued at the last settlement price at the end of each day on the exchange upon which they are traded and are classified as Level 1. Index and single name credit default swaps and interest rate swaps previously held were valued based on valuations furnished by pricing services and classified as Level 2.

As a practical expedient, we rely on the NAVs of certain investments as their fair value. The NAVs that have been provided by investees are derived from the fair values of the underlying investments as of the reporting date.

As of March 31, 2012, approximately 3% of total assets (13% of financial assets measured at fair value) and 10% of total liabilities meet the definition of Level 3. Excluding the assets and liabilities of CIVs, approximately 2% of total assets (13% of financial assets measured at fair value) and no liabilities meet the definition of Level 3.

Any transfers between categories are measured at the beginning of the period.

See Note 3 of Notes to Consolidated Financial Statements for additional information.

Intangible Assets and Goodwill

Balances as of March 31, 2012, are as follows:

Amortizable asset management contracts	$33,437
Indefinite-life intangible assets	3,753,629
Trade names	69,800
Goodwill	1,275,045
	$5,131,911

Our identifiable intangible assets consist primarily of asset management contracts, contracts to manage proprietary mutual funds or funds-of-hedge funds and trade names resulting from acquisitions. Asset management contracts are amortizable intangible assets that are capitalized at acquisition and amortized over the expected life of the contract. Contracts to manage proprietary mutual funds or funds-of-hedge funds are indefinite-life intangible assets because we assume that there is no foreseeable limit on the contract period due to the likelihood of continued renewal at little or no cost. Similarly, trade names are considered indefinite-life intangible assets because they are expected to generate cash flows indefinitely.

In allocating the purchase price of an acquisition to intangible assets, we must determine the fair value of the assets acquired. We determine fair values of intangible assets acquired based upon projected future cash flows, which take into consideration estimates and assumptions including profit margins, growth or attrition rates for acquired contracts based upon historical experience, estimated contract lives, discount rates, projected net client flows and market performance. The determination of estimated contract lives requires judgment based upon historical client turnover and attrition rates and the probability that contracts with termination provisions will be renewed. The discount rate employed is a weighted-average cost of capital that takes into consideration a premium representing the degree of risk inherent in the asset as more fully described below.

For indefinite-life intangible assets and goodwill, we project the impact of both net client flows and market appreciation/depreciation on cash flows for the near-term (generally the first five years) based on a year-by-year assessment that considers current market conditions, our past experience, relevant

publicly available statistics and projections, internal budgets, and discussions with our own market experts. Beyond five years, our projections for net client flows and market performance migrate towards relevant long-term rates in line with our own results and industry growth statistics. We believe our growth assumptions are reasonable given our consideration of multiple inputs, including internal and external sources described above. However, there continues to be uncertainty in the markets, and our assumptions are subject to change based on fluctuations in our actual results and market conditions.

Goodwill represents the residual amount of acquisition cost in excess of identified tangible and intangible assets and assumed liabilities.

Given the relative significance of our intangible assets and goodwill to our consolidated financial statements, on a quarterly basis we consider if triggering events have occurred that may indicate a significant change in fair values. Triggering events may include significant adverse changes in our business, legal or regulatory environment, loss of key personnel, significant business dispositions, or other events. If a triggering event has occurred, we perform tests, which include critical reviews of all significant assumptions, to determine if any intangible assets or goodwill are impaired. At a minimum, we perform these tests for indefinite-life intangible assets and goodwill annually at December 31.

We completed our annual impairment tests of goodwill and indefinite-life intangible assets as of December 31, 2011, and determined that there was no impairment in the value of these assets as of that date. Further, no impairment in the value of amortizable intangible assets was recognized during the year ended March 31, 2012, as our estimates of the related future cash flows exceeded the asset carrying values. We have also determined that no triggering events have occurred as of March 31, 2012, therefore, no additional indefinite-life intangible asset and goodwill impairment testing was necessary.

Amortizable Intangible Assets
Intangible assets subject to amortization are considered for impairment at each reporting period using an undiscounted cash flow analysis. Significant assumptions used in assessing the recoverability of management contract intangible assets include projected cash flows generated by the contracts and the remaining lives of the contracts. Projected cash flows are based on fees generated by current AUM for the applicable contracts. Contracts are generally assumed to turnover evenly throughout the life of the intangible asset. The remaining life of the asset is based upon factors such as average client retention and client turnover rates. If the amortization periods are not appropriate, the expected lives are adjusted and the impact on the fair value is assessed. Actual cash flows in any one period may vary from the projected cash flows without resulting in an impairment charge because a variance in any one period must be considered in conjunction with other assumptions that impact projected cash flows.

The estimated useful lives of amortizable intangible assets currently range from one to five years with a weighted-average life of approximately 2.9 years.

Indefinite-Life Intangible Assets
For intangible assets with lives that are indeterminable or indefinite, fair value is determined from a market participant's perspective based on projected discounted cash flows. We have two primary types of indefinite-life intangible assets: proprietary fund contracts and, to a lesser extent, trade names.

We determine the fair value of our intangible assets based upon discounted projected cash flows, which take into consideration estimates of profit margins, growth rates and discount rates. An asset is determined to be impaired if the current implied fair value is less than the recorded carrying value of the asset. If an asset is impaired, the difference between the current implied fair value and the carrying value of the asset reflected on the financial statements is recognized as an expense in the period in which the impairment is determined to be other than temporary.

Projected cash flows are based on annualized cash flows for the applicable contracts projected forward 40 years, assuming annual cash flow growth from estimated net client flows and projected market performance. Contracts that are managed and operated as a single unit, such as contracts within the same family of funds, are reviewed in aggregate and are considered interchangeable because investors can transfer between funds with limited restrictions. Similarly, cash flows generated by new funds added to the fund group are included when determining the fair value of the intangible asset. Actual cash flows in any one period may vary from the projected cash flows without resulting in an impairment charge because a variance in any one period must be considered in conjunction with other assumptions that impact projected cash flows.

The domestic mutual fund contracts acquired in the Citigroup Asset Management ("CAM") acquisition of $2,502 million account for approximately 65% of our indefinite-life intangible assets and are managed primarily by ClearBridge and Western Asset. Permal funds-of-hedge funds contracts of $947 million account for approximately 25% of our indefinite-life intangible assets. For our

December 31, 2011, annual impairment test, cash flows from the domestic mutual fund contracts were assumed to have annual growth rates that average approximately 7%. Cash flows on the Permal funds-of-hedge funds contracts were assumed to have annual growth rates that average approximately 9%. The projected cash flows from the domestic mutual fund and Permal funds were discounted at 13.0% and 14.5%, respectively. Assuming all other factors remain the same, actual results and changes in assumptions for the domestic mutual fund and Permal funds-of-hedge funds contracts would have to cause our cash flow projections over the long-term to deviate more than 5% and 35%, respectively, from previous projections or the discount rate would have to be raised to 13.5% and 19.5%, respectively, for the asset to be deemed impaired. Given the current uncertainty regarding future market conditions, it is reasonably possible that fund performance, flows and AUM levels may decrease in the near term such that actual cash flows from the domestic mutual fund contracts could deviate from the projections by more than 5% and the asset could be deemed to be impaired by a material amount. The approximate fair values of these assets exceed their carrying values by $124 million and $606 million, respectively.

Trade names account for 2% of indefinite-life intangible assets and are primarily related to Permal. We tested these intangible assets using assumptions similar to those described above for indefinite-life contracts, and the resulting fair values significantly exceeded the related carrying amounts.

Goodwill

Goodwill is evaluated at the reporting unit level and is considered for impairment when the carrying amount of the reporting unit exceeds the implied fair value of the reporting unit. In estimating the implied fair value of the reporting unit, we use valuation techniques based on discounted projected cash flows, similar to techniques employed in analyzing the purchase price of an acquisition target. In December 2010, we announced a realignment of our executive management team, which during fiscal 2012, resulted in the combination of our Americas and International divisions into one operating segment, Global Asset Management. Internal management reporting has been modified consistent with this realignment such that discrete financial information regularly received by the chief operating decision maker, our Chief Executive Officer, is at the consolidated Global Asset Management business level. As a result, the former Americas and International operating segments are no longer our reporting units, and subsequently, goodwill is recorded and evaluated at one Global Asset Management reporting unit level. See Note 17 of Notes to Consolidated Financial Statements for additional information related to business segments.

Significant assumptions used in assessing the implied fair value of the reporting unit under the discounted cash flow method include the projected cash flows generated by the reporting unit, including profit margins, expected cash flow growth rates, and the discount rate used to determine the present value of the cash flows. Cash flow growth rates consider estimates of both AUM flows and market expectations by asset class (equity, fixed income and liquidity) and by investment manager based upon, among other things, historical experience and expectations of future market performance from internal and external sources. The impact of both net client flows and market performance on cash flows are projected for the near-term (generally the first five years) based on a year-by-year assessment that considers current market conditions, our experience, our internal financial projections, relevant publicly available statistics and projections, and discussions with our own market experts. Actual cash flows in any one period may vary from the projected cash flows without resulting in an impairment charge because a variance in any one period must be considered in conjunction with other assumptions that impact projected cash flows.

Discount rates are based on appropriately weighted estimated costs of debt and capital using a market participant perspective. We estimate the cost of debt based on published debt rates. We estimate the cost of capital based on the Capital Asset Pricing Model, which considers the risk-free interest rate, market risk and size premiums, peer-group betas and unsystematic risk. The discount rates are also calibrated based on an assessment of relevant market values.

Goodwill principally originated from the acquisitions of CAM, Permal and Royce. The value of the reporting unit is based on projected net cash flows of assets managed in our mutual funds, closed-end funds and other proprietary funds, in addition to separate account assets of our managers. For our annual December 31 impairment test, the projected cash flows are discounted at 14.0% to determine the present value of cash flows. As of December 31, 2011, the implied fair value significantly exceeds the carrying value. Projected cash flows, on an aggregate basis across all asset classes, are assumed to have an average annual growth rate of approximately 8%. Cash flow growth is based on separate factors for equity, fixed income, and liquidity products. Equity product growth projections are based on long-term growth experience and current market conditions. Fixed income product growth projections are based on the past experience of our primary fixed income manager and current market influences relevant to their business, available historical experience and market statistics, and estimates of future expectations. We believe our growth assumptions are reasonable given our consideration of multiple inputs, including internal and external sources described above. However, our assumptions are subject to change based on fluctuations in our actual results and market conditions. Assuming all other factors

remain the same, actual results and changes in assumptions would have to cause our cash flow projections over the long-term to deviate approximately 51% from previous projections or the discount rate would have to increase approximately eight percentage points for goodwill to be considered for impairment.

As of December 31, 2011, considering relevant prices of our common shares, our market capitalization, along with a reasonable control premium, exceeds the aggregate carrying values of our reporting unit.

Stock-Based Compensation

Our stock-based compensation plans include stock options, employee stock purchase plans, market-based performance share awards, restricted stock awards and deferred compensation payable in stock. Under our stock compensation plans, we issue equity awards to directors, officers, and key employees.

In accordance with the applicable accounting guidance, compensation expense for the years ended March 31, 2012, 2011 and 2010, includes compensation cost for all non-vested share-based awards at their grant date fair value amortized over the respective vesting periods on the straight-line method. Also, under the accounting guidance, cash flows related to income tax deductions in excess of or less than the stock-based compensation expense are classified as financing cash flows.

We granted 0.8 million, 0.7 million, and 1.5 million stock options in fiscal 2012, 2011 and 2010, respectively. For additional information on share-based compensation, see Note 12 of Notes to Consolidated Financial Statements.

We determine the fair value of each option grant using the Black-Scholes option-pricing model, except for market-based grants, for which we would use a Monte Carlo option-pricing model. Both models require management to develop estimates regarding certain input variables. The inputs for the Black-Scholes model include: stock price on the date of grant, exercise price of the option, dividend yield, volatility, expected life and the risk-free interest rate, all of which except the grant date stock price and the exercise price require estimates or assumptions. We calculate the dividend yield based upon the average of the historical quarterly dividend payments over a term equal to the vesting period of the options. We estimate volatility equally weighted between the historical prices of our stock over a period equal to the expected life of the option and the implied volatility of market listed options at the date of grant. The expected life is the estimated length of time an option will be held before it is either exercised or canceled, based upon our historical option exercise experience. The risk-free interest rate is the rate available for zero-coupon U.S. Government issues with a remaining term equal to the expected life of the options being valued. If we used different methods to estimate our variables for the Black-Scholes and Monte Carlo models, or if we used a different type of option-pricing model, the fair value of our option grants might be different.

Income Taxes

We are subject to the income tax laws of the federal, state and local jurisdictions of the U.S. and numerous foreign jurisdictions in which we operate. We file income tax returns representing our filing positions with each jurisdiction. Due to the inherent complexities arising from conducting business and being taxed in a substantial number of jurisdictions, we must make certain estimates and judgments in determining our income tax provision for financial statement purposes.

These estimates and judgments are used in determining the tax basis of assets and liabilities and in the calculation of certain tax assets and liabilities that arise from differences in the timing of revenue and expense recognition for tax and financial statement purposes. Management assesses the likelihood that we will be able to realize our deferred tax assets. If it is more likely than not that the deferred tax asset will not be realized, then a valuation allowance is established with a corresponding increase to deferred tax provision.

Substantially all of our deferred tax assets relate to U.S. and U.K. taxing jurisdictions. As of March 31, 2012, U.S. federal deferred tax assets aggregated $718 million, realization of which is expected to require $4.1 billion of future U.S. earnings, approximately $169 million of which must be in the form of foreign sourced income. Deferred tax assets generated in U.S. jurisdictions resulting from net operating losses generally expire 20 years after they are generated and those resulting from foreign tax credits generally expire 10 years after they are generated. Based on estimates of future taxable income, using assumptions consistent with those used in our goodwill impairment testing, it is more likely than not that current federal tax benefits relating to net operating losses are realizable and no valuation allowance is necessary at this time. With respect to those resulting from foreign tax credits, it is more likely than not that tax benefits relating to $10.4 million foreign tax credits will not be realizable and a valuation allowance of $3.4 million was recorded in fiscal 2012 with respect thereto. While tax planning may enhance our positions, the realization of current tax benefits is not dependent on any significant tax strategies.

As of March 31, 2012, U.S. state deferred tax assets aggregated $237 million. Due to limitations on net operating loss and capital loss carryforwards and, taking into consideration certain state tax planning strategies, a valuation allowance has been established for the state capital loss and net operating loss benefits in certain jurisdictions in the amount of $12.1 million for fiscal 2012. Due to the uncertainty of future state apportionment factors and future effective state tax rates, the value of state net operating

loss benefits ultimately realized may vary. A net release of $7.3 million in fiscal 2012 of the full valuation allowance on foreign deferred tax assets related to various jurisdictions, primarily the U.K. and Japan. To the extent our analysis of the realization of deferred tax assets relies on deferred tax liabilities, we have considered the timing, nature and jurisdiction of reversals, as well as, future increases relating to the tax amortization of goodwill and indefinite-life intangible assets. In the event we determine all or any portion of our deferred tax assets that are not already subject to a valuation allowance are not realizable, we will be required to establish a valuation allowance by a charge to the income tax provision in the period in which that determination is made. Depending on the facts and circumstances, the charge could be material to our earnings.

The calculation of our tax liabilities involves uncertainties in the application of complex tax regulations. We recognize liabilities for anticipated tax uncertainties in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due.

RECENT ACCOUNTING DEVELOPMENTS

See discussion of Recent Accounting Developments in Note 1 of Notes to Consolidated Financial Statements.

FORWARD-LOOKING STATEMENTS

We have made in this Report on Form 10-K, and from time to time may otherwise make in our public filings, press releases and

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statements by our management, "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, including information relating to anticipated growth in revenues, margins or earnings per share, anticipated changes in our business or in the amount of our client AUM, anticipated future performance of our business, including expected earnings per share in future periods, anticipated future investment performance of our affiliates, our expected future net client cash flows, anticipated expense levels, changes in expenses, the expected effects of acquisitions and expectations regarding financial market conditions. The words or phrases "can be," "may be," "expects," "may affect," "may depend," "believes," "estimate," "project," "anticipate" and similar words and phrases are intended to identify such forward-looking statements. Such forward-looking statements are subject to various known and unknown risks and uncertainties and we caution readers that any forward-looking information provided by or on behalf of Legg Mason is not a guarantee of future performance.

Actual results may differ materially from those in forward-looking information as a result of various factors, some of which are beyond our control, including but not limited to those discussed below and those discussed under the heading "Risk Factors" and elsewhere in this Report on Form 10-K and our other public filings, press releases and statements by our management. Due to such risks, uncertainties and other factors, we caution each person receiving such forward-looking information not to place undue reliance on such statements. Further, such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligations to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Our future revenues may fluctuate due to numerous factors, such as: the total value and composition of our AUM; the mix of our AUM among our affiliates; the revenue yield of our AUM; the volatility and general level of securities prices and interest rates; the relative investment performance of company-sponsored investment funds and other asset management products both in absolute terms and relative to competing offerings and market indices; investor sentiment and confidence; general economic conditions; our ability to maintain investment management and administrative fees at current levels; competitive conditions in our business; the ability to attract and retain key personnel and the effects of acquisitions, including prior acquisitions. Our future operating results are also dependent upon the level of operating expenses, which are subject to fluctuation for the following or other reasons: variations in the level of compensation expense incurred as a result of changes in the number of total employees, competitive factors, changes in the percentages of revenues paid as compensation or other reasons; variations in expenses and capital costs, including depreciation, amortization and other non-cash charges incurred by us to maintain our administrative infrastructure; unanticipated costs that may be incurred by Legg Mason from time to time to protect client goodwill, to otherwise support investment products or in connection with litigation or regulatory proceedings; and the effects of acquisitions and dispositions.

Our business is also subject to substantial governmental regulation and changes in legal, regulatory, accounting, tax and compliance requirements that may have a substantial effect on our business and results of operations.

EFFECTS OF INFLATION

The rate of inflation can directly affect various expenses, including employee compensation, communications and technology and occupancy, which may not be readily recoverable in charges for services provided by us. Further, to the extent inflation adversely affects the securities markets, it may

impact revenues and recorded intangible asset and goodwill values. See discussion of "Market Risks — Revenues and Net Income" and "Critical Accounting Policies — Intangible Assets and Goodwill" previously discussed.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk" for disclosures about market risk.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

REPORT OF MANAGEMENT ON
INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Legg Mason, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting.

Legg Mason's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Legg Mason's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Legg Mason; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of Legg Mason are being made only in accordance with authorizations of management and directors of Legg Mason; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of Legg Mason's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of Legg Mason's internal control over financial reporting as of March 31, 2012, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control — Integrated Framework. Based on that assessment, management concluded that, as of March 31, 2012, Legg Mason's internal control over financial reporting is effective based on the criteria established in the COSO framework.

The effectiveness of Legg Mason's internal control over financial reporting as of March 31, 2012, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report appearing herein, which expresses an unqualified opinion on the effectiveness of Legg Mason's internal control over financial reporting as of March 31, 2012.

Mark R. Fetting
Chairman of the Board, President and Chief Executive Officer

Peter H. Nachtwey
Senior Executive Vice President and Chief Financial Officer

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REPORT OF INDEPENDENT
REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
and Stockholders of Legg Mason, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income (loss), comprehensive income (loss), changes in stockholders' equity and cash flows present fairly, in all material respects, the financial position of Legg Mason, Inc. and its subsidiaries ("the Company") at March 31, 2012 and March 31, 2011, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of March 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Baltimore, Maryland
May 25, 2012

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	March 31, 2012	2011
ASSETS		
Current Assets		
Cash and cash equivalents	$1,382,263	$1,375,918
Cash and cash equivalents of consolidated investment vehicles	26,139	37,153
Restricted cash	2,167	9,253
Receivables:		
Investment advisory and related fees	333,777	366,571
Other	100,060	29,466
Investment securities	412,119	400,510
Investment securities of consolidated investment vehicles	31,575	82,829
Deferred income taxes	117,391	82,174
Other	51,977	59,700
Other current assets of consolidated investment vehicles	326	2,982
Total current assets	2,457,794	2,446,556
Fixed assets, net	239,411	286,705
Intangible assets, net	3,856,866	3,876,775
Goodwill	1,275,045	1,311,652
Investments of consolidated investment vehicles	294,853	312,765
Deferred income taxes	142,706	232,394
Other	287,653	239,210
Other assets of consolidated investment vehicles	1,419	1,699
Total Assets	$8,555,747	$8,707,756
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Liabilities		
Current Liabilities		
Accrued compensation	$409,759	$368,164
Accounts payable and accrued expenses	195,808	207,870
Short-term borrowings	250,000	250,000
Current portion of long-term debt	1,278	792
Other	114,840	87,393
Other current liabilities of consolidated investment vehicles	4,097	54,753
Total current liabilities	975,782	968,972
Deferred compensation	57,339	92,487
Deferred income taxes	242,567	266,193
Other	167,544	90,059
Other liabilities of consolidated investment vehicles	3,872	3,553
Long-term debt	1,135,614	1,201,076
Long-term debt of consolidated investment vehicles	271,707	278,320
Total Liabilities	2,854,425	2,900,660

Commitments and Contingencies (Note 9)		
Redeemable Noncontrolling Interests	24,031	36,712
Stockholders' Equity		
Common stock, par value $.10; authorized 500,000,000 shares; issued 139,874,034 shares in 2012 and 150,218,810 shares in 2011	13,987	15,022
Additional paid-in capital	3,864,216	4,111,095
Employee stock trust	(32,419)	(34,466)
Deferred compensation employee stock trust	32,419	34,466
Retained earnings	1,715,395	1,539,984
Appropriated retained earnings of consolidated investment vehicle	12,221	10,922
Accumulated other comprehensive income, net	71,472	93,361
Total Stockholders' Equity	5,677,291	5,770,384
Total Liabilities and Stockholders' Equity	$8,555,747	$8,707,756

See Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except per share amounts)

	Years Ended March 31,		
	2012	2011	2010
OPERATING REVENUES			
Investment advisory fees:			
Separate accounts	$775,534	$815,633	$814,824
Funds	1,491,325	1,486,615	1,367,297
Performance fees	49,499	96,661	71,452
Distribution and service fees	340,966	379,161	375,333
Other	5,250	6,247	5,973
Total operating revenues	2,662,574	2,784,317	2,634,879
OPERATING EXPENSES			
Compensation and benefits	1,109,671	1,140,305	1,111,298
Transition-related compensation	34,638	45,048	—
Total compensation and benefits	1,144,309	1,185,353	1,111,298
Distribution and servicing	649,739	712,839	691,931
Communications and technology	164,712	161,969	163,098
Occupancy	154,816	137,861	156,967
Amortization of intangible assets	19,574	22,913	22,769
Other	190,671	176,574	167,633
Total operating expenses	2,323,821	2,397,509	2,313,696
OPERATING INCOME	338,753	386,808	321,183
OTHER NON-OPERATING INCOME (EXPENSE)			
Interest income	11,481	9,246	7,354
Interest expense	(87,584)	(92,157)	(126,273)
Fund support	—	—	23,171
Other income	22,097	59,596	86,892
Other non-operating income of consolidated investment vehicles, net	18,336	1,704	17,329
Total other non-operating income (expense)	(35,670)	(21,611)	8,473
INCOME BEFORE INCOME TAX PROVISION	303,083	365,197	329,656
Income tax provision	72,052	119,434	118,676
NET INCOME	231,031	245,763	210,980
Less: Net income (loss) attributable to noncontrolling interests	10,214	(8,160)	6,623
NET INCOME ATTRIBUTABLE TO LEGG MASON, INC.	$220,817	$253,923	$204,357
NET INCOME PER SHARE ATTRIBUTABLE TO LEGG MASON, INC. COMMON SHAREHOLDERS			
Basic	$1.54	$1.63	$1.33
Diluted	$1.54	$1.63	$1.32

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

	Years ended March 31,		
	2012	2011	2010
NET INCOME	$231,031	$245,763	$210,980
Other comprehensive income:			
Foreign currency translation adjustment	(22,098)	35,159	61,029
Unrealized gains (losses) on investment securities:			
Unrealized holding gains (losses), net of tax provision (benefit) of $132, $(22), and $(9), respectively	198	(33)	(13)
Reclassification adjustment for (gains) losses included in net income	11	8	(5)
Net unrealized gains (losses) on investment securities	209	(25)	(18)
Total other comprehensive income (loss)	(21,889)	35,134	61,011
COMPREHENSIVE INCOME	209,142	280,897	271,991
Less: Comprehensive income (loss) attributable to noncontrolling interests	10,214	(8,160)	6,623
COMPREHENSIVE INCOME ATTRIBUTABLE TO LEGG MASON, INC.	$198,928	$289,057	$265,368

See Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Dollars in thousands)

	Years Ended March 31,		
	2012	2011	2010
COMMON STOCK			
Beginning balance	$15,022	$16,144	$14,185
Stock options and other stock-based compensation	17	64	8
Deferred compensation employee stock trust	7	7	13
Deferred compensation, net	124	152	66
Exchangeable shares	—	110	12
Equity Units exchanged	183	—	1,860
Employee tax withholdings by net share transactions	(6)	—	—
Shares repurchased and retired	(1,360)	(1,455)	—
Ending balance	13,987	15,022	16,144
SHARES EXCHANGEABLE INTO COMMON STOCK			
Beginning balance	—	2,760	3,069
Exchanges	—	(2,760)	(309)
Ending balance	—	—	2,760
ADDITIONAL PAID-IN CAPITAL			
Beginning balance	4,111,095	4,447,612	3,452,530
Stock options and other stock-based compensation	16,508	31,674	18,758
Deferred compensation employee stock trust	2,020	2,673	3,156
Deferred compensation, net	32,193	34,619	29,056
Exchangeable shares	—	2,650	297
Equity Units exchanged	102,831	35,877	943,815
Employee tax withholdings by net share transactions	(1,525)	—	—
Shares repurchased and retired	(398,906)	(444,010)	—
Ending balance	3,864,216	4,111,095	4,447,612
EMPLOYEE STOCK TRUST			
Beginning balance	(34,466)	(33,095)	(35,094)
Shares issued to plans	(2,027)	(2,136)	(2,938)
Distributions and forfeitures	4,074	765	4,937
Ending balance	(32,419)	(34,466)	(33,095)
DEFERRED COMPENSATION EMPLOYEE STOCK TRUST			
Beginning balance	34,466	33,095	35,094
Shares issued to plans	2,027	2,136	2,938
Distributions and forfeitures	(4,074)	(765)	(4,937)
Ending balance	32,419	34,466	33,095
RETAINED EARNINGS			
Beginning balance	1,539,984	1,316,981	1,131,625
Net income attributable to Legg Mason, Inc.	220,817	253,923	204,357
Dividends declared	(45,406)	(30,920)	(19,001)
Ending balance	1,715,395	1,539,984	1,316,981
APPROPRIATED RETAINED EARNINGS OF CONSOLIDATED INVESTMENT VEHICLE			

Beginning balance	10,922	—	—
Cumulative effect of change in accounting principle	—	24,666	—
Net income (loss) reclassified to appropriated retained earnings	1,299	(13,744)	—
Ending balance	12,221	10,922	—
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET			
Beginning balance	93,361	58,227	(2,784)
Unrealized holding gains (losses) on investment securities, net of tax	209	(25)	(18)
Foreign currency translation adjustment	(22,098)	35,159	61,029
Ending balance	71,472	93,361	58,227
TOTAL STOCKHOLDERS' EQUITY	$5,677,291	$5,770,384	$5,841,724

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Years ended March 31,		
	2012	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	$231,031	$245,763	$210,980
Loss on Equity Units exchange	—	—	22,040
Adjustments to reconcile Net Income to net cash provided by operations:			
Depreciation and amortization	93,795	102,748	114,078
Imputed interest for 2.5% convertible senior notes	39,077	36,688	34,445
Accretion and amortization of securities discounts and premiums, net	4,552	4,539	13,387
Stock-based compensation	48,735	56,245	46,578
Net gains on investments	(1,714)	(58,851)	(103,457)
Net losses (gains) of consolidated investment vehicles	(6,711)	3,959	(17,359)
Unrealized gains on fund support	—	—	(22,115)
Deferred income taxes	49,192	80,272	113,947
Other	(12,191)	5,393	2,808
Decrease (increase) in assets:			
Investment advisory and related fees receivable	31,790	(13,794)	(53,402)
Net (purchases) sales of trading and other current investments	(40,020)	(55,540)	52,288
Refundable income taxes	—	—	992,548
Other receivables	1,432	1,962	177,667
Other assets	1,810	(20,923)	(50,082)
Increase (decrease) in liabilities:			
Accrued compensation	42,763	75,970	(89,800)
Deferred compensation	(35,148)	(44,825)	32,197
Accounts payable and accrued expenses	(11,147)	(251)	2,686
Other liabilities	28,135	(49,954)	(86,484)
Net increase in operating assets and liabilities of consolidated investment vehicles, including cash	31,388	42,739	20,213
CASH PROVIDED BY OPERATING ACTIVITIES	496,769	412,140	1,413,163
CASH FLOWS FROM INVESTING ACTIVITIES			
Payments for fixed assets	(31,822)	(32,904)	(84,117)
Payments for business acquisitions-related costs	—	—	(11,092)
Contractual acquisition earnout payments	—	—	(179,804)
Proceeds from sale of assets	3,060	—	150
Fund support	—	—	38,890
Restricted cash	11,221	—	—
Purchases of investment securities	(6,493)	(8,430)	(55,507)
Proceeds from sales and maturities of investment securities	6,197	9,077	14,792
Purchases of investments by consolidated investment vehicles	(141,727)	(173,261)	—
Proceeds from sales and maturities of investments by consolidated investment vehicles	161,894	161,047	—
CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	$2,330	$(44,471)	$(276,688)

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(Dollars in thousands)

	Years ended March 31,		
	2012	2011	2010
CASH FLOWS FROM FINANCING ACTIVITIES			
Debt issue costs	$—	$—	$(3,056)
Third-party distribution financing, net	—	(1,639)	(2,428)
Repayment of principal on long-term debt	(1,014)	(3,515)	(554,913)
Payment on Equity Units exchange	—	—	(135,015)
Issuance of common stock	4,538	14,440	4,999
Repurchase of common stock	(401,797)	(445,465)	—
Dividends paid	(43,602)	(26,813)	(48,241)
Net repayments of consolidated investment vehicles	(18,309)	(7,025)	—
Net (redemptions/distributions paid to)/subscriptions received from noncontrolling interest holders	(21,596)	1,551	(8,066)
CASH USED IN FINANCING ACTIVITIES	(481,780)	(468,466)	(746,720)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(10,974)	10,827	19,481
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,345	(89,970)	409,236
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	1,375,918	1,465,888	1,056,652
CASH AND CASH EQUIVALENTS AT END OF YEAR	$1,382,263	$1,375,918	$1,465,888
SUPPLEMENTARY DISCLOSURE			
Cash paid (received) for:			
Income taxes, net of (refunds) payments of ($12,034), ($12,090) and $60,747, respectively	$24,552	$39,524	$(994,823)
Interest	41,039	46,620	73,909

See Notes to Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands, except per share amounts or unless otherwise noted)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation
Legg Mason, Inc. ("Parent") and its subsidiaries (collectively, "Legg Mason") are principally engaged in providing asset management and related financial services to individuals, institutions, corporations and municipalities.

The consolidated financial statements include the accounts of the Parent and its subsidiaries in which it has a controlling financial interest. Generally, an entity is considered to have a controlling financial interest when it owns a majority of the voting interest in an entity. Legg Mason is also required to consolidate any variable interest entity ("VIE") in which it is considered to be the primary beneficiary. See Note 18 for a further discussion of VIEs. All material intercompany balances and transactions have been eliminated.

Where appropriate, prior years financial statements reflect reclassifications to conform to the current year presentation.

Unless otherwise noted, all per share amounts include common shares of Legg Mason and shares issued in connection with the acquisition of Legg Mason Canada Inc., which were exchangeable into common shares of Legg Mason on a one-for-one basis at any time. In May 2010, all outstanding exchangeable shares were exchanged for shares of Legg Mason common stock.

All references to fiscal 2012, 2011 or 2010, refer to Legg Mason's fiscal year ended March 31 of that year.

Use of Estimates
The consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make assumptions and estimates that affect the amounts reported in the financial statements and accompanying notes, including revenue recognition, valuation of financial instruments, intangible assets and goodwill, stock-based compensation, income taxes, and consolidation. Management believes that the estimates used are reasonable, although actual amounts could differ from the estimates and the differences could have a material impact on the consolidated financial statements.

Consolidation
Effective April 1, 2010, Legg Mason adopted Accounting Standards Codification ("ASC") Topic 810, "Consolidation," (Statement of Financial Accounting Standards No. 167, "Amendments to Financial Accounting Standards Board Interpretation No. 46(R)") ("SFAS No. 167"), relating to the consolidation of VIEs, which includes a new approach for determining who should consolidate a VIE, changes to when it is necessary to reassess who should consolidate a VIE, and changes in the assessment of which entities are VIEs. The application of the revised accounting guidance has been deferred for certain investment funds, including money market funds. Investment funds that qualify for the deferral continue to be assessed for consolidation under prior guidance, ASC Topic 810, "Consolidation," (Financial Accounting Standards Board Interpretation No. 46(R), "Consolidation of Variable Interest Entities — an interpretation of ARB No. 51") ("FIN 46(R)").

In the normal course of its business, Legg Mason sponsors and is the manager of various types of investment vehicles. Certain of these investment vehicles are considered to be VIEs while others are considered to be voting rights entities ("VREs") subject to traditional consolidation concepts based on ownership rights. For its services, Legg Mason is entitled to receive management fees and may be eligible, under certain circumstances, to receive additional subordinate management fees or other incentive fees. Legg Mason did not sell or transfer assets to any of the VIEs or VREs. 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. Uncollected management fees from these VIEs were not material at March 31, 2012 and 2011. Legg Mason has not issued any investment performance guarantees to these VIEs, VREs or their investors. Investment vehicles that are considered VREs are consolidated if Legg Mason has a controlling financial interest in the investment vehicle.

Financial Accounting Standards Board Interpretation No. 46(R) (Accounting Standards Update 2010-10, "Amendments to Statement 167 for Certain Investment Funds")

For most sponsored investment funds, including money market funds, which qualify for the deferral of the revised accounting guidance, Legg Mason determines it is the primary beneficiary of a VIE if it absorbs a majority of the VIE's expected losses, or receives a majority of the VIE's expected residual returns, if any. Legg Mason's determination of expected residual returns excludes gross fees paid to a decision maker. It is unlikely that Legg Mason will be the primary beneficiary for VIEs created to manage assets for clients which qualify for the deferral unless Legg Mason's ownership interest in the VIE, including interests of related parties, is substantial, unless Legg Mason may earn significant performance fees from the VIE or unless Legg Mason is considered

to have a material implied variable interest. In determining whether it is the primary beneficiary of a VIE which qualifies for the deferral, Legg Mason considers both qualitative and quantitative factors such as the voting rights of the equity holders, economic participation of all parties, including how fees are earned and paid to Legg Mason, related party ownership, guarantees and implied relationships. In determining the primary beneficiary, Legg Mason must make assumptions and estimates about, among other things, the future performance of the underlying assets held by the VIE, including investment returns, cash flows, and credit and interest rate risks. In determining whether a VIE is significant for disclosure purposes, Legg Mason considers the same factors used for determination of the primary beneficiary.

Statement of Financial Accounting Standards No. 167 (Accounting Standards Codification Topic 810, "Consolidation")
Legg Mason sponsors and is the manager for collateralized debt obligation entities ("CDOs") and collateralized loan obligations ("CLOs") that do not qualify for the deferral, and are assessed under the revised accounting guidance, as follows. Legg Mason determines whether it has a variable interest in a VIE by considering if, among other things, it has the obligation to absorb losses, or the right to receive benefits, that are expected to be significant to the VIE. Legg Mason also considers the management fee structure, including the seniority level of its fees, the current and expected economic performance of the entity, as well as other provisions included in the governing documents that might restrict or guarantee an expected loss or residual return. If Legg Mason has a significant variable interest, it determines it is the primary beneficiary of the VIE if it has both the power to direct the activities of the VIE that most significantly impact the entity's economic performance and the obligation to absorb losses, or the right to receive benefits, that potentially could be significant to the VIE.

In evaluating whether it has the obligation to absorb losses, or the right to receive benefits, that potentially could be significant to the VIE, Legg Mason considers factors regarding the design, terms, and characteristics of the investment vehicles, including, but not limited to, the following qualitative factors: if Legg Mason has involvement with the investment vehicle beyond providing management services; if Legg Mason holds equity or debt interests in the investment vehicle; if Legg Mason has transferred any assets to the investment vehicle; if the potential aggregate fees in future periods are insignificant relative to the potential cash flows of the investment vehicle; and if the variability of the expected fees in relation to the potential cash flows of the investment vehicle is more than insignificant.

Under both the revised accounting guidance and prior guidance, Legg Mason must consolidate VIEs for which it is deemed to be the primary beneficiary. Under the revised accounting guidance, effective April 1, 2010, Legg Mason consolidated a CLO that was not previously consolidated. As of March 31, 2012 and 2011, Legg Mason's Consolidated Balance Sheet reflects $291,853 and $314,617, respectively, in assets, and $271,707 and $278,320, respectively, in debt issued by the CLO, despite the fact that the assets cannot be used by Legg Mason, nor is Legg Mason obligated for the debt. The adoption had no impact on Net Income Attributable to Legg Mason, Inc.'s common shareholders. In addition, Legg Mason's Consolidated Statements of Cash Flows for the years ended March 31, 2012 and 2011, reflect the cash flows of this CLO. In accordance with the revised accounting guidance, periods prior to fiscal 2011 have not been restated. See Note 18 for additional information related to the application of the amended VIE consolidation model and the required disclosures.

Cash and Cash Equivalents
Cash equivalents are highly liquid investments with original maturities of 90 days or less.

Restricted Cash

Restricted cash primarily represents long-term escrow deposits and cash collateral required for market hedge arrangements. This cash is not available to Legg Mason for general corporate use.

Financial Instruments

Substantially all financial instruments are reflected in the financial statements at fair value or amounts that approximate fair value, except Legg Mason's long-term debt.

For equity investments where Legg Mason does not control the investee, and where it is not the primary beneficiary of a VIE, but can exert significant influence over the financial and operating policies of the investee, Legg Mason follows the equity method of accounting. The evaluation of whether Legg Mason can exert control or significant influence over the financial and operational policies of its investees requires significant judgment based on the facts and circumstances surrounding each individual investment. Factors considered in these evaluations may include investor voting or other rights, any influence Legg Mason may have on the governing board of the investee, the legal rights of other investors in the entity pursuant to the fund's operating documents and the relationship between Legg Mason and other investors in the entity. Substantially all of Legg Mason's equity method investees are investment companies which record their underlying investments at fair value. Therefore, under the equity method of accounting, Legg Mason's share of the investee's underlying net income or loss predominantly represents fair value adjustments in the investments held by the equity method investee. Legg Mason's share of the investee's net income or loss is based on the most current information available and is recorded as a net gain (loss) on investments within non-operating income (expense). A

significant portion of earnings (losses) attributable to Legg Mason's equity method investments has offsetting compensation expense adjustments under revenue sharing agreements and deferred compensation arrangements, therefore, fluctuations in the market value of these investments will not have a material impact on Net Income Attributable to Legg Mason, Inc.

Legg Mason also holds debt and marketable equity investments which are classified as available-for-sale, held-to-maturity or trading. Debt and marketable equity securities classified as available-for-sale are reported at fair value and resulting unrealized gains and losses are reflected in stockholders' equity, noncontrolling interests, and comprehensive income, net of applicable income taxes. Debt securities, for which there is positive intent and ability to hold to maturity, are classified as held-to-maturity and are recorded at amortized cost. Amortization of discount or premium is recorded under the interest method and is included in interest income. Certain investment securities, including those held by consolidated investment vehicles ("CIVs"), are classified as trading securities. These investments are recorded at fair value and unrealized gains and losses are included in current period earnings. Realized gains and losses for all investments are included in current period earnings.

Equity and fixed income securities classified as trading or available-for-sale are valued using closing market prices for listed instruments or broker or dealer price quotations, when available. Fixed income securities may also be valued using valuation models and estimates based on spreads to actively traded benchmark debt instruments with readily available market prices.

Legg Mason evaluates its non-trading investment securities for "other-than-temporary" impairment. Impairment may exist when the fair value of an investment security has been below the adjusted cost for an extended period of time. If an "other-than-temporary" impairment is determined to exist, the amount of impairment that relates to credit losses is recognized as a charge to income. As of March 31, 2012, 2011 and 2010, the amount of temporary unrealized losses for investment securities not recognized in income was not material.

For investments in illiquid or privately-held securities for which market prices or quotations may not be readily available, including certain investments held by CIVs, management estimates the value of the securities using a variety of methods and resources, including the most current available financial information for the investment and the industry.

In addition to the financial instruments described above and the derivative instruments and CLO loans, bonds and debt, described below, other financial instruments that are carried at fair value or amounts that approximate fair value include Cash and cash equivalents and Short-term borrowings. The fair value of Long-term debt at March 31, 2012 and 2011, was $1,214,245 and $1,322,960, respectively. These fair values were estimated using cash flow analysis discounted at current market rates and are classified as Level 2 in the fair value hierarchy described below.

Derivative Instruments
The fair values of derivative instruments are recorded as assets or liabilities on the Consolidated Balance Sheets. Legg Mason has used foreign exchange forwards and interest rate swaps to hedge the risk of movement in exchange rates or interest rates on financial assets on a limited basis. Also, Legg Mason has used futures contracts on index funds to hedge the market risk of certain seed capital investments. In addition, certain CIVs use derivative instruments. However, there is no risk to Legg Mason in relation to the derivative assets and liabilities of the CIVs in excess of its investment in the funds, if any.

Legg Mason has not designated any financial instruments for hedge accounting, as defined in the accounting literature, during the periods presented. The gains or losses on derivative instruments not designated for hedge accounting are included as Other income (expense) or Other non-operating income (expense) in the Consolidated Statements of Income, with the exception of gains and losses on derivative instruments of CIVs, which are recorded as Other non-operating income (expense) of consolidated investment vehicles, net, in the Consolidated Statements of Income.

Fair Value Measurements

Accounting guidance for fair value measurements defines fair value and establishes a framework for measuring fair value. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Under the accounting guidance, a fair value measurement should reflect all of the assumptions that market participants would use in pricing the asset or liability, including assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of non-performance.

The objective of fair value accounting measurements is to reflect, at the date of the financial statements, how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) under current market conditions. Specifically, it requires the use of judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. This accounting guidance also relates to other-than-temporary impairments and is intended to bring greater consistency to the timing of impairment recognition. It is also intended to provide greater clarity to investors about

the credit and noncredit components of impaired debt securities that are not expected to be sold. The guidance also requires timely disclosures regarding expected cash flows, credit losses, and an aging of securities with unrealized losses.

The fair value accounting guidance also establishes a hierarchy that prioritizes the inputs for valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

Legg Mason's financial instruments measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 — Financial instruments for which prices are quoted in active markets, which, for Legg Mason, include investments in publicly traded mutual funds with quoted market prices and equities listed in active markets.

Level 2 — Financial instruments for which: prices are quoted for similar assets and liabilities in active markets; prices are quoted for identical or similar assets in inactive markets; or prices are based on observable inputs, other than quoted prices, such as models or other valuation methodologies. For Legg Mason, this category may include repurchase agreements, fixed income securities, and certain proprietary fund products. This category also includes CLO loans and liabilities of a CIV, and previously included certain derivative assets and liabilities of CIVs.

Level 3 — Financial instruments for which values are based on unobservable inputs, including those for which there is little or no market activity. This category includes investments in partnerships, limited liability companies, and private equity funds. This category may also include certain proprietary fund products with redemption restrictions and CLO debt of a CIV.

The valuation of an asset or liability may involve inputs from more than one level of the hierarchy. The level in the fair value hierarchy which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Proprietary fund products and certain investments held by CIVs are valued at net asset value ("NAV") determined by the applicable fund administrator. These funds are typically invested in exchange traded investments with observable market prices. Their valuations may be classified as Level 1, Level 2 or Level 3 based on whether the fund is exchange traded, the frequency of the related NAV determinations and the impact of redemption restrictions. For investments in illiquid and privately-held securities (private equity and investment partnerships) for which market prices or quotations may not be readily available, including certain investments held by CIVs, management must estimate the value of the securities using a variety of methods and resources, including the most current available financial information for the investment and the industry to which it applies in order to determine fair value. These valuation processes for illiquid and privately-held securities inherently require management's judgment and are therefore classified in Level 3.

The fair values of CLO loans and bonds are determined based on prices from well-recognized third-party pricing services that utilize available market data and are therefore classified as Level 2. Legg Mason has established controls designed to assess the reasonableness of the prices provided. The fair value of CLO debt is valued using a discounted cash flow methodology. Inputs used to determine the expected cash flows include assumptions about forecasted default and recovery rates that a market participant would use in determining the fair value of the CLO's underlying collateral assets. Given the

significance of the unobservable inputs to the fair value measurement, the CLO debt valuation is classified as Level 3.

Exchange traded options are valued using the last sale price or in the absence of a sale, the last offering price. Options traded over the counter are valued using dealer supplied valuations. Options are classified as Level 1. Futures contracts are valued at the last settlement price at the end of each day on the exchange upon which they are traded and are classified as Level 1. Index and single name credit default swaps and interest rate swaps previously held were valued based on valuations furnished by pricing services and classified as Level 2.

As a practical expedient, Legg Mason relies on the NAV of certain investments as their fair value. The NAVs that have been provided by investees are derived from the fair values of the underlying investments as of the reporting date.

Any transfers between categories are measured at the beginning of the period.

See Note 3 for additional information regarding fair value measurements.

Fair Value Option
Legg Mason has elected the fair value option for certain eligible assets and liabilities, including corporate loans and debt, of a CLO it is consolidating (see Note 18). Management believes that the use of the fair value option eliminates certain timing differences and better matches the changes in fair value of assets and liabilities related to the CLO. Unrealized gains and losses on assets and liabilities for which the fair value option has been elected are reported in earnings. The decision to elect the fair value option is determined on an instrument by instrument basis, must be applied to an entire instrument and is irrevocable once elected. Assets and liabilities which are measured at fair value pursuant to the fair value option are included in the assets and liabilities of consolidated investment vehicles in the Consolidated Balance Sheets. At this time, the Company has not elected to apply the fair value option to any of its other financial instruments.

Appropriated Retained Earnings
Upon the adoption of revised consolidation guidance as of April 1, 2010, and the related election of the fair value option for eligible assets and liabilities of the CLO described above, Legg Mason recorded a cumulative effect adjustment to Appropriated retained earnings of consolidated investment vehicles on the Consolidated Balance Sheets equal to the difference between the fair values of the CLO's assets and liabilities. This difference is recorded as "Appropriated retained earnings" because the investors in the CLO, not Legg Mason shareholders, will ultimately realize any benefits or losses associated with the CLO. Beginning April 1, 2010, changes in the fair values of the CLO assets and liabilities are recorded as Net income (loss) attributable to noncontrolling interests in the Consolidated Statements of Income and Appropriated retained earnings of consolidated investment vehicle in the Consolidated Balance Sheets.

Fixed Assets
Fixed assets consist of equipment, software and leasehold improvements and capital lease assets. Equipment consists primarily of communications and technology hardware and furniture and fixtures. Software includes both purchased software and internally developed software. Fixed assets are reported at cost, net of accumulated depreciation and amortization. Capital lease assets are initially reported at the lesser of the present value of the related future minimum lease payments or the asset's then current fair value, subsequently reduced by accumulated depreciation. Depreciation and amortization are determined by use of the straight-line method. Equipment is depreciated over the estimated useful lives of the assets, generally ranging from three to eight years. Software is amortized over the estimated useful lives of the assets, which are generally three years. Leasehold improvements and capital lease assets are amortized or depreciated over the initial term of the lease unless options to extend are likely to be exercised. Maintenance and repair costs are expensed as incurred. Internally developed software is reviewed periodically to determine if there is a change in the useful life, or if an impairment in value may exist. If impairment is deemed to exist, the asset is written down to its fair value or is written off if the asset is determined to no longer have any value.

Intangible Assets and Goodwill
Legg Mason's intangible assets consist principally of asset management contracts, contracts to manage proprietary funds and trade names resulting from acquisitions. Intangible assets are amortized over their estimated useful lives, using the straight-line method, unless the asset is determined to have an indefinite useful life. Asset management contracts are amortizable intangible assets that are capitalized at acquisition and amortized over the expected life of the contract. The value of contracts to manage assets in proprietary funds and the value of trade names are classified as indefinite-life intangible assets. The assignment of indefinite lives to proprietary fund contracts is based upon the assumption that there is no foreseeable limit on the contract period to manage proprietary funds due to the likelihood of

continued renewal at little or no cost. The assignment of indefinite lives to trade names is based on the assumption that they are expected to generate cash flows indefinitely.

Goodwill represents the excess cost of a business acquisition over the fair value of the net assets acquired. Indefinite-life intangible assets and goodwill are not amortized for book purposes. Given the relative significance of intangible assets and goodwill to the Company's consolidated financial statements, on a quarterly basis Legg Mason considers if triggering events have occurred that may indicate that the fair values have declined below their respective carrying amounts. Triggering events may include significant adverse changes in the Company's business, legal or regulatory environment, loss of key personnel, significant business dispositions, or other events. If a triggering event has occurred, the Company will perform tests, which include critical reviews of all significant assumptions, to determine if any intangible assets or goodwill are impaired. At a minimum, the Company performs these tests annually at December 31, for indefinite-life intangible assets and goodwill, considering factors such as projected cash flows and revenue multiples, to determine whether the value of the assets is impaired and the indefinite-life assumptions are appropriate. If an asset is impaired, the difference between the value of the asset reflected on the financial statements and its current fair value is recognized as an expense in the period in which the impairment is determined. The fair values of intangible assets subject to amortization are reviewed at each reporting period using an undiscounted cash flow analysis. For intangible assets with indefinite lives, fair value is determined based on anticipated discounted cash flows. Goodwill is evaluated at the reporting unit level, and is potentially impaired if the carrying amount of the reporting unit exceeds its implied fair value. In estimating the fair value of the reporting unit, Legg Mason uses valuation techniques principally based on discounted cash flows similar to models employed in analyzing the purchase price of an acquisition target. Goodwill is deemed to be recoverable at the reporting unit level, which

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is also the operating segment level that Legg Mason defines as the Global Asset Management segment. This results from the fact that the chief operating decision maker, Legg Mason's Chief Executive Officer, regularly receives discrete financial information at the consolidated Global Asset Management business level and does not regularly receive discrete financial information, such as operating results, at any lower level, such as the asset management affiliate level. Prior to fiscal 2012, Legg Mason's reporting units were its Americas and International divisions. Allocations of goodwill for management restructures, acquisitions and dispositions are based on relative fair values of the respective businesses restructured, added to or sold from the divisions.

See Note 5 for additional information regarding intangible assets and goodwill and Note 17 for additional business segment information.

Translation of Foreign Currencies
Assets and liabilities of foreign subsidiaries that are denominated in non-U.S. dollar functional currencies are translated at exchange rates as of the Consolidated Balance Sheet dates. Revenues and expenses are translated at average exchange rates during the period. The gains or losses resulting from translating foreign currency financial statements into U.S. dollars are included in stockholders' equity and comprehensive income. Gains or losses resulting from foreign currency transactions are included in Net income.

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. These fees are primarily based on predetermined percentages of the market value of the assets under management ("AUM"), are recognized over the period in which services are performed and may be billed in advance of the period earned based on AUM at the beginning of the billing period in accordance with the related advisory contracts. Revenue associated with advance billings is deferred and included in Other (current) liabilities in the Consolidated Balance Sheets and is recognized over the period earned. Performance fees may be earned on certain investment advisory contracts for exceeding performance benchmarks on a relative or absolute basis, depending on the product, and are recognized at the end of the performance measurement period. Accordingly, neither advanced billings nor performance fees are subject to reversal.

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.

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 servicing proprietary funds 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. Distribution fees earned on company-sponsored investment funds are reported as revenue. 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. Distribution and servicing expense also includes payments to third parties for certain shareholder administrative services and sub-advisory fees paid to unaffiliated asset managers.

Deferred Sales Commissions
Commissions paid to financial intermediaries in connection with sales of certain classes of company-sponsored mutual funds are 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 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 years ended March 31, 2012, 2011 and 2010, no impairment charges were recorded. Deferred sales commissions, included in Other non-current assets in the Consolidated Balance Sheets, were $9,510 and $11,339 at March 31, 2012 and 2011, respectively.

Income Taxes
Deferred income taxes are provided for the effects of temporary differences between the tax basis of an asset or liability and its reported amount in the financial statements. Deferred income tax assets are subject to a valuation allowance if, in management's opinion, it is more likely than not that these benefits will not be realized. Legg Mason's deferred income taxes principally relate to net operating loss and other carryforward benefits, business combinations, amortization and accrued compensation.

Under applicable accounting guidance, a tax benefit should only be recognized if it is more likely than not that the position will be sustained based on its technical merits. A tax position that meets this threshold is measured as the largest amount of benefit that has a greater than 50% likelihood of being realized upon settlement by the appropriate taxing authority having full knowledge of all relevant information.

The Company's accounting policy is to classify interest related to tax matters as interest expense and related penalties, if any, as other operating expense.

See Note 8 for additional information regarding income taxes.

Loss Contingencies
Legg Mason accrues estimates for loss contingencies related to legal actions, investigations, and proceedings, exclusive of legal fees, when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated.

Stock Based Compensation
Legg Mason's stock-based compensation includes stock options, employee stock purchase plans, restricted stock awards, market-based performance shares payable in common stock and deferred compensation payable in stock. Under its stock compensation plans, Legg Mason issues equity awards to directors, officers, and other key employees.

In accordance with the applicable accounting guidance, compensation expense includes costs for all non-vested share-based awards at their grant date fair value amortized over the respective vesting periods on the straight-line method. Legg Mason determines the fair value of stock options using the Black-Scholes option-pricing model, with the exception of market-based performance grants, which would be valued with a Monte Carlo option-pricing model. See Note 12 for additional information regarding stock based compensation.

Earnings Per Share
Basic earnings per share attributable to Legg Mason, Inc. common shareholders ("EPS") is calculated by dividing Net income attributable to Legg Mason, Inc. by the weighted-average number of shares outstanding. The calculation of weighted-average shares includes common shares, shares exchangeable into common stock and certain unvested share-based payment awards that are considered participating securities because they contain nonforfeitable rights to dividends. Diluted EPS is similar to basic EPS, but adjusts for the effect of potential common shares unless they are antidilutive. See Note 13 for additional discussion of EPS.

Restructuring Costs
In May 2010, Legg Mason's management committed to a plan to streamline its business model as further described in Note 16. The streamlining initiative was complete as of March 31, 2012. The costs associated with this initiative primarily related to employee termination benefits, incentives to retain

employees during the transition period, charges for consolidating leased office space, and contract termination costs. Termination benefits, including severance, and retention incentives were recorded as Transition-related compensation in the Consolidated Statements of Income. These compensation items required employees to provide future service and were therefore expensed ratably over the required service period. Contract termination and other costs were expensed when incurred.

Noncontrolling interests

Noncontrolling interests related to CIVs are classified as redeemable noncontrolling interests if investors in these funds may request withdrawals at any time. Redeemable noncontrolling interests as of and for the years ended March 31, 2012, 2011 and 2010, were as follows:

	2012	2011	2010
Balance, beginning of period	$36,712	$29,577	$31,020
Net income attributable to redeemable noncontrolling interests	8,915	5,584	6,623
Net (redemptions/distributions paid to)/subscriptions received from noncontrolling interest holders	(21,596)	1,551	(8,066)
Balance, end of period	$24,031	$36,712	$29,577

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Other Recent Accounting Developments
The following relevant accounting pronouncements were recently issued.

In December 2011, the Financial Accounting Standards Board ("FASB") updated the guidance on disclosures for offsetting assets and liabilities to require both gross and net information about instruments and transactions, including derivatives, repurchase and reverse repurchase and other arrangements that are eligible for offset in the balance sheet. The disclosures will be effective for Legg Mason in fiscal 2014, and are not expected to have a material impact on Legg Mason's consolidated financial statements.

In September 2011, the FASB updated the guidance on the annual goodwill test for impairment. The update permits companies to assess qualitative factors to determine if it is more likely than not that the fair value of the reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the currently required quantitative fair value assessment. This update will be effective for Legg Mason in fiscal 2013, and is not expected to have a material effect on its recorded goodwill.

2. ACQUISITIONS
Effective November 1, 2005, Legg Mason acquired 80% of the outstanding equity of Permal Group, Ltd. ("Permal") Permal, a leading global funds-of-hedge funds manager. Concurrent with the acquisition, Permal completed a reorganization in which the residual 20% of outstanding equity was converted to preference shares, with Legg Mason owning 100% of the outstanding voting common stock of Permal. During fiscal 2010, Legg Mason paid an aggregate of $170,804 in cash to acquire the remaining 62.5% of the outstanding preference shares. The Company also elected to purchase, for $9,000, the rights of the sellers of the preference shares to receive an earnout payment of up to $149,200 in two years. As a result of this transaction, there will be no further payments for the Permal acquisition. In addition, during fiscal 2010, Legg Mason paid $7,524 in dividends on the preference shares. All payments for preference shares, including dividends, were recognized as additional goodwill.
3. INVESTMENTS AND FAIR VALUES OF ASSETS AND LIABILITIES
The disclosures below include details of Legg Mason's assets and liabilities that are measured at fair value, excluding the assets and liabilities of CIVs. See Note 18, Variable Interest Entities and Consolidation of Investment Vehicles, for information related to the assets and liabilities of CIVs that are measured at fair value.

Legg Mason has investments in debt and equity securities that are generally classified as available-for-sale and trading as described in Note 1. Investments as of March 31, 2012 and 2011, are as follows:

	2012	2011
Investment securities:		
Current investments	$412,119	$400,510
Available-for-sale	11,913	11,300
Other[(1)]	112	270
Total	$424,144	$412,080

(1) Includes investments in private equity securities that do not have readily determinable fair values.

The net unrealized and realized (loss) gain for investment securities classified as trading was $(6,063), $28,355 and $125,395 for fiscal 2012, 2011 and 2010, respectively.

Legg Mason's available-for-sale investments consist of mortgage backed securities, U.S. government and agency securities and equity securities. Gross unrealized gains (losses) for investments classified as available-for-sale were $551 and $(184), respectively, as of March 31, 2012, and $157 and $(186), respectively, as of March 31, 2011.

Legg Mason uses the specific identification method to determine the cost of a security sold and the amount reclassified from accumulated other comprehensive income into earnings. The proceeds and gross realized gains and losses from sales and maturities of available-for-sale investments are as follows:

	Years Ended March 31,		
	2012	2011	2010
Available-for-sale:			
Proceeds	$6,197	$4,012	$1,279
Gross realized gains	6	7	1
Gross realized losses	(25)	(19)	(4)

Legg Mason had no investments classified as held-to-maturity as of March 31, 2012 and 2011.

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

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Value as of March 31, 2012
Assets:				
Cash equivalents[1]:				
Money market funds	$893,738	$—	$—	$893,738
Time deposits	—	88,289	—	88,289
Total cash equivalents	893,738	88,289	—	982,027
Investment securities:				
Trading investments relating to long-term incentive compensation plans[2]	111,257	—	—	111,257
Trading proprietary fund products and other investments[3]	143,002	79,583	—	222,585
Equity method investments relating to long-term incentive compensation plans, proprietary fund products and other investments[4][5]	11,565	54,934	11,778	78,277
Total current investments	265,824	134,517	11,778	412,119
Available-for-sale investment securities	2,091	9,810	12	11,913
Investments in partnerships, LLCs and other	851	5,351	28,763	34,965
Equity method investments in partnerships and LLCs[4]	1,415	1,348	166,438	169,201
Derivative assets:				
Currency and market hedges	84	—	—	84
Other investments	—	—	112	112
	$1,164,003	$239,315	$207,103	$1,610,421
Liabilities:				
Derivative liabilities:				
Currency and market hedges	$(886)	$—	$—	$(886)

Substantially all of the above financial instruments where valuation methods rely on other than observable market inputs as a significant input utilize either the equity method, the cost method or NAV practical expedient, such that measurement uncertainty has little relevance.

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Value as of March 31, 2011
Assets:				
Cash equivalents[1]:				
Money market funds	$912,951	$—	$—	$912,951
Time deposits	—	92,877	—	92,877
Total cash equivalents	912,951	92,877	—	1,005,828
Investment securities:				
Trading investments relating to long-term incentive compensation plans[2]	120,107	—	—	120,107
Trading proprietary fund products and other investments[3]	90,123	102,562	11,378	204,063
Equity method investments relating to long-term incentive compensation plans, proprietary fund products and other investments[4][5]	15,645	48,528	12,167	76,340
Total current investments	225,875	151,090	23,545	400,510
Available-for-sale investment securities	2,666	8,622	12	11,300
Investments in partnerships, LLCs and other	—	—	22,167	22,167
Equity method investments in partnerships and LLCs[4]	1,420	—	153,931	155,351
Derivative assets:				
Currency and market hedges	1,169	—	—	1,169
Other investments	—	—	270	270
	$1,144,081	$252,589	$199,925	$1,596,595
Liabilities:				
Derivative liabilities:				
Currency and market hedges	$(3,120)	$—	$—	$(3,120)

(1) Cash equivalents include highly liquid investments with original maturities of 90 days or less. Cash investments in actively traded money market funds are measured at NAV and are classified as Level 1. Cash investments in time deposits are measured at amortized cost, which approximates fair value because of the short time between the purchase of the instrument and its expected realization, and are classified as Level 2.

(2) Primarily mutual funds where there is minimal market risk to the Company as any change in value is primarily offset by an adjustment to compensation expense and related deferred compensation liability.

(3) Trading proprietary fund products and other investments primarily represent mutual funds that are invested approximately 52% and 48% in equity and debt securities as of March 31, 2012, respectively, and were invested approximately 60% and 40% in equity and debt securities as of March 31, 2011, respectively.

(4) Substantially all of Legg Mason's equity method investments are investment companies which record their underlying investments at fair value. Fair value is measured using Legg Mason's share of the investee's underlying net income or loss, which is predominately representative of fair value adjustments in the investments held by the equity method investee.

(5) Includes investments under the equity method (which approximates fair value) relating to long-term incentive compensation plans of $54,934 and $48,528 as of March 31, 2012 and March 31, 2011,

respectively, and proprietary fund products and other investments of $23,343 and $27,812 as of March 31, 2012 and March 31, 2011, respectively, which are classified as Investment securities on the Consolidated Balance Sheets.

In accordance with new accounting guidance adopted during fiscal 2012, the changes in financial assets measured at fair value using significant unobservable inputs (Level 3) for the period from March 31, 2011 to March 31, 2012, are now presented on a gross basis in the table below:

	Value as of March 31, 2011	Purchases	Sales	Settlements/ Other	Transfers	Realized and unrealized gains/(losses), net	Value as of March 31, 2012
Assets:							
Trading proprietary fund products and other investments	$11,378	$—	$(11,906)	$—	$—	$528	$—
Equity method investments in proprietary fund products	12,167	—	—	—	—	(389)	11,778
Investments in partnerships, LLCs and other	22,167	6,932	—	(578)	—	242	28,763
Equity method investments in partnerships and LLCs	153,931	25,883	(6,387)	(14,168)	—	7,179	166,438
Other investments	282	—	—	(159)	—	1	124
	$199,925	$32,815	$(18,293)	$(14,905)	$—	$7,561	$207,103

	Value as of March 31, 2010	Purchases, sales, issuances and settlements, net	Transfers	Realized and unrealized gains/(losses), net	Value as of March 31, 2011
Assets:					
Trading proprietary fund products and other investments	$22,459	$(13,429)	$350	$1,998	$11,378
Equity method investments in proprietary fund products	12,090	—	—	77	12,167
Investments in partnerships, LLCs and other	23,049	831	—	(1,713)	22,167
Equity method investments in partnerships and LLCs	98,968	29,335	—	25,628	153,931
Other investments	1,464	(4,065)	—	2,883	282

$158,030	$12,672	$350	$28,873	$199,925

Realized and unrealized gains and losses recorded for Level 3 investments are included in Other income (expense) on the Consolidated Statements of Income. The change in unrealized gains relating to Level 3 assets and liabilities still held at the reporting date was $5,495 and $11,472, for the years ended March 31, 2012 and 2011, respectively.

There were no significant transfers between Levels 1 and 2 during the years ended March 31, 2012 and 2011.

As a practical expedient, Legg Mason relies on the net asset value of certain investments as their fair value. The net asset values that have been provided by the investees have been derived from the fair values of the underlying investments as of the reporting date. The following table summarizes, as of March 31, 2012, the nature of these investments and any related liquidation restrictions or other factors which may impact the ultimate value realized.

Category of Investment	Investment Strategy	Fair Value Determined Using NAV		Unfunded Commitments	Remaining Term
Funds-of-hedge funds	Global, fixed income, macro, long/short equity, natural resources, systematic, emerging market, European hedge	$51,251	(1)	n/a	n/a
Hedge funds	Fixed income - developed market, event driven, fixed income - hedge, relative value arbitrage, European hedge	25,460	(2)	$ 20,000	n/a
Private equity funds	Long/short equity	27,927	(2)	5,906	Up to 8 years
Private fund	Fixed income, residential and commercial mortgage-backed securities	89,323	(2) (3)	n/a	6 years, subject to two one-year extensions
Other	Various	2,450	(2)	n/a	Various (4)
Total		$196,411		$ 25,906	

n/a-not applicable

(1) 63% monthly redemption; 37% quarterly redemption, of which 36% is subject to two-year lock-up.

(2) Liquidations are expected over the remaining term.

(3) Redemptions prohibited until November 2012.

(4) 4% remaining term of less than one year; 96% 20-year remaining term.

There are no current plans to sell any of these investments.

4. FIXED ASSETS

The following table reflects the components of fixed assets as of March 31:

	2012	2011
Equipment	$155,173	$200,696
Software	205,760	224,026
Leasehold improvements	242,566	280,277
Total cost	603,499	704,999
Less: accumulated depreciation and amortization	(364,088)	(418,294)
Fixed assets, net	$239,411	$286,705

Depreciation and amortization expense related to fixed assets was $74,221, $79,835 and $91,309 for fiscal 2012, 2011 and 2010, respectively. The decrease in the total cost of fixed assets was substantially due to disposals in conjunction with the business streamlining initiative. See additional information regarding Legg Mason's business streamlining initiative in Note 16.

5. INTANGIBLE ASSETS AND GOODWILL

Goodwill and indefinite-life intangible assets are not amortized and the values of identifiable intangible assets are amortized over their useful lives, unless the assets are determined to have indefinite useful lives. Goodwill and indefinite-life intangible assets are analyzed to determine if the fair value of the assets exceeds the book value. Intangible assets subject to amortization are considered for impairment at each reporting period. If the fair value is less than the book value, Legg Mason will record an impairment charge.

The following table reflects the components of intangible assets as of March 31:

	2012	2011
Amortizable asset management contracts		
Cost	$206,411	$208,454
Accumulated amortization	(172,974)	(155,136)
Net	33,437	53,318
Indefinite–life intangible assets		
Fund management contracts	3,753,629	3,753,657
Trade names	69,800	69,800
	3,823,429	3,823,457
Intangible assets, net	$3,856,866	$3,876,775

As of March 31, 2012, management contracts are being amortized over a weighted-average life of 2.9 years.

Estimated amortization expense for each of the next five fiscal years is as follows:

2013	$14,018
2014	11,835
2015	2,920
2016	2,663
2017	2,001
Thereafter	—
Total	$33,437

The change in indefinite-life intangible assets is attributable to the impact of foreign currency translation. Legg Mason completed its most recent annual impairment tests of indefinite-life intangible assets as of December 31, 2011, and determined that there was no impairment in the value of these assets during fiscal 2012. Legg Mason also determined that no triggering events occurred as of March 31, 2012, that would require further impairment testing. Specific to the $2,502,000 of indefinite-life domestic mutual fund contracts acquired in the Citigroup Asset Management ("CAM") acquisition principally managed by ClearBridge Advisors LLC and Western Asset Management Company, as of Legg Mason's most recent annual impairment test, its assessed fair value exceeded its carrying value by 5%. Given the current uncertainty regarding future market conditions, should market performance, flows, or related AUM levels decrease in the near term such that cash flow projections deviate from current projections, it is reasonably possible that the asset could be deemed to be impaired by a material amount.

The change in the carrying value of goodwill is summarized below:

	Gross Book Value	Accumulated Impairment	Net Book Value
Balance as of March 31, 2010	$2,477,196	$(1,161,900)	$1,315,296
Impact of excess tax basis amortization	(22,735)	—	(22,735)
Other, including changes in foreign exchange rates	19,091	—	19,091
Balance as of March 31, 2011	2,473,552	(1,161,900)	1,311,652
Impact of excess tax basis amortization	(21,694)	—	(21,694)
Other, including changes in foreign exchange rates	(14,913)	—	(14,913)
Balance as of March 31, 2012	$2,436,945	$(1,161,900)	$1,275,045

Legg Mason completed its most recent annual impairment test of goodwill as of December 31, 2011, and determined that there was no impairment in the value of these assets during fiscal 2012. Legg Mason also determined that no triggering events occurred as of March 31, 2012, that would require further impairment testing.

Legg Mason also recognizes the tax benefit of the amortization of excess tax basis related to the CAM acquisition. In accordance with accounting guidance for income taxes, the tax benefit is recorded as a reduction of goodwill and deferred tax liabilities as the benefit is realized.

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6. SHORT-TERM BORROWINGS

Legg Mason maintains a revolving credit facility, which expires in February 2013, with a maximum amount available of $500,000, subject to the covenant discussed in Note 7. As of both March 31, 2012 and 2011, the revolving credit facility rate was LIBOR plus 262.5 basis points and the effective interest rate was 2.9%. The facility rate may change in the future based on changes in Legg Mason's credit ratings or LIBOR rates. As of both March 31, 2012 and 2011, there was $250,000 outstanding under this facility.

This facility has standard financial covenants, including a maximum net debt to EBITDA ratio of 2.5 to 1 and minimum EBITDA to interest ratio of 4.0 to 1. As of March 31, 2012, Legg Mason's net debt to EBITDA ratio was 1.1 to 1 and EBITDA to interest expense ratio was 13.8 to 1. Legg Mason has maintained compliance with the applicable covenants but if it is determined that compliance with these covenants becomes under pressure, a number of actions may be taken, including reducing expenses to increase EBITDA, using available cash to repay all or a portion of the $250,000 outstanding debt subject to these covenants or seeking to negotiate with lenders to modify the terms or to restructure the debt.

See Note 20 for subsequent borrowing of remaining $250,000 available under the revolving credit facility in May 2012.

A subsidiary of Legg Mason maintains a credit line for general operating purposes. The maximum amount that may be borrowed on this credit line is $15,000, subject to the covenant discussed in Note 7. There were no borrowings outstanding under this facility as of March 31, 2012 and 2011.

7. LONG-TERM DEBT

The disclosures below include details of Legg Mason’s debt, excluding the debt of CIVs. See Note 18, Variable Interest Entities and Consolidation of Investment Vehicles, for information related to the debt of CIVs.

The accreted value of long-term debt consists of the following:

	2012			2011
	Current Accreted Value	Unamortized Discount	Maturity Amount	Accreted Value
2.5% convertible senior notes	$1,127,009	$122,991	$1,250,000	$1,087,932
5.6% senior notes from Equity Units	—	—	—	103,039
Other term loans	9,883	—	9,883	10,897
Subtotal	1,136,892	122,991	1,259,883	1,201,868
Less: current portion	1,278	—	1,278	792
Total	$1,135,614	$122,991	$1,258,605	$1,201,076

2.5% Convertible Senior Notes and Related Hedge Transactions

On January 14, 2008, Legg Mason sold $1,250,000 of 2.5% convertible senior notes (the “Notes”). The Notes bear interest at 2.5%, payable semi-annually in cash. Legg Mason is accreting the carrying value to the principal amount at maturity using an imputed interest rate of 6.5% (the effective borrowing rate for nonconvertible debt at the time of issuance) over its expected life of seven years, resulting in additional interest expense for fiscal 2012, 2011 and 2010, of $39,077, $36,688, and $34,445 respectively. The Notes are convertible, if certain conditions are met, at an initial conversion rate of 11.3636 shares of Legg Mason common stock per one thousand dollar principal amount of Notes (equivalent to a conversion price of approximately $88 per share), or a maximum of 14,205 shares, subject to adjustment. Unconverted notes mature at par in January 2015. Upon conversion of a one

thousand dollar principal amount note, the holder will receive cash in an amount equal to one thousand dollars or, if less, the conversion value of the note. If the conversion value exceeds the principal amount of the Note at conversion, Legg Mason will also deliver, at its election, cash or common stock or a combination of cash and common stock for the conversion value in excess of one thousand dollars. The amount by which the Notes’ if-converted value exceeds the accreted value as of March 31, 2012 (representing a potential loss), is approximately $77,353 using a current interest rate of 4.00%. The agreement governing the issuance of the Notes contains certain covenants for the benefit of the initial purchaser of the Notes, including that no additional debt may be incurred if Legg Mason's gross debt to EBITDA ratio (as defined in the documents) exceeds 2.5 to 1. These covenants may result in the Notes becoming immediately due and payable if the covenants are not met. The leverage covenant was waived to accommodate the Equity Units issuance in May 2008. This waiver expired in June 2011. Legg Mason has maintained compliance with the applicable covenants. As of March 31, 2012, our leverage ratio was 2.7 to 1, thus the covenant prohibits Legg Mason from borrowing additional amounts as of that date.

In connection with the sale of the Notes, on January 14, 2008, Legg Mason entered into convertible note hedge transactions with respect to its common stock (the “Purchased Call Options”) with financial institution counterparties (“Hedge Providers”). The Purchased Call Options are exercisable solely in connection with any conversions of the Notes in the event that the market value per share of Legg Mason common stock at the time of exercise is greater than the exercise price of the Purchased Call Options, which is equal to the $88 conversion price of the Notes, subject to adjustment. Simultaneously, in separate transactions Legg Mason also sold to the Hedge Providers warrants to purchase, in the aggregate and subject to adjustment, 14,205 shares of common stock on a net share-settled basis at an exercise price of $107.46 per share of common stock. The Purchased Call Options and warrants are not part of the terms of the Notes and will not affect the holders' rights under the Notes. These hedging transactions had a net cost of approximately $83,000, which was paid from the proceeds of the Notes and recorded as a reduction of additional paid-in capital.
If, when the Notes are converted, the market price per share of Legg Mason common stock exceeds the $88 exercise price of the Purchased Call Options, the Purchased Call Options entitle Legg Mason to receive from the Hedge Providers shares of Legg Mason common stock, cash, or a combination of shares of common stock and cash, that will match the shares or cash Legg Mason must deliver under terms of the Notes. Additionally, if at the same time the market price per share of Legg Mason common stock exceeds the $107.46 exercise price of the warrants, Legg Mason will be required to deliver to the Hedge Providers net shares of common stock, in an amount based on the excess of such market price per share of common stock over the exercise price of the warrants. These transactions effectively increase the conversion price of the Notes to $107.46 per share of common stock. Legg Mason has contractual rights, and, at execution of the related agreements, had the ability to settle its obligations under the conversion feature of the Notes, the Purchased Call Options and warrants, with Legg Mason common stock. Accordingly, these transactions are accounted for as equity, with no subsequent adjustment for changes in the value of these obligations.
5.6% Senior Notes from Equity Units
In May 2008, Legg Mason issued 23,000 Equity Units for $1,150,000, of which approximately $50,000 was used to pay issuance costs. Each unit consisted of a 5% interest in one thousand dollar principal amount of 5.6% senior notes due June 30, 2021, and a detachable contract to purchase a varying number of shares of Legg Mason's common stock for $50 by June 30, 2011. The notes and purchase contracts were separate and distinct instruments, but their terms were structured to simulate a conversion of debt to equity and potentially remarketed debt approximately three years after issuance. The holders' obligations to purchase shares of Legg Mason's common stock were collateralized by their pledge of the notes or other prescribed collateral. In connection with the issuance of the Equity Units, Legg Mason incurred issuance costs of $36,200, of which $27,600 was allocated to the equity component of the Equity Units and recorded as a reduction of Additional paid-in capital. The notes were considered to be mandatorily convertible. For their commitment to purchase shares of Legg Mason's common stock, holders also received quarterly payments, referred to as Contract Adjustment Payments (“CAP”), at a fixed annual rate of 1.4% of the commitment amount over the three-year contract term. Upon issuance of the Equity Units, Legg Mason recognized a liability of approximately $45,800 for the fair value of its obligation (based upon discounted cash flows) to pay unitholders a quarterly contract adjustment payment. This amount also represented the fair value of Legg Mason's commitment under the contract to issue shares of common stock in the future at designated prices, and was recorded as a reduction to Additional paid-in capital. The CAP obligation liability was accreted over the approximate three-year contract term by charges to Interest expense based on a constant rate calculation. Subsequent contract adjustment payments reduced the CAP obligation liability, which as of March 31, 2011, was $168, and was included in Other liabilities on the Consolidated Balance Sheets. Due to the retirement of the remaining Equity Units discussed below, there was no CAP obligation liability as of March 31, 2012.

Each purchase contract obligated Legg Mason to sell a number of newly issued shares of common stock that was based on a settlement rate determined by Legg Mason's stock price at the purchase date. The settlement rate adjusted with the price of Legg Mason stock in a way intended to maintain the original investment value when Legg Mason's common stock was priced between $56.30 and $67.56 per share. The settlement rate was 0.7401 shares of Legg Mason common stock, subject to adjustment, for each Equity Unit if the market value of Legg Mason common stock was at or above $67.56. The settlement rate was 0.8881 shares of Legg Mason common stock, subject to adjustment, for each Equity Unit if the market value of Legg Mason common stock was at or below $56.30. If the market value of Legg Mason common stock was between $56.30 and $67.56, the settlement rate was the number of shares of Legg Mason common stock equal to $50 divided by the market value.

During the September 2009 quarter, Legg Mason completed a tender offer and retired 91% of its outstanding Equity Units (20,939 units) including the extinguishment of $1,050,000 of its outstanding 5.6% senior notes and termination of the related purchase contracts in exchange for the issuance of approximately 18,596 shares of Legg Mason common stock and a payment of approximately $130,870 in cash. The cash payment was allocated between the liability and equity components of the Equity Units based on relative fair values, resulting in a loss on debt extinguishment of approximately $22,040 (including a non-cash charge of approximately $6,355 of accelerated expense of deferred issue costs) and a decrease in additional paid-in capital of approximately $115,186.

The $103,039 of outstanding debt on the remaining 5.6% senior notes was retired on June 30, 2011, as part of a remarketing. Concurrently, Legg Mason issued 1,830 shares of Legg Mason common stock upon the exercise of the purchase contracts from the Equity Units.

Other Term Loans
In fiscal 2006, a subsidiary of Legg Mason entered into a $12,803 term loan agreement to finance an aircraft. The loan bears interest at 5.9%, is secured by the aircraft, and has a maturity date of January 1, 2016. The outstanding balance at March 31, 2012 and 2011, was $8,568, and $9,363, respectively.

As of March 31, 2012, the aggregate maturities of long-term debt, based on their contractual terms, are as follows:

2013	$1,278
2014	1,332
2015	1,251,386
2016	5,887
2017	—
Thereafter	—
Total	$1,259,883

See Note 20 for subsequent issuance of $650,000 of 5.5% senior notes and repurchase of all $1,250,000 of the Notes in May 2012.

8. INCOME TAXES
The components of income before income tax provision are as follows:

	2012	2011	2010
Domestic	$257,866	$230,334	$207,210
Foreign	45,217	134,863	122,446
Total	$303,083	$365,197	$329,656

The components of income tax expense are as follows:

	2012	2011	2010
Federal	$54,179	$75,290	$78,224
Foreign	(7,850)	18,788	14,066
State and local	25,723	25,356	26,386
Total income tax provision	$72,052	$119,434	$118,676
Current	$22,860	$39,162	$4,729
Deferred	49,192	80,272	113,947
Total income tax provision	$72,052	$119,434	$118,676

Legg Mason received approximately $580,000 in tax refunds during the June 2009 quarter, primarily attributable to the utilization of $1,600,000 of realized losses incurred in fiscal 2009 on the sale of securities issued by structured investment vehicles. Federal legislation, enacted in November 2009 to temporarily extend the net operating loss carryback period from two to five years enabled Legg Mason to utilize an additional $1,300,000 of net operating loss deductions and, as a result, an additional $459,000 in tax refunds was received in January 2010.

A reconciliation of the difference between the effective income tax rate and the statutory federal income tax rate is as follows:

	2012	2011	2010
Tax provision at statutory U.S. federal income tax rate	35.0 %	35.0 %	35.0 %
State income taxes, net of federal income tax benefit[1]	5.4	4.9	2.5
Effect of foreign tax rates[1]	(1.8)	(5.4)	(3.5)
Effect of loss on Australian restructuring	(6.0)	—	—
Changes in U.K. tax rates on deferred tax assets and liabilities	(6.0)	(2.5)	—
Net (income) loss attributable to noncontrolling interests	(1.1)	0.8	—
Other, net	(1.7)	(0.1)	2.0
Effective income tax rate	23.8 %	32.7 %	36.0 %

(1) State income taxes include changes in valuation allowances, net of the impact on deferred tax assets of changes in state apportionment factors and planning strategies. The effect of foreign tax rates also includes changes in valuation allowances.

During the quarter ended September 30, 2010, the U.K. Finance (No. 2) Act 2010 was enacted, which reduced the main U.K. corporate tax rate from 28% to 27%. In July 2011, The U.K. Finance Act 2011 (the "Act") was enacted. The Act further reduced the main U.K. corporate tax rate from 27% to 26% effective April 1, 2011, and from 26% to 25% effective April 1, 2012. The reductions in the U.K. corporate tax rate resulted in tax benefits of $18,268 and $8,878, recognized in fiscal 2012 and 2011, respectively, as a result of the revaluation of deferred tax assets and liabilities at the new rates. In addition, during the year ended March 31, 2012, Legg Mason recorded $18,254 of tax benefits related to a restructuring of our Australian business.

Deferred income taxes are provided for the effects of temporary differences between the tax basis of an asset or liability and its reported amount in the Consolidated Balance Sheets. These temporary differences result in taxable or deductible amounts in future years. A summary of Legg Mason's deferred tax assets and liabilities are as follows:

	2012	2011
DEFERRED TAX ASSETS		
Accrued compensation and benefits	$125,797	$129,320
Accrued expenses	62,410	46,650
Operating loss carryforwards	397,013	375,703
Capital loss carryforwards	46,244	44,475
Convertible debt obligations	4,951	4,609
Foreign tax credit carryforward	59,871	45,119
Federal benefit of uncertain tax positions	17,602	17,451
Mutual fund launch costs	14,476	102
Net unrealized losses from investments	5,327	2,590
Other	18,119	6,844
Deferred tax assets	751,810	672,863
Valuation allowance	(102,722)	(94,541)
Deferred tax assets after valuation allowance	$649,088	$578,322

	2012	2011
DEFERRED TAX LIABILITIES		
Basis differences, principally for intangible assets and goodwill	$196,611	$229,879

Depreciation and amortization	431,280	295,699
Other	3,667	4,369
Deferred tax liabilities	631,558	529,947
Net deferred tax asset	$17,530	$48,375

Certain tax benefits associated with Legg Mason's employee stock plans are recorded directly in Stockholders' Equity. No tax benefit was recorded to equity in fiscal 2012, 2011 or 2010, due to the net operating loss position of the Company. As of March 31, 2012, an additional $6,700 of net operating loss will be recognized as an increase in Stockholders' Equity when ultimately realized.

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In connection with the completion and filing of its fiscal 2010 federal tax return in December 2010, Legg Mason recorded a net additional tax benefit of approximately $36,000 in fiscal 2011 with respect to the Equity Unit extinguishment that occurred in fiscal 2010. The tax benefit increased Additional paid-in capital in a manner consistent with the fiscal 2010 allocation of the extinguishment payment.

Legg Mason has various loss carryforwards that may provide future tax benefits. Related valuation allowances are established in accordance with accounting guidance for income taxes, if it is management's opinion that it is more likely than not that these benefits will not be realized. Substantially all of Legg Mason's deferred tax assets relate to U.S. and U.K. taxing jurisdictions. As of March 31, 2012, U.S. federal deferred tax assets aggregated $717,552, realization of which is expected to require approximately $4,120,000 of future U.S. earnings, approximately $169,000 of which must be in the form of foreign source income. Based on estimates of future taxable income, using assumptions consistent with those used in Legg Mason's goodwill impairment testing, it is more likely than not that current federal tax benefits relating to net operating losses are realizable and no valuation allowance is necessary at this time. With respect to those resulting from foreign tax credits, it is more likely than not that tax benefits relating to $10,370 of foreign tax credits will not be realized and a valuation allowance of $3,411 was established in fiscal 2012. While tax planning may enhance Legg Mason's tax positions, the realization of these current tax benefits is not dependent on any significant tax strategies. As of March 31, 2012, U.S. state deferred tax assets aggregated $236,675. Due to limitations on net operating loss and capital loss carryforwards and, taking into consideration certain state tax planning strategies, a valuation allowance was established for the state capital loss and net operating loss benefits in certain jurisdictions. An additional valuation allowance of $12,076 was recorded for fiscal 2012. Due to the uncertainty of future state apportionment factors and future effective state tax rates, the value of state net operating loss benefits ultimately realized may vary. A net release of $7,306 in fiscal 2012 of the full valuation allowance on foreign deferred tax assets related to various jurisdictions, primarily the U.K. and Japan. To the extent the analysis of the realization of deferred tax assets relies on deferred tax liabilities, Legg Mason has considered the timing, nature and jurisdiction of reversals, as well as, future increases relating to the tax amortization of goodwill and indefinite-life intangible assets.

The following deferred tax assets and valuation allowances relating to carryforwards have been recorded at March 31, 2012 and 2011, respectively.

	2012	2011	Expires Beginning after Fiscal Year
Deferred tax assets			
U.S. federal net operating losses	$219,984	$203,971	2029
U.S. federal capital losses	74	74	2015
U.S. federal foreign tax credits	59,871	45,119	2015
U.S. state net operating losses [1,2]	151,772	143,542	2015
U.S. state capital losses	39,046	36,675	2015
Non-U.S. net operating losses	25,257	28,190	2011
Non-U.S. capital losses	7,124	7,726	n/a
Total deferred tax assets for carryforwards	$503,128	$465,297	
Valuation allowances			
U.S. federal capital losses	$74	74	
U.S. federal foreign tax credits	6,542	3,131	
U.S. state net operating losses	23,911	14,206	
U.S. state capital losses	39,046	36,675	
Non-U.S. net operating losses	22,956	28,190	

Non-U.S. capital losses	7,124	7,726
Valuation allowances for carryforwards	99,653	90,002
Non-U.S. other deferred assets	3,069	4,539
Total valuation allowances	$102,722	$94,541

(1) Substantially all of the U.S. state net operating losses carryforward through fiscal 2029.

(2) Due to potential for change in the factors relating to apportionment of income to various states, the Company's effective state tax rates are subject to fluctuation which will impact the value of the Company's deferred tax assets, including net operating losses, and could have a material impact on the future effective tax rate of the Company.

Legg Mason had total gross unrecognized tax benefits of approximately $90,831, $77,653 and $51,027 as of March 31, 2012, 2011 and 2010, respectively. Of these totals, approximately $62,400, $53,500 and $40,600, respectively, (net of the federal benefit for state tax liabilities) are the amounts of unrecognized benefits which, if recognized, would favorably impact future income tax

provisions and effective tax rates.
A reconciliation of the beginning and ending amount of unrecognized gross tax benefits for the years ended March 31, 2012, 2011 and 2010, is as follows:

	2012	2011	2010
Balance, beginning of year	$77,653	$51,027	$43,662
Additions based on tax positions related to the current year	9,822	1,361	2,830
Additions for tax positions of prior years	10,668	34,959	12,664
Reductions for tax positions of prior years	(3,575)	(6,107)	(5,846)
Decreases related to settlements with taxing authorities	(3,185)	(2,667)	(515)
Expiration of statute of limitations	(552)	(920)	(1,768)
Balance, end of year	$90,831	$77,653	$51,027

Although management cannot predict with any degree of certainty the timing of ultimate resolution of matters under review by various taxing jurisdictions, it is reasonably possible that the Company's gross unrecognized tax benefits balance may change within the next twelve months by up to $20,500 as a result of the expiration of statutes of limitation and the completion of tax authorities' exams.

The Company accrues interest related to unrecognized tax benefits in interest expense and recognizes penalties in other operating expense. During the years ended March 31, 2012, 2011 and 2010, the Company recognized approximately $1,300, $3,000, and $2,200, respectively, which was substantially all interest. At March 31, 2012, 2011 and 2010, Legg Mason had approximately $10,000, $9,000, and $6,000, respectively, accrued for interest and penalties on tax contingencies in the Consolidated Balance Sheets.

Legg Mason is under examination by the Internal Revenue Service and other tax authorities in various states. The following tax years remain open to income tax examination for each of the more significant jurisdictions where Legg Mason is subject to income taxes: after fiscal 2005 for U.S. federal; after fiscal 2005 for the United Kingdom; after fiscal 2003 for the state of California; after fiscal 2005 for the state of New York; and after fiscal 2008 for the states of Connecticut, Maryland and Massachusetts. The Company does not anticipate making any significant cash payments with the settlement of these audits in excess of amounts that have been reserved.

In a prior year, Legg Mason initiated plans to repatriate accumulated earnings of approximately $225,000, of which approximately $100,000 has been repatriated as of March 31, 2012. Legg Mason currently intends to repatriate $100,000 to $150,000 of foreign earnings to create foreign source income in order to utilize foreign tax credits that may otherwise expire unutilized. No further repatriation of accumulated prior period foreign earnings beyond the above range is currently planned, however, Legg Mason may repatriate future earnings.

Except as noted above, Legg Mason intends to permanently reinvest cumulative undistributed earnings of its non-U.S. subsidiaries in non-U.S. operations. Accordingly, no U.S. federal income taxes have been provided for the undistributed earnings to the extent that they are permanently reinvested in Legg Mason's non-U.S. operations. It is not practical at this time to determine the income tax liability that would result upon repatriation of the earnings.

9. COMMITMENTS AND CONTINGENCIES
Legg Mason leases office facilities and equipment under non-cancelable operating leases, and also has multi-year agreements for certain services. These leases and service agreements expire on varying dates through fiscal 2026. Certain leases provide for renewal options and contain escalation clauses providing

for increased rentals based upon maintenance, utility and tax increases.

As of March 31, 2012, the minimum annual aggregate rentals under operating leases and service agreements are as follows:

2013	$148,202
2014	118,146
2015	107,880
2016	96,379
2017	87,710
Thereafter	489,268
Total	$1,047,585

The minimum rental commitments shown above have not been reduced by $148,775 for minimum sublease rentals to be received in the future under non-cancelable subleases, of which approximately 51% is due from one counterparty. If a sub-tenant defaults on a sublease, Legg Mason may incur operating charges to reflect expected future sublease rentals at reduced amounts, as a result of the current commercial real estate market.

The above minimum rental commitments include $931,703 in real estate and equipment leases and $115,882 in service and maintenance agreements.

Included in the table above is $37,858 in commitments related to space that has been vacated, but for which subleases are being pursued. A lease liability was adjusted in fiscal 2012 and 2011, to reflect the present value of the excess existing lease obligations over the estimated sublease income and related costs. The lease liability takes into consideration various assumptions, including the amount of time it will take to secure a sublease agreement and prevailing rental rates in the applicable real estate markets. These, and other related costs incurred during fiscal 2012 and 2011, primarily related to Legg Mason's business streamlining initiative, aggregated $13,375 and $2,587, respectively.

The following table reflects rental expense under all operating leases and servicing agreements.

	2012	2011	2010
Rental expense	$140,285	$137,072	$137,771
Less: sublease income	14,310	10,848	8,573
Net rent expense	$125,975	$126,224	$129,198

Legg Mason recognizes rent expense ratably over the lease period based upon the aggregate lease payments. The lease period is determined as the original lease term without renewals, unless and until the exercise of lease renewal options is reasonably assured, and also includes any period provided by the landlord as a "free rent" period. Aggregate lease payments include all rental payments specified in the contract, including contractual rent increases, and are reduced by any lease incentives received from the landlord, including those used for tenant improvements.

As of March 31, 2012 and 2011, Legg Mason had commitments to invest approximately $36,653 and $23,381, respectively, in limited partnerships that make private investments. These commitments are expected to be funded as required through the end of the respective investment periods ranging through fiscal 2018.

In the normal course of business, Legg Mason enters into contracts that contain a variety of representations and warranties and that provide general indemnifications. Legg Mason’s maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against Legg Mason that have not yet occurred.

Legg Mason has been the subject of customer complaints and has also been named as a defendant in various legal actions arising primarily from securities brokerage, asset management and investment banking activities, including certain class actions, which primarily allege violations of securities laws and seek unspecified damages, which could be substantial. In the normal course of its business, Legg Mason has also received subpoenas and is currently involved in governmental and self-regulatory agency inquiries, investigations and, from time to time, proceedings involving asset management activities. In accordance with guidance for accounting for contingencies, Legg Mason has established provisions for estimated losses from pending complaints, legal actions, investigations and proceedings when it is probable that a loss has been incurred and a reasonable estimate of loss can be made.

In a transaction with Citigroup in December 2005, Legg Mason transferred to Citigroup the subsidiaries that constituted its Private Client/Capital Markets ("PC/CM") businesses, thus transferring the entities that would have primary liability for most of the

customer complaint, litigation and regulatory liabilities and proceedings arising from those businesses. However, as part of that transaction, Legg Mason agreed to indemnify Citigroup for most customer complaint, litigation and regulatory liabilities of Legg Mason's former PC/CM businesses that result from pre-closing events. While the ultimate resolution of these matters cannot be currently determined based on current information, after consultation with legal counsel, management believes that any accrual or range of reasonably possible losses as of March 31, 2012 and 2011 is not material. Similarly, although Citigroup transferred to Legg Mason the entities that would be primarily liable for most customer complaint, litigation and regulatory liabilities and proceedings of the CAM business, Citigroup has agreed to indemnify Legg Mason for most customer complaint, litigation and regulatory liabilities of the CAM business that result from pre-closing events.

The ultimate resolution of other matters cannot be currently determined. In the opinion of management and after consultation with legal counsel, due to the preliminary nature of certain of these matters, Legg Mason is currently unable to estimate the amount or range of potential losses from these matters, and Legg Mason's financial condition, results of operations and cash flows could be materially affected during a period in which a matter is ultimately resolved. In addition, the ultimate costs of litigation-related charges can vary significantly from period-to-period, depending on factors such as market conditions, the size and volume of customer complaints and claims, including class action suits, and recoveries from indemnification, contribution or insurance reimbursement.

One of Legg Mason's asset management subsidiaries was named as the defendant in a lawsuit filed by a former institutional client in late August 2011. The complaint alleges breach of contract and breach of fiduciary duty arising from investments in the former client's account allegedly being inconsistent with the account's objectives, and seeks damages in excess of $90,000. Legg Mason believes that the claims are without merit and intends to defend the matter vigorously. During the third quarter of fiscal year 2012, the subsidiary filed a motion to dismiss, which has not yet been ruled upon by the court. Discovery in the case is ongoing, and a pretrial conference is currently scheduled for April 2013. Because of the preliminary status of the matter, Legg Mason cannot estimate the possible loss or range of loss from this matter, if any. In addition, although Legg Mason believes that this matter would likely be covered by insurance policies that may substantially mitigate the amount of any eventual loss, as is not unusual with litigation at this point in the process, there can be no assurance that the action will not have a material effect on Legg Mason's financial position, results of operations or cash flows.

As of March 31, 2012 and 2011, Legg Mason's liability for losses and contingencies was $200 and $500, respectively. During fiscal 2012, 2011 and 2010, Legg Mason recorded litigation related charges of approximately $1,000, $2,500, and $21,200, respectively. The charge in fiscal 2010 primarily represents a $19,000 accrual for an affiliate investor settlement, which was settled during fiscal 2011. During fiscal 2012, 2011 and 2010, the liability was reduced for settlement payments of approximately $1,300, $23,500, and $1,500, respectively.

10. EMPLOYEE BENEFITS

Legg Mason, through its subsidiaries, maintains various defined contribution plans covering substantially all employees. Through its primary plan, Legg Mason can make two types of discretionary contributions. One is a profit sharing contribution to eligible Plan participants based on a percentage of qualified compensation and the other is a 50% match of employee 401(k) contributions up to 6% of employee compensation with a maximum of five thousand dollars per year. Profit sharing and matching contributions amounted to $22,336 and $22,739 in fiscal 2012 and 2011, respectively. In addition, employees can make voluntary contributions under certain plans.

11. CAPITAL STOCK

At March 31, 2012, the authorized numbers of common and preferred shares were 500,000 and 4,000, respectively. At March 31, 2012 and 2011, there were 19,275 and 14,557 shares of common stock, respectively, reserved for issuance under Legg Mason's equity plans. As of March 31, 2010, 1,099 common shares were reserved for exchangeable shares issued in connection with the acquisition of Legg Mason Canada Inc. Exchangeable shares were exchangeable at any time by the holder on a one-for-one basis into shares of Legg Mason's common stock and were included in basic shares outstanding. In May 2010, all outstanding exchangeable shares were converted into shares of Legg Mason common stock.

On May 10, 2010, Legg Mason announced that its Board of Directors replaced its existing stock buyback authority with the authority to purchase up to $1 billion worth of Legg Mason common stock. There is no expiration date attached to this authorization. During fiscal 2012, Legg Mason purchased and retired 13,597 shares of its common stock for $400,266 through open market purchases. During fiscal 2011, Legg Mason purchased and retired 14,552 shares of its common stock for $445,465 through accelerated share repurchase ("ASR") agreements and open market purchases. The remaining balance of the authorized stock buyback is $154,938.

As discussed in Note 7, in May 2008, Legg Mason issued $1,150,000 of Equity Units, each unit consisting of a 5% interest in one thousand dollar principal amount of senior notes due June 30, 2021, and a purchase contract committing the holder to purchase

shares of Legg Mason's common stock by June 30, 2011. During fiscal 2010, Legg Mason issued approximately 18,596 shares through the Equity Unit tender offer in exchange for 91% of the outstanding Equity Units. During fiscal 2012, Legg Mason issued 1,830 shares of Legg Mason common stock upon the exercise of the purchase contracts from the remaining Equity Units and the senior notes from the Equity Units were retired in a remarketing. As also discussed in Note 7, in January 2008, Legg Mason issued $1,250,000 of 2.5% contingent convertible senior notes, which, if certain conditions are met, could result in the issuance of a maximum of approximately 14,205 shares of Legg Mason common stock, subject to adjustment.

Changes in common stock and shares exchangeable into common stock for the three years ended March 31, 2012, 2011 and 2010, are as follows:

	Years Ended March 31,		
	2012	2011	2010
COMMON STOCK			
Beginning balance	150,219	161,439	141,853
Shares issued for:			
Stock option exercises and other stock-based compensation	172	638	72
Deferred compensation trust	68	75	133
Deferred compensation	1,182	1,520	662
Exchangeable shares	—	1,099	123
Shares repurchased and retired	(13,597)	(14,552)	—
Equity Units exchange	1,830	—	18,596
Ending balance	139,874	150,219	161,439
SHARES EXCHANGEABLE INTO COMMON STOCK			
Beginning balance	—	1,099	1,222
Exchanges	—	(1,099)	(123)
Ending balance	—	—	1,099

Dividends declared per share were $0.32, $0.20, and $0.12 for fiscal 2012, 2011 and 2010, respectively. Dividends declared but not paid at March 31, 2012, 2011 and 2010, were $11,493, $8,990, and $4,844, respectively, and are included in Other current liabilities.

12. STOCK-BASED COMPENSATION

Legg Mason's stock-based compensation includes stock options, employee stock purchase plans, restricted stock awards and units, performance shares payable in common stock, and deferred compensation payable in stock. Effective July 26, 2011, the number of shares authorized to be issued under Legg Mason's active equity incentive stock plan was increased by 6,500 to 41,500. Shares available for issuance as of March 31, 2012, were 13,134. Options under Legg Mason's employee stock plans have been granted at prices not less than 100% of the fair market value. Options are generally exercisable in equal increments over four to five years and expire within eight to ten years from the date of grant.

Compensation expense relating to stock options for the years ended March 31, 2012, 2011 and 2010, was $14,076, $19,926 and $17,281 respectively. The related income tax benefit for the years ended March 31, 2012, 2011 and 2010, was $5,539, $7,718 and $6,221, respectively.

Stock option transactions under Legg Mason's equity incentive plans during the years ended March 31, 2012, 2011 and 2010, respectively, are summarized below:

	Number of shares		Weighted-average exercise price per share
Options outstanding at March 31, 2009	5,554		$64.09
Granted	1,457		26.82
Exercised	(72	)	25.40
Canceled/forfeited	(885	)	49.24
Options outstanding at March 31, 2010	6,054		57.75
Granted	729		33.12
Exercised	(634	)	21.85
Canceled/forfeited	(730	)	48.94
Options outstanding at March 31, 2011	5,419		59.82
Granted	810		33.99
Exercised	(117	)	25.32
Canceled/forfeited	(488	)	48.80
Options outstanding at March 31, 2012	5,624		$57.78

The total intrinsic value of options exercised during the years ended March 31, 2012, 2011 and 2010, was $398, $6,977, and $229, respectively. At March 31, 2012, the aggregate intrinsic value of options outstanding was $1,715.

The following information summarizes Legg Mason's stock options outstanding at March 31, 2012:

Exercise Price Range	Option Shares Outstanding	Weighted Average Exercise Price Per Share	Weighted Average Remaining Life (in years)
$ 12.65 - $ 25.00	86	$14.82	4.4
25.01 - 35.00	3,284	31.61	5.6
35.01 - 94.00	304	55.65	0.6
94.01 - 100.00	550	95.19	2.3
100.01 - 134.97	1,400	107.56	2.2
	5,624		

At March 31, 2012, 2011 and 2010, options were exercisable on 3,334, 2,860, and 2,810 shares, respectively, and the weighted-average exercise prices were $73.60, $77.20, and $73.57, respectively. Stock options exercisable at March 31, 2012, have a weighted-average remaining contractual life of 2.9 years. At March 31, 2012, the aggregate intrinsic value of options exercisable was $934.

The following information summarizes Legg Mason's stock options exercisable at March 31, 2012:

Exercise Price Range	Option Shares Exercisable	Weighted Average Exercise Price Per Share
$ 12.65 - $ 25.00	51	$14.73
25.01 - 35.00	1,134	31.13
35.01 - 94.00	304	55.65
94.01 - 100.00	550	95.19
100.01 - 134.97	1,295	108.11

3,334

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The following information summarizes unvested stock options under Legg Mason's equity incentive plans for the year ended March 31, 2012:

	Number of Shares	Weighted Average Grant Date Fair Value
Shares unvested at March 31, 2011	2,559	$15.89
Granted	810	13.13
Vested [(1)]	(961)	17.84
Canceled/forfeited	(118)	14.78
Shares unvested at March 31, 2012	2,290	$14.00

(1) Stock options granted prior to fiscal 2011 vest in July each year; beginning in fiscal 2011, stock options granted vest in May each year.

Unamortized compensation cost related to unvested options at March 31, 2012, was $22,843 and is expected to be recognized over a weighted-average period of 1.7 years.

Cash received from exercises of stock options under Legg Mason's equity incentive plans was $2,851, $12,094, and $1,829 for the years ended March 31, 2012, 2011 and 2010, respectively. The tax benefit expected to be realized for the tax deductions from these option exercises totaled $47, $2,645, and $73 for the years ended March 31, 2012, 2011, and 2010, respectively.

The weighted-average fair value of stock options granted in fiscal 2012, 2011 and 2010, using the Black Scholes option pricing model, was $13.13, $14.32, and $12.09 per share, respectively.

The following weighted-average assumptions were used in the model for grants in fiscal 2012, 2011 and 2010:

	2012	2011	2010
Expected dividend yield	1.39 %	1.39 %	1.45 %
Risk-free interest rate	1.95 %	2.37 %	2.86 %
Expected volatility	47.16 %	52.64 %	55.26 %
Expected lives (in years)	5.12	5.18	5.17

Legg Mason uses an equally weighted combination of both implied and historical volatility to measure expected volatility for calculating Black-Scholes option values.

Legg Mason has a qualified Employee Stock Purchase Plan covering substantially all U.S. employees. Shares of common stock are purchased in the open market on behalf of participating employees, subject to a 4,500 total share limit under the plan. Purchases are made through payroll deductions and Legg Mason provides a 10% contribution towards purchases, which is charged to earnings. During the fiscal years ended March 31, 2012, 2011 and 2010, approximately 107, 102, and 147 shares, respectively, have been purchased in the open market on behalf of participating employees. In fiscal 2012, 2011 and 2010, Legg Mason recognized $267, $286, and $313, respectively, in compensation expense related to the stock purchase plan.

On January 28, 2008, the Compensation Committee of Legg Mason approved grants to senior officers of 120 market based performance shares, of which 100 remain outstanding, that upon vesting, subject to certain conditions, are distributed as shares of common stock. The grants will vest ratably on January 28 of each of the five years following the grant date, upon attaining the service criteria and the stock price hurdles beginning at $77.97 in year one and ending at $114.15 in year five.

The weighted average fair value per share for these awards of $11.81 was estimated as of the grant date using a grant price of $70.88, and a Monte Carlo option pricing model with the following assumptions:

Expected dividend yield	1.33 %
Risk-free interest rate	3.30 %

Expected volatility	36.02	%

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Restricted stock and restricted stock unit transactions during the years ended March 31, 2012, 2011 and 2010, respectively, are summarized below:

	Number of shares		Weighted-average grant date value
Unvested shares at March 31, 2009	1,341		$51.26
Granted	786		22.35
Vested	(467	)	58.83
Canceled/forfeited	(55	)	53.37
Unvested shares at March 31, 2010	1,605		34.80
Granted	1,867		33.02
Vested	(617	)	38.62
Canceled/forfeited	(218	)	30.42
Unvested shares at March 31, 2011	2,637		33.01
Granted	1,370		33.48
Vested	(1,075	)	31.49
Canceled/forfeited	(59	)	32.68
Unvested shares at March 31, 2012	2,873		$33.83

The restricted stock and restricted stock unit awards were non-cash transactions. In fiscal 2012, 2011 and 2010, Legg Mason recognized $32,826, $35,770, and $27,233, respectively, in compensation expense and related tax benefits of $12,705, $13,854, and $9,804, respectively, for restricted stock and restricted stock unit awards. Unamortized compensation cost related to unvested restricted stock and restricted stock unit awards for 2,873 shares not yet recognized at March 31, 2012, was $63,196 and is expected to be recognized over a weighted-average period of 1.7 years.

Legg Mason also has an equity plan for non-employee directors. Under the equity plan, directors may elect to receive shares of stock or restricted stock units. Prior to a July 19, 2007 amendment to the Plan, directors could also elect to receive stock options. Options granted under the old plan are immediately exercisable at a price equal to the market value of the shares on the date of grant and have a term of not more than ten years. In fiscal 2012, 2011 and 2010, Legg Mason recognized expense of $1,375, $1,425, and $1,575, respectively, for awards under this plan. Shares, options, and restricted stock units issuable under the equity plan are limited to 625 shares in aggregate, of which 276 shares were issued under the plan as of March 31, 2012. At March 31, 2012, non-employee directors held 184 stock options, which are included in the outstanding options presented in the table above. As of March 31, 2012, non-employee directors held 74 restricted stock units, which vest on the grant date and are, therefore, not included in the unvested shares of restricted stock and restricted stock units in the table above. During the year ended March 31, 2012, non-employee directors did not exercise any stock options and no restricted stock units were distributed. There were 12 restricted stock units and 31 shares of common stock granted during fiscal 2012. There were 36 stock options and no restricted stock units canceled or forfeited during fiscal 2012.

During fiscal 2012, Legg Mason established a long-term incentive plan (the "LTIP") under its equity incentive plan, which provides an additional element of compensation that is based on performance. Under the LTIP, executive officers were granted cash value performance units in the June 2011 quarter that will vest at the end of a three year period based upon Legg Mason's cumulative adjusted earnings per share over the period. Awards granted under the LTIP may be settled in cash and/or shares of Legg Mason common stock, at the discretion of Legg Mason. The estimated amount of the award, if any, would be expensed over the vesting period based on a probability assessment of the expected outcome under the LTIP provisions.

Deferred compensation payable in shares of Legg Mason common stock has been granted to certain employees in an elective plan. The vesting in the plan is immediate and the plan provides for discounts of up to 10% on contributions and dividends. There are 5,792 additional shares reserved for future issuance under the plan. In fiscal 2012, 2011 and 2010, Legg Mason recognized $191, $263, and $176, respectively, in compensation expense related to this plan. During fiscal 2012, 2011 and 2010, Legg Mason issued 68, 77, and 128 shares, respectively, under the plan with a weighted average fair value per share at the grant date of $27.05, $28.38, and $22.53, respectively.

Legg Mason has issued shares in connection with certain deferred compensation plans that are held in rabbi trusts. Assets of rabbi trusts are consolidated with those of the employer, and the value of the employer's stock held in the rabbi trusts is classified in stockholders' equity and accounted for in a manner similar to treasury stock. Therefore, the shares Legg Mason has issued to its

rabbi trusts and the corresponding liability related to the deferred compensation plans are presented as components of stockholders' equity as Employee stock trust and Deferred compensation employee stock trust, respectively. Shares held by the trusts at March 31, 2012, 2011 and 2010, were 690, 706 and 653, respectively.
As part of the Company's streamlining initiative, as further discussed in Note 16, the employment of certain recipients of stock option and restricted stock awards has been terminated. The termination benefits extended to these employees included accelerated vesting of any portion of their equity incentive awards that would not have vested by January 1, 2012, under the original terms of the awards. During fiscal 2011, the portion of the awards subject to accelerated vesting was revalued and was expensed over the new vesting period, the impact of which is included above. Also in connection with the restructuring initiative, the departure of an executive officer in December 2010, resulted in the accelerated vesting of a portion of certain equity incentive awards, the impact of which is also included above.

13. EARNINGS PER SHARE
Basic EPS is calculated by dividing Net income attributable to Legg Mason, Inc. by the weighted-average number of shares outstanding. The calculation of weighted-average shares includes common shares, shares exchangeable into common stock and unvested restricted shares deemed to be participating securities. Diluted EPS is similar to basic EPS, but adjusts for the effect of potentially issuable common shares, except when inclusion is antidilutive.

During fiscal 2012, Legg Mason purchased and retired 13,597 shares of its common stock for $400,266, through open market purchases. During fiscal 2011, Legg Mason purchased and retired 14,552 shares of its common stock for $445,465, through ASR agreements and open market purchases. These repurchases reduced weighted-average shares outstanding by 9,716 and 9,088 shares for the years ended March 31, 2012 and 2011, respectively.

In June 2011, Legg Mason issued 1,830 shares of common stock upon the exercise of purchase contracts on the remaining Equity Units. Of these shares, 1,380 shares are included in weighted-average shares outstanding for the year ended March 31, 2012.

In August 2009, Legg Mason issued 18,596 shares of common stock through the Equity Units tender offer. Of these shares, 11,565 shares are included in the weighted-average shares outstanding for the year ended March 31, 2010.

The following table presents the computations of basic and diluted EPS:

	Years ended March 31		
	2012	2011	2010
Weighted-average basic shares outstanding	143,292	155,321	153,715
Potential common shares:			
Employee stock options	57	163	56
Shares related to deferred compensation	—	—	455
Shares issuable upon payment of contingent consideration	—	—	1,136
Weighted-average diluted shares	143,349	155,484	155,362
Net income	$231,031	$245,763	$210,980
Less: Net income (loss) attributable to noncontrolling interests	10,214	(8,160)	6,623
Net income attributable to Legg Mason, Inc.	$220,817	$253,923	$204,357
Net income per Share attributable to Legg Mason, Inc. common shareholders			

Basic	$1.54	$1.63	$1.33
Diluted	$1.54	$1.63	$1.32

The diluted EPS calculations for the years ended March 31, 2012, 2011 and 2010, exclude any potential common shares issuable under the convertible 2.5% senior notes, and for the years ended March 31, 2011 and 2010, exclude any potential common shares issuable under the convertible Equity Units, because the market price of Legg Mason common stock had not exceeded the price at which conversion under either instrument would be dilutive using the treasury stock method.

Options to purchase 5,239, 5,204, and 5,130 shares for the fiscal years ended March 31, 2012, 2011 and 2010, respectively, were not included in the computation of diluted earnings per share because the presumed proceeds from exercising such options, including related income tax benefits, exceed the average price of the common shares for the fiscal year and therefore the options are deemed antidilutive. Also at March 31, 2012, 2011 and 2010, warrants issued in connection with the convertible note hedge

transactions described in Note 7 are excluded from the calculation of diluted earnings per share because the effect would be antidilutive.

14. ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income includes cumulative foreign currency translation adjustments and net of tax, gains and losses on investment securities. The change in the accumulated translation adjustments for fiscal 2012 and 2011, primarily resulted from the impact of changes in the Brazilian real, the Polish zloty, the Australian dollar, the Japanese yen, the British pound, and the Singapore dollar in relation to the U.S. dollar on the net assets of Legg Mason's subsidiaries in Brazil, Poland, Australia, Japan, the United Kingdom, and Singapore, for which the real, the zloty, the Australian dollar, the yen, the pound, and the Singapore dollar are the functional currencies, respectively.

A summary of Legg Mason's accumulated other comprehensive income as of March 31, 2012 and 2011, is as follows:

	2012	2011
Foreign currency translation adjustment	$71,204	$93,302
Unrealized gains on investment securities, net of tax provision of $179 and $39, respectively	268	59
Total	$71,472	$93,361

15. DERIVATIVES AND HEDGING

The disclosures below detail Legg Mason’s derivatives and hedging excluding the derivatives and hedging of CIVs. See Note 18, Variable Interest Entities and Consolidation of Investment Vehicles, for information related to the derivatives and hedging of CIVs.

Legg Mason uses currency forwards to economically hedge the risk of movements in exchange rates, primarily between the U.S. dollar, euro, Canadian dollar, Japanese yen, Singapore dollar, Brazilian real, British pound, and Australian dollar. In the Consolidated Balance Sheets, Legg Mason nets the fair value of certain foreign currency forwards executed with the same counterparty where Legg Mason has both the legal right and intent to settle the contracts on a net basis.

Legg Mason also uses market hedges on certain seed capital investments by entering into futures contracts to sell index funds that benchmark the hedged seed capital investments. Open futures contracts required cash collateral of $1,919 and $7,099 as of March 31, 2012 and 2011, respectively.

The following table presents the fair values as of March 31, 2012 and 2011, of derivative instruments not designated for accounting purposes as hedging instruments, classified as Other assets and Other liabilities:

	2012		2011	
	Assets	Liabilities	Assets	Liabilities
Currency forward contracts	$38	$685	$1,112	$1,633
Futures contracts	46	201	57	1,487
Total	$84	$886	$1,169	$3,120

The following table presents gains (losses) recognized on derivative instruments for the years ended March 31, 2012 and 2011:

	2012		2011	
	Gains	Losses	Gains	Losses

	Income Statement Classification				
Currency forward contracts for:					
Operating activities	Other expense	$5,604	$(3,159)	$4,943	$(6,094)
Seed capital investments	Other non-operating income (expense)	431	(351)	123	(355)
Futures contracts	Other non-operating income (expense)	5,684	(4,560)	1,652	(7,146)
Total		$11,719	$(8,070)	$6,718	$(13,595)

16. RESTRUCTURING

In May 2010, Legg Mason announced a plan to streamline its business model to drive increased profitability and growth that primarily involved transitioning certain shared services to its investment affiliates which are closer to actual client relationships. This plan involved headcount reductions in operations, technology, and other administrative areas, which were partially offset by headcount increases at the affiliates, and enabled Legg Mason to eliminate a portion of its corporate office space

that was primarily dedicated to operations and technology employees. The initiative was complete as of March 31, 2012.

This initiative involved transition-related costs, primarily comprised of charges for employee termination benefits and retention incentives during the transition period, recorded in Transition-related compensation in the Consolidated Statements of Income. The transition-related costs also involved other costs, including charges for consolidating leased office space, early contract terminations, asset disposals, and professional fees, recorded in the appropriate operating expense classifications. Total transition-related costs were $127,500 through March 31, 2012. Charges for transition-related costs were $73,066 and $54,434 for the years ended March 31, 2012 and 2011, respectively, which primarily represent costs for severance and retention incentives.

The table below presents a summary of changes in the transition-related liability from the initiation of the restructuring plan through March 31, 2012, including non-cash charges, such as asset write-offs and stock-based compensation expense, and cumulative charges incurred to date:

	Severance and retention incentives	Other	Total
Balance as of March 31, 2010	$—	$—	$—
Accrued charges	35,487	6,160	41,647
Payments	(12,276)	(325)	(12,601)
Balance as of March 31, 2011	23,211	5,835	29,046
Accrued charges	29,096	25,916 (1)	55,012
Payments	(51,140)	(16,121)	(67,261)
Balance as of March 31, 2012	$1,167	$15,630	$16,797
Non-cash charges (2)			
Year ended March 31, 2011	$9,561	$3,226	$12,787
Year ended March 31, 2012	5,542	12,512	18,054
Total	$15,103	$15,738	$30,841
Cumulative charges incurred as of March 31, 2012	$79,686	$47,814	$127,500

(1) Includes lease loss accruals of $17,983 for space permanently abandoned.

(2) Includes stock-based compensation expense, fixed asset accelerated depreciation related to space permanently abandoned, and accelerated depreciation for internally-developed software that will no longer be utilized as a result of the initiative.

17. BUSINESS SEGMENT INFORMATION

Legg Mason is a global asset management company that provides investment management and related services to a wide array of clients. Due to a realignment of its executive management team, beginning in fiscal 2012, the previous separation of the Americas and International divisions has been eliminated and the company operates in one reportable business segment, Global Asset Management. Global Asset Management provides investment advisory services to institutional and individual clients and to company-sponsored investment funds. The primary sources of revenue in Global Asset Management are investment advisory, distribution and administrative fees, which typically are calculated as a percentage of the AUM and vary based upon factors such as the type of underlying investment product and the type of services that are provided. In addition, performance fees may be earned under certain

investment advisory contracts for exceeding performance benchmarks.

Revenues by geographic location are primarily based on the geographic location of the advisor or the domicile of fund families managed by Legg Mason.

The table below reflects our revenues and long-lived assets by geographic region (in thousands) as of March 31:

	2012	2011	2010
OPERATING REVENUES			
United States	$1,806,990	$1,919,680	$1,866,909
United Kingdom	448,863	512,313	478,510
Other International	406,721	352,324	289,460
Total	$2,662,574	$2,784,317	$2,634,879
INTANGIBLE ASSETS, NET AND GOODWILL			
United States	$3,548,628	$3,565,019	$3,590,283
United Kingdom	1,108,297	1,136,386	1,139,065
Other International	474,986	487,022	488,170
Total	$5,131,911	$5,188,427	$5,217,518

18. VARIABLE INTEREST ENTITIES AND CONSOLIDATION OF INVESTMENT VEHICLES

Legg Mason is the investment manager for CDOs/CLOs that are considered VIEs under revised accounting guidance, since investors in these structures lack unilateral decision making authority. These investment vehicles were created for the sole purpose of issuing collateralized instruments that offer investors the opportunity for returns that vary with the risk level of their investment. Legg Mason's management fee structure for these investment vehicles typically includes a senior management fee, and may also include subordinated and incentive management fees. Legg Mason holds no equity interest in any of these investment vehicles and did not transfer or sell any assets to any of these investment vehicles. In accordance with the methodology described in Note 1 above, Legg Mason concluded that it had a variable interest in only two of these investment vehicles, which are CLOs, and is the primary beneficiary of one of the two CLOs, because although Legg Mason holds no equity interest in either of these investment vehicles, it had both the power to control and had a significant variable interest in one CLO because of its expected subordinated fees. As of March 31, 2012 and 2011, the balances related to this CLO were consolidated on the Company's consolidated financial statements. The collateral assets of this VIE are primarily comprised of investments in corporate loans, and to a lesser extent, bonds. The assets of the CLO cannot be used by Legg Mason and gains and losses related to these assets have no impact on Net Income Attributable to Legg Mason, Inc. The liabilities of this VIE are primarily comprised of debt and the CLO's debt holders have no recourse to the general credit or assets of Legg Mason.

In addition, Legg Mason was the primary beneficiary of one sponsored investment fund VIE, and also held a controlling financial interest in one sponsored investment fund VRE, both of which were consolidated as of March 31, 2012, 2011 and 2010. Effective December 31, 2011, a controlling financial interest of $20,814 in a second sponsored investment fund VRE, which was consolidated as of March 31, 2011, by Legg Mason, was redeemed. Accordingly, the fund was deconsolidated by Legg Mason and the fund's balance sheet amounts have been excluded from Legg Mason's consolidated balance sheet as of March 31, 2012, but income statement and cash flow amounts for the fund have been included in Legg Mason's consolidated income and cash flow statements for the year ended March 31, 2012. Legg Mason's investment in CIVs as of March 31, 2012 and 2011, was $38,919 and $53,708, respectively, which represents its maximum risk of loss, excluding uncollected advisory fees. The assets of these CIVs are primarily comprised of investment securities. Investors and creditors of these CIVs have no recourse to the general credit or assets of Legg Mason beyond its investment in these funds.

The following tables reflect the impact of CIVs on the Consolidated Balance Sheets as of March 31, 2012 and 2011, respectively, and the Consolidated Statements of Income for the years ended March 31, 2012, 2011 and 2010, respectively:

Consolidating Balance Sheets

	March 31, 2012				March 31, 2011			
	Balance Before Consolidation of CIVs	CIVs	Eliminations	As Reported	Balance Before Consolidation of CIVs	CIVs	Eliminations	As Reported
Current assets	$2,439,162	$58,040	$(39,408)	$2,457,794	$2,378,226	$122,963	$(54,633)	$2,446,556
Non-current assets	5,801,680	296,273	—	6,097,953	5,946,737	314,463	—	6,261,200
Total assets	$8,240,842	$354,313	$(39,408)	$8,555,747	$8,324,963	$437,426	$(54,633)	$8,707,756
Current liabilities	$971,804	$4,467	$(489)	$975,782	$914,803	$55,094	$(925)	$968,972
Long-term debt of CIVs	—	271,707	—	271,707	—	278,320	—	278,320
Other non-current liabilities	1,603,064	3,872	—	1,606,936	1,649,815	3,553	—	1,653,368
Total liabilities	2,574,868	280,046	(489)	2,854,425	2,564,618	336,967	(925)	2,900,660
Redeemable non-controlling interests	996	—	23,035	24,031	976	—	35,736	36,712
Total stockholders' equity	5,664,978	74,267	(61,954)	5,677,291	5,759,369	100,459	(89,444)	5,770,384
Total liabilities and equity	$8,240,842	$354,313	$(39,408)	$8,555,747	$8,324,963	$437,426	$(54,633)	$8,707,756

Consolidating Statements of Income

	Fiscal Year Ended March 31, 2012			
	Balance Before Consolidation of CIVs	CIVs	Eliminations	As Reported
Total operating revenues	$2,665,668	$—	$(3,094)	$2,662,574
Total operating expenses	2,323,213	3,709	(3,101)	2,323,821
Operating income (loss)	342,455	(3,709)	7	338,753
Total other non-operating income (expense)	(49,236)	18,336	(4,770)	(35,670)
Income (loss) before income tax provision	293,219	14,627	(4,763)	303,083
Income tax provision	72,052	—	—	72,052
Net income (loss)	221,167	14,627	(4,763)	231,031
Less: Net income (loss) attributable to noncontrolling interests	350	—	9,864	10,214

Net income (loss) attributable to Legg Mason, Inc.	$220,817	$14,627	$(14,627)	$220,817

	Fiscal Year Ended March 31, 2011			
	Balance Before Consolidation of CIVs	CIVs	Eliminations	As Reported
Total operating revenues	$2,788,450	$—	$(4,133)	$2,784,317
Total operating expenses	2,396,938	4,704	(4,133)	2,397,509
Operating income (loss)	391,512	(4,704)	—	386,808
Total other non-operating income (expense)	(17,931)	1,704	(5,384)	(21,611)
Income (loss) before income tax provision	373,581	(3,000)	(5,384)	365,197
Income tax provision	119,434	—	—	119,434
Net income (loss)	254,147	(3,000)	(5,384)	245,763
Less: Net income (loss) attributable to noncontrolling interests	224	—	(8,384)	(8,160)
Net income (loss) attributable to Legg Mason, Inc.	$253,923	$(3,000)	$3,000	$253,923

	Fiscal Year Ended March 31, 2010			
	Balance Before Consolidation of CIVs	CIVs	Eliminations	As Reported
Total operating revenues	$2,637,658	$—	$(2,779)	$2,634,879
Total operating expenses	2,314,376	2,263	(2,943)	2,313,696
Operating income (loss)	323,282	(2,263)	164	321,183
Total other non-operating income (expense)	(47)	17,329	(8,809)	8,473
Income (loss) before income tax provision	323,235	15,066	(8,645)	329,656
Income tax provision	118,676	—	—	118,676
Net income (loss)	204,559	15,066	(8,645)	210,980
Less: Net income (loss) attributable to noncontrolling interests	202	—	6,421	6,623
Net income (loss) attributable to Legg Mason, Inc.	$204,357	$15,066	$(15,066)	$204,357

Other non-operating income (expense) includes interest income, interest expense and net gains (losses) on investments and long-term debt determined on an accrual basis.

The consolidation of CIVs has no impact on Net Income Attributable to Legg Mason, Inc.

The fair value of the financial assets and (liabilities) of CIVs were determined using the following categories of inputs (as defined in Note 1) as of March 31, 2012:

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Value as of March 31, 2012
Assets:				
Trading investments:				
Hedge funds	$1,016	$6,443	$24,116	$31,575
Investments:				
CLO loans	—	260,690	—	260,690
CLO bonds	—	9,092	—	9,092
Private equity funds	—	—	25,071	25,071
Total investments	—	269,782	25,071	294,853
	$1,016	$276,225	$49,187	$326,428
Liabilities:				
CLO debt	$—	$—	$(271,707)	$(271,707)
Derivative liabilities	—	(3,872)	—	(3,872)
	$—	$(3,872)	$(271,707)	$(275,579)

Except for the CLO debt, substantially all of the above financial instruments where valuation methods rely on other than observable market inputs as a significant input utilize the NAV practical expedient, such that measurement uncertainty has little relevance. The following table provides a summary of

qualitative information relating to the valuation of CLO debt.

Value as of March 31, 2012	Valuation technique	Unobservable input	Range (weighted average)
$(271,707)	Discounted cash flow	Discount rate	1.7%- 24.5% (3.8%)
		Default rate	2.5%- 4.0% (3.4%)
		Constant prepayment rate	15.0%

Significant increases (decreases) in any of these inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, both the constant rate of prepayment and default rate are driven by market conditions related to interest rates, credit ratings, and other factors. Each of the inputs noted could move independently depending on specific market conditions,

making it possible for varying market conditions to drive changes in these inputs with a positive, negative, or zero correlation.

The fair value of the financial assets and (liabilities) of CIVs were determined using the following categories of inputs (as defined in Note 1) as of March 31, 2011:

	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Value as of March 31, 2011
Assets:				
Trading investments:				
Hedge funds	$—	$14,087	$34,272	$48,359
Government and corporate securities	—	22,139	—	22,139
Repurchase agreements	—	12,331	—	12,331
Total trading investment securities	—	48,557	34,272	82,829
Investments:				
CLO loans	—	275,948	—	275,948
CLO bonds	—	18,813	—	18,813
Private equity funds	—	—	17,879	17,879
Total investments	—	294,761	17,879	312,640
Derivative assets	125	45	—	170
	$125	$343,363	$52,151	$395,639
Liabilities:				
CLO debt	$—	$—	$(278,320)	$(278,320)
Reverse repurchase agreements	—	(18,310)	—	(18,310)
Derivative liabilities	(128)	(14,169)	—	(14,297)
	$(128)	$(32,479)	$(278,320)	$(310,927)

In accordance with new accounting guidance adopted during fiscal 2012, the changes in assets and (liabilities) of CIVs measured at fair value using significant unobservable inputs (Level 3) for the year ended March 31, 2012 are now presented on a gross basis in the table below:

	Value as of March 31, 2011	Purchases	Sales	Transfers In	Transfers Out	Realized and unrealized gains/(losses), net	Value as of March 31, 2012
Assets:							
Hedge funds	$34,272	$17,018	$(32,058)	$3,302	$(3,316)	$ 4,898	$24,116
Private equity funds	17,879	4,889	(762)	—	—	3,065	25,071
	$52,151	$21,907	$(32,820)	$3,302	$(3,316)	$ 7,963	$49,187
Liabilities:							
CLO debt	$(278,320)	$—	$—	$—	$—	$ 6,613	$(271,707)
Total realized and unrealized gains (losses), net						$ 14,576	

	Value as of March 31, 2010	Purchases, sales, issuances and settlements, net	Transfers [1]	Realized and unrealized gains/(losses), net	Value as of March 31, 2011
Assets:					
Hedge funds	$12,374	$8,340	$5,862	$ 7,696	$34,272
Private equity funds	13,692	4,906	—	(719)	17,879
	$26,066	$13,246	$5,862	$ 6,977	$52,151
Liabilities:					
CLO debt	$—	$—	$(249,668)	$ (28,652)	$(278,320)
Total realized and unrealized gains (losses), net				$ (21,675)	

(1) Transfers into Level 3 for the year ended March 31, 2011, primarily represent assets and liabilities recorded upon the initial consolidation of investment vehicles.

Realized and unrealized gains and losses recorded for Level 3 assets and liabilities of CIVs are included in Other non-operating income (expense) of CIVs on the Consolidated Statements of Income. Total unrealized gains (losses) for Level 3 investments and liabilities of CIVs relating only to those assets and liabilities still held at the reporting date were $7,297 and $(21,668) for the fiscal year ended March 31, 2012 and 2011, respectively.

There were no significant transfers between Levels 1 and 2 during either of the years ended March 31, 2012 or 2011.

The NAV values used as a practical expedient by CIVs have been provided by the investees and have been derived from the fair values of the underlying investments as of the reporting date. The following table summarizes, as of March 31, 2012, the nature of these investments and any related liquidation restrictions or other factors which may impact the ultimate value realized.

Category of Investment	Investment Strategy	Fair Value Determined Using NAV	Unfunded Commitments	Remaining Term
Hedge funds	Global, fixed income, macro, long/short equity, systematic, emerging market, U.S. and European hedge	$31,575 [1]	n/a	n/a
Private equity funds	Long/short equity	25,071 [2]	$7,444	7 years
Total		$56,646	$7,444	

n/a – not applicable

(1) 5% daily redemption; 6% monthly redemption; 5% quarterly redemption; and 84% subject to three to five year lock-up or side pocket provisions.
(2) Liquidations are expected over the remaining term.

There are no current plans to sell any of these investments.

Legg Mason has elected the fair value option for certain eligible assets and liabilities, including corporate loans and debt, of the consolidated CLO. Management believes that the use of the fair value option eliminates certain timing differences and better matches the changes in fair value of assets and liabilities related to the CLO.

The following table presents the fair value and unpaid principal balance of CLO loans, bonds and debt carried at fair value under the fair value option as of March 31, 2012 and 2011:

	March 31, 2012	March 31, 2011
CLO loans and bonds		
Unpaid principal balance	$277,156	$299,044
Unpaid principal balance in excess of fair value	(7,374)	(4,283)
Fair value	$269,782	$294,761
Unpaid principal balance of loans that are more than 90 days past due and also in nonaccrual status	$2,963	$4,963
Unpaid principal balance in excess of fair value for loans that are more than 90 days past due and also in nonaccrual status	(1,023)	(2,837)
Fair value of loans more than 90 days past due and in nonaccrual status	$1,940	$2,126
CLO debt		
Principal amounts outstanding	$300,959	$300,959
Excess unpaid principal over fair value	(29,252)	(22,639)
Fair value	$271,707	$278,320

During the years ended March 31, 2012 and 2011, total net gains (losses) of $2,054 and $(14,686), respectively, were recognized in Other non-operating income of CIVs in the Consolidated Statements of Income related to assets and liabilities for which the fair value option was elected. For CLO loans and CLO debt measured at fair value, substantially all of the estimated gains and losses included in earnings for the fiscal year ended March 31, 2012, were attributable to instrument specific credit risk, as overall credit spreads widened and the general credit curve steepened.

The CLO debt bears interest at variable rates based on LIBOR plus a pre-defined spread, which ranges from 25 basis points to 400 basis points. All outstanding debt matures on July 15, 2018.

Total derivative liabilities of CIVs of $3,872 as of March 31, 2012, and total derivative assets and liabilities of CIVs of $170 and $14,297, respectively, as of March 31, 2011, are primarily recorded in Other liabilities of CIVs. Gains and (losses) of $54,603 and $(47,697), respectively, for the fiscal year ended March 31, 2012, related to derivative assets and liabilities of CIVs are included in Other non-operating income of CIVs. Gains and (losses) of $15,364 and $(18,022), respectively, for the fiscal year ended March 31, 2011, related to derivative assets and liabilities of CIVs are included in Other non-operating income (expense) of CIVs. There is no risk to Legg Mason in relation to the derivative assets and liabilities of the CIVs in excess of its investment in the funds, if any.

As of March 31, 2012 and 2011, for VIEs in which Legg Mason holds a significant variable interest or is the sponsor and holds a variable interest, but for which it was not the primary beneficiary, Legg Mason's carrying value, the related VIE assets and liabilities and maximum risk of loss were as follows:

	As of March 31, 2012			
	VIE Assets Not Consolidated	VIE Liabilities Not Consolidated	Equity Interests on the Consolidated Balance Sheet	Maximum Risk of Loss [(1)]
CLO	$390,861	$362,861	$—	$442

Public-Private Investment Program	674,520	3,213	282	282
Other sponsored investment funds	17,296,521	20,544	54,161	93,521
Total	$18,361,902	$386,618	$54,443	$94,245

	As of March 31, 2011			
	VIE Assets Not Consolidated	VIE Liabilities Not Consolidated	Equity Interests on the Consolidated Balance Sheet	Maximum Risk of Loss [(1)]
CLO	$382,692	$354,692	$—	$196
Public-Private Investment Program	692,488	2,002	290	290
Other sponsored investment funds	20,241,752	16,771	83,480	121,899
Total	$21,316,932	$373,465	$83,770	$122,385

(1) Includes equity investments the Company has made or is required to make and any earned but uncollected management fees.

The assets of these VIEs are primarily comprised of cash and cash equivalents and investment securities, and the liabilities are primarily comprised of debt and various expense accruals.

19. LIQUIDITY FUND SUPPORT

Due to stress in the liquidity markets in prior years, certain asset backed securities previously held by liquidity funds that a Legg Mason subsidiary manages were in default or had been restructured after a default. Although the company was not required to provide support to the funds, Legg Mason elected to do so to maintain the confidence of its clients, maintain its reputation in the marketplace, and in certain cases, support the AAA/Aaa credit ratings of funds. If clients were to lose confidence in the company, they could potentially withdraw funds in favor of investments offered by competitors, resulting in a reduction in Legg Mason's AUM and investment advisory and other fees.

As of March 31, 2010, all previously existing support arrangements had expired or were terminated in accordance with their terms. For the year ended March 31, 2010, Legg Mason recognized pre-tax gains of $23,171 ($16,565 net of income taxes), which represents the reversal of unrealized, non-cash losses recorded in fiscal 2009 related to four CSAs to support investments in non-asset backed securities. This amount also includes pre-tax gains on foreign exchange forward contracts of $1,484 and an interest payment of $1,056 received related to SIV securities that were sold in fiscal 2009.

All gains and losses, including interest payments and those related to foreign exchange forward contracts, are included in Fund support in Other non-operating income (expense) on the Consolidated Statements of Income.

20. SUBSEQUENT EVENTS

In May 2012, Legg Mason's board of directors approved a new capital plan that includes refinancing the Notes, as defined in Note 7 (the 2.5% convertible senior notes). The refinancing was effected through the issuance of $650,000 of 5.5% senior notes due May 2019, the net proceeds of which, together with cash on hand and $250,000 of borrowings under the existing revolving credit facility, were used to repurchase all $1,250,000 of the Notes. The terms of the repurchase include the repayment of the Notes at par plus accrued interest, a prepayment fee of $6,250, and the issuance of warrants (the "Warrants") to the holders of the Notes that replicate and extend the contingent conversion feature of the Notes. The Warrants provide for the purchase of 14,205 shares of Legg Mason's common stock at $88 per share, subject to customary anti-dilution adjustments, and will expire in July 2017. Extinguishment of the Notes results in an approximate $69,000 pre-tax non-operating charge, including approximately $8,000 of charges deferred from the initial issuance of the Notes. The hedge transactions (Purchased Call Options and warrants) executed in conjunction with the initial issuance of the Notes were also

extinguished.

As part of the new capital plan, Legg Mason's board of directors has authorized $1,000,000 for additional purchases of Legg Mason common stock and the acceleration of the purchase of the remaining approximate $155,000 of Legg Mason common stock previously authorized into the first quarter of fiscal 2013. The new capital plan authorizes using up to 65% of cash generated from future operations, beginning with fiscal 2013, to purchase shares of Legg Mason common stock.

QUARTERLY FINANCIAL DATA
(Dollars in thousands, except per share amounts)
(Unaudited)

	Quarter Ended			
Fiscal 2012[(1)]	Mar. 31	Dec. 31	Sept. 30	June 30
Operating Revenues	$648,591	$626,978	$669,897	$717,108
Operating Expenses	576,379	567,655	563,045	616,742
Operating Income	72,212	59,323	106,852	100,366
Other Non-Operating Income (Expense)	37,781	(11,575)	(51,075)	(10,801)
Income before Income Tax Provision (Benefit)	109,993	47,748	55,777	89,565
Income tax provision (benefit)	33,184	12,607	(1,606)	27,867
Net Income	76,809	35,141	57,383	61,698
Less: Net income attributable to noncontrolling interests	740	7,009	719	1,746
Net Income attributable to Legg Mason, Inc.	$76,069	$28,132	$56,664	$59,952
Net Income per Share attributable to Legg Mason, Inc. common shareholders:				
Basic	$0.54	$0.20	$0.39	$0.40
Diluted	0.54	0.20	0.39	0.40
Cash dividend per share	0.08	0.08	0.08	0.08
Stock price range:				
High	29.49	29.56	34.32	37.82
Low	23.75	22.61	24.11	30.86
Assets Under Management:				
End of period	$643,318	$626,960	$611,794	$662,533
Average	634,916	622,004	643,296	670,761

(1) Due to rounding of quarterly results, total amounts for fiscal year may differ immaterially from the annual results.

As of May 22, 2012, the closing price of Legg Mason's common stock was $24.39.

	Quarter Ended			
Fiscal 2011[(1)]	Mar. 31	Dec. 31	Sept. 30	June 30
Operating Revenues	$713,430	$721,928	$674,794	$674,165
Operating Expenses	614,290	624,936	586,895	571,388
Operating Income	99,140	96,992	87,899	102,777
Other Non-Operating Income (Expense)	3,486	(9,836)	15,409	(30,670)
Income before Income Tax Provision	102,626	87,156	103,308	72,107
Income tax provision	31,858	33,792	26,720	27,064
Net Income	70,768	53,364	76,588	45,043
Less: Net income (loss) attributable to noncontrolling interests	1,731	(8,256)	1,253	(2,888)
Net Income attributable to Legg Mason, Inc.	$69,037	$61,620	$75,335	$47,931
Net Income per Share attributable to Legg Mason, Inc. common shareholders:				
Basic	$0.45	$0.41	$0.50	$0.30
Diluted	0.45	0.41	0.50	0.30
Cash dividend per share	0.06	0.06	0.04	0.04
Stock price range:				

High	37.29	37.72	31.04	34.83
Low	32.21	29.68	24.94	27.36
Assets Under Management:				
End of period	$677,646	$671,799	$673,467	$645,362
Average	673,495	672,399	658,585	668,268

(1) Due to rounding of quarterly results, total amounts for fiscal year may differ immaterially from the annual results.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

As of March 31, 2012, Legg Mason's management, including the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the design and operation of Legg Mason's disclosure controls and procedures. In evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on that evaluation, Legg Mason's management, including its Chief Executive Officer and its Chief Financial Officer, concluded that Legg Mason's disclosure controls and procedures were effective on a reasonable assurance basis. There have been no changes in Legg Mason's internal control over financial reporting that occurred during the quarter ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, Legg Mason's internal control over financial reporting.

Legg Mason's Report of Management on Internal Control Over Financial Reporting and PricewaterhouseCoopers LLP's Report of Independent Registered Public Accounting Firm, which contains its attestation report on Legg Mason's internal control over financial reporting, are included in Item 8 of this Report and are incorporated herein by reference.

ITEM 9B. OTHER INFORMATION.

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

The information about our Directors required by this item will be contained under the caption “Election of Directors” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. Information about compliance with Section 16(a) of the Securities Exchange Act of 1934 required by this item will be contained under the caption “Section 16(a) Beneficial Ownership Reporting Compliance” in that proxy statement. All of that information is incorporated herein by reference to the proxy statement. See Part I, Item 4A of This Report for information regarding certain of our executive officers. The process by which our stockholders may recommend nominees to our Board of Directors and any material changes to that process will be discussed in our definitive proxy statement for the 2012 Annual Meeting of Stockholders under the caption “Corporate Governance - Director Nomination Process.” That information is incorporated herein by reference to the proxy statement.

Our Board of Directors has an Audit Committee, a Compensation Committee, a Finance Committee, a Nominating & Corporate Governance Committee and a Risk Committee. Information about our Board of Directors' determination regarding the service of an audit committee financial expert on the Audit Committee of the Board of Directors and the name and independence of such expert will be contained under the caption “Election of Directors - Committees of the Board Board Meetings - Audit Committee” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. That information is incorporated herein by reference to the proxy statement. Information about the identities of the members of the Audit Committee of the Board of Directors will be contained in the proxy statement under the heading “Election of Directors - Committees of the Board - Board Meetings - Audit Committee” and is also incorporated herein by reference.

We have adopted a corporate Code of Conduct that applies to all directors and employees of Legg Mason and its subsidiaries, including Legg Mason's Chief Executive Officer, Chief Financial Officer, Principal Accounting Officer and Controller. This Code of Conduct is designed to deter wrongdoing and to, among other things, promote honest and ethical conduct; full, fair, accurate, timely and understandable disclosure; compliance with applicable governmental laws, rules and regulations; prompt internal reporting of violations of the Code; and accountability for adherence to the Code. The Code of Conduct is posted on our corporate website at http://www.leggmason.com under the “About Us - Corporate Governance” section. In addition, a copy of the Code of Conduct may be obtained, free of charge, upon written request to Corporate Secretary, Legg Mason, Inc., 100 International Drive, Baltimore, MD 21202. We will post any amendments or waivers to the Code of Conduct that are required to be disclosed by the rules of the SEC or the NYSE, on our corporate website at the foregoing address.

ITEM 11. EXECUTIVE COMPENSATION.

The information required by this item will be contained under the captions “Election of Directors - Compensation of Directors,” "Election of Directors - Relationship of Compensation and Risk," “Executive Compensation,” “Compensation Committee Interlocks, Insider Participation and Certain Transactions” and “Compensation Committee Report” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. All of that information is incorporated herein by reference to the proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information about security ownership of management, directors, and certain beneficial owners required by this item will be contained under the caption “Security Ownership of Management and Principal Stockholders” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. That information is incorporated herein by reference to the proxy statement.

Equity Compensation Plan Information

The following table provides information about our equity compensation plans as of March 31, 2012.

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights		(b) Weighted average exercise price of outstanding options, warrants and rights		(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))	
Equity compensation plans approved by stockholders	6,664,646	(1)	$57.78	(2)	16,438,245	(3)(4)
Equity compensation plans not approved by stockholders	—		—		—	
Total	6,664,646		$57.78		16,438,245	(3)(4)

(1) Includes 690,283 shares of Legg Mason Common Stock (“Common Stock”) that are held in a trust pending distribution of phantom stock units. The phantom stock units, which are converted into shares of Common Stock on a one-for-one basis upon distribution, were granted to plan participants upon their deferral of compensation or dividends paid on phantom stock units. When amounts are deferred, participants receive a number of phantom stock units equal to the deferred amount divided by 90% to 95% of the fair market value of a share of Common Stock. Also includes 74,732 restricted stock units granted to non-employee directors as equity compensation that are converted into shares of Common Stock on a one-for-one basis upon distribution.

(2) Weighted-average exercise price does not include phantom stock units or restricted stock units that will be converted into Common Stock on a one-for-one basis upon distribution at no additional cost, and were granted as described in footnote (1).

(3) In addition, 5,792,080 shares of Common Stock may be issued under the Legg Mason & Co, LLC Deferred Compensation/Phantom Stock Plan upon the distribution of phantom stock units that may be acquired in the future as described in footnote (1).

(4) 13,133,590 of these shares may be issued under our omnibus equity plan as stock options, restricted or unrestricted stock grants or any other form of equity compensation. 348,933 of these shares may be issued under the Legg Mason, Inc. Equity Plan for Non-Employee Directors as grants of stock or restricted stock units. 2,955,722 of these shares may be purchased under our employee stock purchase plan, which acquires the shares that are purchased thereunder in the open market.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

The information required by this item will be contained under the captions “Compensation Committee Interlocks, Insider Participation and Certain Transactions,” “Corporate Governance - Policies and Procedures Regarding Related Party Transactions” and “Corporate Governance - Independent Directors” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. That information is incorporated herein by reference to the proxy statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

The information required by this item will be contained under the captions “Proposed Ratification of the Appointment of Independent Registered Public Accounting Firm - Fees Paid to Independent Registered Public Accounting Firm” and “Proposed Ratification of the Appointment of Independent Registered

Public Accounting Firm - Pre-approval of Independent Registered Public Accounting Firm Services" in our definitive proxy statement for the 2012 Annual Meeting of Stockholders. That information is incorporated herein by reference to the proxy statement.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Documents filed as a part of the report:

1. The following consolidated financial statements are included in Item 8 of this Report:

	Page Number in this Report
Report of Independent Registered Public Accounting Firm	56
Consolidated Balance Sheets	57
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All schedules to the consolidated financial statements for which provision is made in the accounting regulations of the SEC are not applicable or are not required and therefore have been omitted.

3. Exhibits

3.1	Articles of Incorporation of Legg Mason, as amended (incorporated by reference to Legg Mason's Current Report on Form 8-K for the event on July 26, 2011)
3.2	By-laws of Legg Mason, as amended and restated July 26, 2011 (incorporated by reference to Legg Mason's Current Report on Form 8-K for the event on July 26, 2011)
4.1	Base Indenture, dated as of May 21, 2012, between Legg Mason and The Bank of New York Mellon, as trustee, with respect to the 5.5% senior notes due May 21, 2019 (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 22, 2012)
4.2	Supplemental Indenture, dated as of May 21, 2012, between Legg Mason, Inc. and The Bank of New York Mellon, as trustee, with respect to the 5.5% senior notes due May 21, 2019 (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 22, 2012)
4.3	Notes Registration Rights Agreement, dated as of May 21, 2012, among Legg Mason, Inc., and Citigroup Global Markets Inc. and Morgan Stanley & Co., LLC, as representatives of the several initial purchasers of the 5.5% senior notes due May 21, 2019 (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 22, 2012)
4.4	Warrant Agreement, dated as of May 23, 2012, between Legg Mason, Inc. and American Stock Transfer & Trust Company LLC, as warrant agent (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 23, 2012)
4.5	Warrants Registration Rights Agreement, dated as of May 23, 2012, by and between Legg Mason, Inc. and KKR I-L Limited (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 23, 2012)
4.6	Legg Mason hereby agrees, pursuant to Item 601(b)(4)(iii)(A) of Regulation S-K, to furnish to the SEC upon request a copy of each instrument with respect to the rights of holders of long-term debt of Legg Mason and its subsidiaries.
10.1	Legg Mason, Inc. Non-Employee Director Equity Plan, as amended (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008)*
10.2	Form of Common Stock Grant Award Letter under the Legg Mason, Inc. Non-Employee Director Equity Plan (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended September 30, 2005)*
10.3	Form of Restricted Stock Unit Grant Award Letter under the Legg Mason, Inc. Non-Employee Director Equity Plan (incorporated by reference to Legg Mason's Quarterly Report on

	Form 10-Q for the quarter ended September 30, 2005)*
10.4	Legg Mason & Co., LLC Deferred Compensation/Phantom Stock Plan, as amended (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended June 30, 2009)*
10.5	Legg Mason, Inc. Executive Incentive Compensation Plan (incorporated by reference to Appendix A to the definitive proxy statement for Legg Mason's 2010 Annual Meeting of Stockholders)*

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10.6	Legg Mason, Inc. 1996 Equity Incentive Plan, as amended (incorporated by reference to Appendix A to the definitive proxy statement for Legg Mason's 2011 Annual Meeting of Stockholders)*
10.7	Form of Non-Qualified Stock Option Agreement under the Legg Mason, Inc. 1996 Equity Incentive Plan (incorporated by reference to Legg Mason's Annual Report on Form 10-K for the year ended March 31, 2011)*
10.8	Form of Restricted Stock Agreement under the Legg Mason, Inc. 1996 Equity Incentive Plan (incorporated by reference to Legg Mason's Annual Report on Form 10-K for the year ended March 31, 2011)*
10.9	Form of Restricted Stock Unit Agreement under the Legg Mason Inc. 1996 Equity Incentive Plan (incorporated by reference to Legg Mason's Annual Report on Form 10-K for the year ended March 31, 2011)*
10.10	Form of Long-Term Incentive Plan award document under the Legg Mason, Inc. 1996 Equity Incentive Plan (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended June 30, 2011)*
10.11	Lease Agreement, dated August 16, 2006, between Legg Mason and FC Eighth Ave., LLC (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006)
10.12	Agreement dated October 25, 2009 among Legg Mason, Inc. and Trian Fund Management, L.P., funds managed by it and certain of its affiliates (incorporated by reference to Legg Mason's Current Report on Form 8-K for the event on October 25, 2009)
10.13	5-Year Revolving Credit Agreement, dated as of October 14, 2005, as amended and restated by the Amendment Agreement dated as of February 11, 2010, among Legg Mason, Inc., as Borrower; Citibank, N.A., as Administrative Agent; and the other banks party thereto (incorporated by reference to Legg Mason's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011)
10.14	Agreement dated February 1, 2008 between Legg Mason Asset Management Australia Limited and Ronald R. Dewhurst, filed herewith*
10.15	Amended and Restated Standstill Agreement, dated as of May 23. 2012, between Legg Mason, Inc. and Kohlberg Kravis Roberts & Co. L.P. (incorporated by reference to Legg Mason's Current Report on Form 8-K filed on May 23, 2012)
10.16	Note Exchange Agreement, dated as of May 16, 2012, among Legg Mason, inc. KKR I-L Limited, Citibank N.A., Credit Suisse International, HSBC Bank USA, N.A. and Kohlberg Kravis Roberts & Co. L.P. (incorporated by reference to Legg Mason's Current report on Form 8-K filed on May 22, 2012)
12	Computation of consolidated ratios of earnings to fixed charges, filed herewith
21	Subsidiaries of the Company, filed herewith
23	Consent of Independent Registered Public Accounting Firm, filed herewith
31.1	Certification of Chief Executive Officer, filed herewith
31.2	Certification of Principal Financial Officer, filed herewith
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002, filed herewith
32.2	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002, filed herewith
101	Financial statements from the annual report on Form 10-K of Legg Mason, Inc. for the year ended March 31, 2012, filed on May 25, 2012, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to Consolidated Financial

Statements tagged in detail

* These exhibits are management contracts or compensatory plans or arrangements.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

LEGG MASON, INC.

By: /s/ Mark R. Fetting
Mark R. Fetting, President, Chief Executive
Officer and Chairman of the Board
Date: May 25, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Mark R. Fetting Mark R. Fetting	President, Chief Executive Officer and Chairman of the Board (Principal Executive Officer)	May 25, 2012
/s/ Peter H. Nachtwey Peter H. Nachtwey	Chief Financial Officer and Senior Executive Vice President (Principal Financial and Accounting Officer)	May 25, 2012
/s/ Harold L. Adams Harold L. Adams	Director	May 25, 2012
/s/ Robert Angelica Robert Angelica	Director	May 25, 2012
/s/ Dennis R. Beresford Dennis R. Beresford	Director	May 25, 2012
/s/ John T. Cahill John T. Cahill	Director	May 25, 2012
/s/ Barry W. Huff Barry W. Huff	Director	May 25, 2012
/s/ John E. Koerner III John E. Koerner III	Director	May 25, 2012
/s/ Cheryl Gordon Krongard Cheryl Gordon Krongard	Director	May 25, 2012
/s/ Nelson Peltz Nelson Peltz	Director	May 25, 2012

/s/ W. Allen Reed W. Allen Reed	Director	May 25, 2012
/s/ Margaret Milner Richardson Margaret Milner Richardson	Director	May 25, 2012

Signature	Title	Date
/s/ Nicholas J. St. George Nicholas J. St. George	Director	May 25, 2012
/s/ Kurt L. Schmoke Kurt L. Schmoke	Director	May 25, 2012

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