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

FORM 10-K

(Mark One)

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

For the fiscal year ended November 27, 1998

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: 0-15175

ADOBE SYSTEMS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0019522
(I.R.S. Employer
Identification No.)

345 Park Avenue, San Jose, California
(Address of principal executive offices)

95110-2704
(Zip Code)

Registrant's telephone number, including area code: (408) 536-6000

Securities registered pursuant to Section 12(b) of the Act: None

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of December 31, 1998 was \$2,796,898,365.

The number of shares outstanding of the registrant's common stock as of December 31, 1998 was 61,297,428.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the Notice of Annual Meeting of Stockholders to be held on April 15, 1999 are incorporated by reference into Part III.

TABLE OF CONTENTS

	<u>Page No.</u>
PART I	
Item 1. Business	3
Item 2. Properties	11
Item 3. Legal Proceedings	12
Item 4. Submission of Matters to a Vote of Security Holders	12
PART II	
Item 5. Market for Registrant's Common Stock and Related Stockholder Matters	13
Item 6. Selected Financial Data	14
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations	15
Item 7a. Quantitative and Qualitative Disclosures About Market Risk	29
Item 8. Financial Statements and Supplementary Data	31
Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	31
PART III	
Item 10. Directors and Executive Officers of the Registrant	32
Item 11. Executive Compensation	32
Item 12. Security Ownership of Certain Beneficial Owners and Management	32
Item 13. Certain Relationships and Related Transactions	32
PART IV	
Item 14. Exhibits, Financial Statement Schedule, and Reports on Form 8-K	33
Signatures	35
Summary of Trademarks	37
Financial Statements	38
Financial Statement Schedule	69
Exhibits	71

Forward-Looking Statements

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Factors That May Affect Future Results of Operations.” Readers should carefully review the risks described in other documents the Company files from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q to be filed by the Company in 1999. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K. The Company undertakes no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

PART I

Item 1. Business

BUSINESS OVERVIEW

Adobe Systems Incorporated (“Adobe” or the “Company”) develops, markets, and supports computer software products and technologies that enable users to express and use information across print and electronic media. The Company offers a market-leading line of application software products, type products, and content for creating, distributing, and managing information of all types; licenses its industry-standard technologies to major hardware manufacturers, software developers, and service providers; and offers integrated software solutions to businesses of all sizes. The Company’s software runs on Microsoft Windows, Apple Macintosh, and UNIX platforms.

The Company was originally incorporated in California in October 1983 and was reincorporated in Delaware in May 1997. The Company maintains its executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Its telephone number is 408-536-6000. The Company maintains a World Wide Web site at <http://www.adobe.com>.

PRODUCTS

In 1984, Adobe developed the software that initiated desktop publishing. Today, Adobe is uniquely positioned to make a further dramatic impact not only on how society creates visually rich information, but also on how it distributes and accesses that information electronically.

Adobe software helps people use the computer to express, share, and manage their ideas in imaginative and meaningful new ways, whether the choice of media is static or dynamic, paper or electronic. In the simplest terms, Adobe products enable people to create, send, view, print, and manage high-impact information, thereby helping them and their ideas stand out. The Company’s strategy is to address the needs of professional publishers, business publishers, consumers, and companies who need to solve document and printing problems.

Adobe software enables users to work with professional creative tools; assemble illustrations, images, and text into fully formatted documents; output documents directly to any kind of printing device; and distribute documents on paper, video, compact disc, the Internet, an e-mail system, or a corporate network. Moreover, Adobe software enables users to perform all of these tasks across multiple computing environments, including Microsoft Windows, Apple Macintosh, and UNIX.

Application Products:

Adobe Acrobat—the fastest way to publish and distribute business documents of any kind on corporate e-mail and intranets, the Internet, or CD-ROM. Adobe Acrobat software enables users to

easily convert any file from any application to Adobe's Portable Document Format ("PDF"), a compact cross-platform electronic format that exactly preserves layout fonts, colors, and images. Adobe Acrobat software includes everything needed to create and distribute rich electronic documents that can be viewed seamlessly within leading Web browsers.

Adobe Acrobat Capture—enables conversion of legacy paper-based documents into indexable, searchable, platform-independent electronic form for archiving and distribution purposes.

Adobe After Effects—provides two-dimensional (2D) animation, motion compositing, and special effects used in multimedia, broadcast, and film production.

Adobe Dimensions—a 3D rendering tool for life-like modeling and visualization. Brings 2D structures into 3D and applies textured surfaces, custom lighting effects and more.

Adobe FrameMaker—an application for authoring and publishing long and complex documents including books, technical manuals, and reports.

Adobe FrameMaker+SGML—integrates all of the features of FrameMaker with features designed to simplify the SGML authoring, and publishing process.

Adobe Illustrator—an illustration and page design tool for print, the Internet, and multimedia used by professional illustrators and Internet content creators.

Adobe ImageReady—provides a comprehensive environment in which to refine and prepare web graphics, which enables a user to quickly and easily assess and balance the trade offs between size and quality before posting images to a web site.

Adobe ImageStyler—a tool to create web graphics and publish them on a web site efficiently. Introduces an innovative, object-based approach to web graphics creation and production.

Adobe PageMaker—a tool for creating and producing professional-quality printed and electronic pages used by designers, business people, publishers, and prepress professionals around the world.

Adobe PageMill—a tool used to create full-featured Web pages without requiring user knowledge of hypertext mark-up language (HTML), and employs easy drag-and-drop techniques to simplify operation, from creating or importing text and images to adding audio, video, and animation.

Adobe PhotoDeluxe—software that allows consumers and small businesses to easily enhance and personalize their photos for a wide variety of applications in print and electronic media.

Adobe Photoshop—provides photo design enhancement, production for print, the Internet, and multimedia used by graphic designers, Internet content creators, Webmasters, and digital photographers.

Adobe Premiere—provides non-linear digital video editing used in multimedia and video production.

Adobe Streamline—converts bitmap shapes into smooth line art.

Adobe Type Library—contains over 2,500 Roman and almost 100 Japanese high-quality outline typefaces used by graphics professionals and Internet content creators worldwide.

Adobe Type Manager—provides powerful, easy management of all Type 1 and TrueType fonts.

GoLive CyberStudio—professional Web design and publishing software. Provides tools Web authors need to design and produce fully dynamic Web sites without complex multimedia programming.

Printing Technologies:

Adobe PostScript—a page description language that delivers high quality output, cross-platform compatibility, and top performance for graphically-rich printing output from corporate desktop printers to high-end publishing printers.

Adobe PostScript 3—a page description language that takes digital printing to a new level, providing an optimized printing environment connected to corporate networks, the Internet, and digital document distribution systems.

Adobe PostScript Extreme—the innovative new production printing architecture that integrates Adobe PostScript and the Portable Document Format (PDF). This architecture has been endorsed by the printing industry as the new standard for high-performance print-on-demand, direct-to-press, and high-resolution imagesetter printing systems.

Adobe PrintGear—a printing architecture that redefines the standards for high-throughput, low-cost, high-quality printing for the small office/home office and small corporate workgroup environments.

COMPETITION

The markets for Adobe products are characterized by intense competition, evolving industry standards, rapid technology developments, and frequent new product introductions. Adobe's future success will depend on its ability to enhance its existing products, introduce new products on a timely and cost-effective basis, meet changing customer needs, extend its core technology into new applications, and anticipate or respond to emerging standards and other technological changes.

Application Products:

In the publishing market, Adobe offers several products: Adobe Photoshop, Adobe PageMaker, Adobe Illustrator, Adobe Dimensions, and Adobe Type Library. In addition, the Company offers two dynamic media products: Adobe Premiere and Adobe After Effects. The Company believes these individual products compete favorably on the basis of features and functions, installed base, ease of use, product reliability, and price and performance characteristics. In addition, the products increasingly work well together, providing broader functionality and minimizing product learning issues for the individual who uses multiple applications to complete a project.

A number of companies currently offer one or more products that compete directly or indirectly with one or more of Adobe's publishing products. These companies include Microsoft, Quark, Macromedia, Corel, MetaCreations, Avid and Linotype.

The Internet market is a constantly evolving and highly volatile market, characterized by rapid technology developments and frequent new product introductions. The needs of the graphics professional are rapidly changing to encompass on-line publishing as well as print-based publishing. Two new products, Adobe ImageStyler and Adobe ImageReady, and one recently acquired product, GoLive CyberStudio, fall in this category. These three products, as well as Adobe PageMill face significant competition from companies offering similar products and will continue to face competition from emerging technologies and products. Some of these competitors include Macromedia, Microsoft, and NetObjects.

In the authoring and technical publishing market, the Company's Adobe FrameMaker product faces competition from large-scale electronic publishing systems developed by several companies, including Interleaf. Participants in this market compete based on the quality and features of their products, the level of customization and integration with other publishing system components, the number of hardware platforms supported, service, and price. The Company believes it can successfully compete in this market based upon the quality and features of the Adobe FrameMaker product, its extensive application programming interface, the large number of platforms supported, and other factors.

In the document exchange and archive area, the Company's Adobe Acrobat family faces competition from entrenched office applications and internet content creation tools that use HTML. The Company feels it competes favorably in terms of the combined benefits of compression, visual fidelity, transmittal time and security of documents expressed using Adobe Acrobat Portable Document Format (PDF). Competitors include Microsoft and Corel.

The consumer software market is characterized by intense competition, price sensitivity, brand awareness, and strength in retail distribution. Adobe faces direct and indirect competition in these markets from a number of companies, including Microsoft, MGI Software, and Live Picture. The Company believes it competes favorably with its Adobe PhotoDeluxe product due to its strong relationships with critical original equipment manufacturer ("OEM") customers and market influencers and its ability to leverage core competencies from established products.

Printing Technologies:

Adobe believes that the principal competitive factors for OEM customers in selecting a page description language or a printing technology are product capabilities, market leadership, reliability, support, engineering development assistance, and price. The Company believes that its competitive advantages include its technology competency, OEM customer relationships, and intellectual property portfolio. Adobe PostScript and Adobe PrintGear software face competition from Hewlett-Packard Company's proprietary PCL page description language, and from developers of page description languages based on the PostScript language standard, including Xionics and Harlequin.

OPERATIONS

Marketing and Distribution

Adobe markets and distributes its products directly and through multiple channels, including distributors, retailers, systems integrators, software developers, and value-added resellers ("VARs"), as well as through OEM and hardware bundle customers. Adobe supports its worldwide distribution network and end-user customers through international subsidiaries. Adobe Systems Europe Ltd. is headquartered in Edinburgh, Scotland, with subsidiaries in Denmark, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom. Adobe's Pacific Rim presence includes Adobe Systems Kabushhiki Kaisha in Japan as well as operations in Asia Pacific and Latin America, including Australia, Brazil, Hong Kong, Korea, China, Singapore, India, and Mexico.

Adobe licenses its Adobe PostScript software and other printing systems technology to computer and printer manufacturers, who in turn distribute their products worldwide. The Company derives a significant portion of Adobe PostScript royalties from international sales of printers, imagesetters, and other output devices by its OEM customers.

Manufacturing

The procurement of the various components of packaged products, including CDs and printed materials, and the assembly of the packages for retail and other applications products is controlled by manufacturing operations. Adobe outsources a majority of its manufacturing activities to third parties, both in the United States and in Europe.

To date, Adobe has not experienced significant difficulties in obtaining raw materials for the manufacture of its products or in the replication of CDs, printing, and assembly of components, although an interruption in production by a supplier could result in a delay in shipment of Adobe's products. There was no material backlog of orders as of December 31, 1998.

Customer Support and Education

For Adobe's application software, a technical support and services staff responds to customer queries by phone and on-line. The Company also informs customers through its *Adobe Magazine* and a growing series of how-to books published by Adobe Press, a joint venture with Macmillan Computer Publishing. In addition, Adobe prepares and authorizes independent trainers to teach Adobe software classes in person or increasingly via computer-based and internet-based training programs, sponsors workshops led by its own graphics staff, interacts with independent user groups, and conducts regular beta-testing programs.

Investment in New Markets

The Company owns a majority interest in two venture capital limited partnerships, Adobe Ventures L.P. and Adobe Ventures II, L.P., that invest in early stage companies with innovative technologies. These companies may create new market opportunities for Adobe or enhance the Company's existing business.

The investments in Adobe Ventures L.P. and Adobe Ventures II, L.P. are accounted for using the equity method of accounting, and, accordingly, the investments are adjusted to reflect the Company's share of Adobe Ventures L.P. and Adobe Ventures II, L.P.'s investment income (loss) and dividend distributions. Adobe Ventures L.P. and Adobe Ventures II, L.P. carry their investments in equity securities at estimated fair market value and unrealized gains and losses are included in investment income (loss). Substantially all of the technology companies held by the limited partnerships at November 27, 1998 are not publicly traded, and, therefore, there is no established market for these investments. As such, these investments are valued based on the most recent round of financing involving new non-strategic investors and estimates made by the general partner, a third party. When investments held by the limited partnerships are publicly traded, the fair value of such investments is based on quoted market prices, and mark-to-market adjustments are included in investment income. In general, as a matter of policy of the limited partnerships, the investments in the technology companies held by the limited partnerships will be distributed to the partners prior to the investee company's initial public offering.

In March 1997, as part of its venture investing program, the Company established an internal limited partnership, Adobe Incentive Partners, L.P. ("AIP"), which allows certain of the Company's executive officers to participate in cash or stock distributions from Adobe's venture investments. Assets held by AIP include Adobe's entire interests in Adobe Ventures L.P. and Adobe Ventures II, L.P. and equity securities of privately-held companies. Adobe is both the general partner and a limited partner of AIP. Other limited partners are executive officers of the Company who are involved in Adobe's venture investing activities and whose participation is deemed critical to the success of the program.

Adobe's Class A senior limited partnership interest in AIP includes both a liquidation preference and a preference in recovery of the cost basis of each specific investment. The executives' Class B junior limited partnership interest qualifies for partnership distributions only after: (a) Adobe has fully recovered the cost basis of its investment in the specific investee company for which a distribution is made; and (b) the participating executive has vested in his or her distribution rights. The distribution rights generally vest on a monthly basis over three years, such that the rights are 25% vested after one year, 50% vested after two years and fully vested at the end of three years. The limited partnership investments are restricted to investments in companies that were private at the time of the establishment of AIP or when the investment is made, whichever is later. Partnership interests may be allocated to designated officers only while the investee company is still private. In fiscal 1998, the participating officers received aggregate cash distributions of \$707,000. The amount of cash distributed to the officers represents their vested portion of investments that were liquidated by AIP. At November 27, 1998, the minority interest held by the participating officers was \$1.5 million and is included in accrued expenses on the consolidated balance sheet.

The Company's portfolio of equity investments, including those held by AIP at November 27, 1998, had a cost basis of \$65.9 million and a recorded fair market value of \$56.3 million. In fiscal 1998, AIP

recorded net income of \$2.2 million. Gross proceeds from the sale of equity securities during fiscal 1998 were \$17.0 million. The Company's equity investments and Adobe Ventures L.P. and Adobe Ventures II, L.P.'s investments in equity securities at November 27, 1998 consisted of the following companies:

	<u>Private</u>	<u>Public</u>
<i>Adobe Equity Investments</i>		
Cascade Systems International	X	
Datalogics Incorporated	X	
Objectivity Incorporated	X	
PointCast Inc.	X	
Tier Two Systems	X	
Vertec Solutions, Inc.	X	
Vignette Corporation	X	
<i>Adobe Ventures L.P. Equity Investments</i>		
Cascade Systems International	X	
Cogito Learning Media, Inc.	X	
Digimarc Corporation	X	
DigitalThink, Inc.	X	
Electronic Submission Publishing Systems, Inc.	X	
Extensis Corporation	X	
FileNet Corporation		X
Managing Editor, Inc.	X	
mFactory, Inc.	X	
Salon Internet, Inc.	X	
<i>Adobe Ventures II, L.P. Equity Investments</i>		
2Way Corporation	X	
AvantGo, Inc.	X	
Cogito Learning Media, Inc.	X	
Digital Intelligence, Inc.	X	
DigitalThink, Inc.	X	
Extensis Corporation	X	
Glyphica	X	
HAHT Software, Inc.	X	
Salon Internet, Inc.	X	
Tumbleweed Software Corporation	X	
Vignette Corporation	X	
Virage, Inc.	X	

The Company intends to continue investing in new markets, through limited partnerships as well as through direct investments by the Company.

PRODUCT DEVELOPMENT

Since the personal computer software industry is characterized by rapid technological change, a continuous high level of expenditures is required for the enhancement of existing products and the development of new products. Adobe primarily develops its software internally. The Company sometimes acquires products developed by others by purchasing the stock or assets of the business entity that held ownership rights to the technology. In other instances, Adobe has licensed or purchased the intellectual property ownership rights of programs developed by others with license or technology transfer agreements

that may obligate the Company to pay royalties, typically based on a percentage of the revenues generated by those programs.

During the fiscal years ended November 27, 1998, November 28, 1997, and November 29, 1996, the Company's research and development expenses, including costs related to contract development, were \$207.3 million, \$170.9 million, and \$155.4 million, respectively. During fiscal years 1997 and 1996, the Company acquired through purchase transactions five software companies or technologies. In fiscal 1997 and 1996, \$6.0 million and \$21.3 million, respectively, of the purchase price was allocated to in-process research and development and expensed at the time of the acquisition. See Management's Discussion and Analysis for further information.

PRODUCT PROTECTION

Adobe regards its software as proprietary and protects it with copyrights, patents, trademarks, trade secret laws, internal and external nondisclosure precautions, and restrictions on disclosure and transferability that are incorporated into its software license agreements. The Company protects the source code of its software programs as trade secrets, and makes source code available to OEM customers only under limited circumstances and specific security and confidentiality constraints.

The Company's products are generally licensed to end users on a "right to use" basis pursuant to a license that is nontransferable and restricts the use of the products to the customer's internal purposes on a designated number of printers or computers. The Company also relies on copyright laws and on "shrink wrap" and electronic licenses that are not signed by the end user. Copyright protection may be unavailable under the laws of certain countries. The enforceability of "shrink wrap" and electronic licenses has not been conclusively determined. Adobe has obtained many patents and has registered numerous copyrights, trademarks and logos in the United States and foreign countries.

Policing unauthorized use of computer software is difficult, and software piracy is a persistent problem for the software industry. This problem is particularly acute in international markets. Adobe conducts vigorous anti-piracy programs. Adobe products do not contain copy protection, except on copies for international distribution in certain countries. Many products, including Adobe PageMaker, Adobe Photoshop, and Adobe Illustrator, incorporate network copy-detection features. These capabilities help encourage compliance with the Company's license agreements by alerting customers about certain concurrent usage problems over a given network.

Adobe believes that, because computer software technology changes and develops rapidly, patent, trade secret, and copyright protection are less significant than factors such as the knowledge, ability, and experience of its personnel, name recognition, contractual relationships, and ongoing product development.

EMPLOYEES

As of December 31, 1998, Adobe employed 2,680 people, none of whom are represented by a labor union. The Company has not experienced work stoppages and believes its employee relations are good. Competition in recruiting personnel in the software industry, especially highly skilled engineers, is intense. Adobe believes its future success will depend in part on its continued ability to recruit and retain highly skilled technical, management and marketing personnel.

EXECUTIVE OFFICERS

The executive officers of the Company as of February 16, 1999 are as follows:

<u>Name</u>	<u>Age</u>	<u>Positions</u>
John E. Warnock	58	Chairman of the Board and Chief Executive Officer
Charles M. Geschke	59	Chairman of the Board and President
Bruce Chizen	43	Executive Vice President, Worldwide Products and Marketing
Frederick A. Snow	62	Executive Vice President, Worldwide Field Operations
Harold L. Covert	52	Senior Vice President and Chief Financial Officer
Derek J. Gray	49	Senior Vice President and General Manager, Adobe Systems Europe
Colleen M. Pouliot	40	Senior Vice President, General Counsel, and Secretary

A biography, including the principal occupations for the past five years of each of the executive officers, is provided below.

Dr. Warnock was a founder of the Company and has been its Chairman of the Board since April 1989. Since September 1997, he has shared the position of Chairman of the Board with Charles M. Geschke. He has been Chief Executive Officer since 1982. Dr. Warnock received a Ph.D. in electrical engineering from the University of Utah.

Dr. Geschke was a founder of the Company and has been its President since April 1989. In September 1997, Dr. Geschke assumed the position of Chairman of the Board, sharing that office with Dr. Warnock. He was Chief Operating Officer from December 1986 until July 1994. Dr. Geschke received a Ph.D. in computer science from Carnegie Mellon University. Dr. Geschke is a director of Rambus Incorporated.

Mr. Chizen joined the Company upon the closing of the acquisition of Aldus in August 1994 as Vice President and General Manager, Consumer Products Division. In December 1997, he was promoted to Senior Vice President and General Manager, Graphic Products Division, and in August 1998, Mr. Chizen was promoted to Executive Vice President, Products and Marketing. Prior to joining the Company, Mr. Chizen was Vice President and General Manager, Consumer Division of Aldus Corporation from February 1994 to August 1994, and from November 1992 to February 1994, he was Vice President and General Manager, Claris Clear Choice for Claris Corp., a wholly owned subsidiary of Apple Computer, Inc., a manufacturer of computers and software.

Mr. Snow joined the Company in February 1998 as Executive Vice President, Worldwide Field Operations. Mr. Snow served as Chairman and Chief Executive Officer of Kenwood Management Group from April 1997 until he joined the Company. From November 1995 to April 1997, Mr. Snow was President and Chief Executive Officer of SoftWorld Services Corporation. Prior to that time, Mr. Snow served as Senior Vice President of Sales of Tech Data Corporation.

Mr. Covert joined the Company in April 1998 as Vice President Finance and Operations for Worldwide Field Operations. In August 1998, Mr. Covert was appointed Senior Vice President and Chief Financial Officer. From July 1997 to April 1998, Mr. Covert was Vice President and Chief Financial Officer of Philips Components NAFTA, an operating entity of Philips Electronic NV. From January 1991 to June 1997 Mr. Covert was a Partner in the firm of DHJ & Associates, Inc., Consultants and Certified Public Accountants. During the last two and a half years of this period he acted in a full time capacity as

Chief Financial Officer for two companies. Prior to that time Mr. Covert held senior financial management positions with ISC Systems Corporation and Northern Telecom Inc.

Mr. Gray joined the Company upon the closing of the acquisition of Aldus in August 1994, at which time he was elected Senior Vice President of the Company and General Manager of Adobe Systems Europe. Prior to that time, Mr. Gray served as Managing Director of Aldus Europe Limited since 1986. Mr. Gray was a co-founder and, for the ten years prior to joining Aldus, Managing Director of McQueen International Limited, a distributor of computer hardware and software, of which the Company was a 17% stockholder by virtue of the acquisition of Aldus.

Ms. Pouliot joined the Company in July 1988 as Associate General Counsel and became the Corporate Secretary in April 1989. In December 1990, she was promoted to General Counsel. In December 1992, she was promoted to Vice President and in December 1997, to Senior Vice President. Ms. Pouliot was an associate at the law firm of Ware & Freidenrich from November 1983 until she joined the Company.

Item 2. Properties

The following table sets forth the location, approximate square footage, and use of each of the principal properties used by the Company. Except as where indicated, all of the properties are leased or subleased by the Company. Such leases expire at various times through January 2014. The annual base rent expense for all facilities (including operating expenses, property taxes, and assessments) is currently \$28.0 million and is subject to annual adjustment.

Location	Approximate Square Footage	Use
North America:		
345 Park Avenue San Jose, California USA	360,000	Research, product development, sales, marketing and administration
321 Park Avenue San Jose, California USA	280,000	Research, product development, sales, marketing and administration
801 N. 34 th Street-Waterfront Seattle, Washington USA	254,328	Product development, customer support, and administration
Europe:		
Five Mid New Cultins Edinburgh EH11 4DU Scotland, United Kingdom (Owned)	22,000	Sales, marketing, and administration
Japan:		
Yebisu Garden Place Tower 4-20-3 Ebisu, Shibuya-ku Tokyo 150 Japan	20,237	Sales, marketing, and administration
Asia Pacific and Latin America:		
18-20 Orion Road Lane Cove, NSW 2066 Australia	4,277	Sales, marketing, and administration

In general, all facilities are in good condition and are operating at capacities that range from 75% to 100%.

The Company owns land in Edinburgh, Scotland on which a building is being constructed for future use as a sales, marketing and administration office. The expected completion date of the building is August 1999.

The Company also leases office space in the United States and various other countries under operating leases.

The Company has two leased office buildings in San Jose, California that were vacated in connection with the restructuring program that was implemented in the third quarter of fiscal 1998. The Company still has commitments under these lease agreements, although the Company has already accrued these commitments, net of anticipated sublease income, under its restructuring plan (see Note 13 of the Consolidated Financial Statements).

Item 3. Legal Proceedings

On April 17, 1997, a derivative action was filed in the Superior Court of the State of California, County of Santa Clara, against the current members of Adobe's Board of Directors and Paul Brainerd, a former member of the Board. The suit was filed by a stockholder purporting to assert on behalf of the Company claims for alleged breach of the Directors' fiduciary duty and mismanagement related to the Company's acquisition of Frame in October 1995. The Court granted Adobe's demurrer to the suit, with leave to amend for the plaintiff. In January 1998, the plaintiff filed an amended complaint making substantially the same claims but not including Mr. Brainerd. In March 1998, Adobe filed a demurrer to the amended complaint, which was overruled by the trial court in May 1998. In June 1998, Adobe filed a writ petition with the California Court of Appeals for review of the trial court's decision, which was denied. In July 1998, Adobe filed a petition for review of the Court of Appeals' refusal to grant the writ with the Supreme Court of California, which was denied in September 1998. The Company intends to continue vigorously defending the action.

On February 6, 1996, a securities class action complaint was filed against Adobe, certain of its officers and directors, certain former officers of Adobe and Frame Technology Corporation ("Frame"), Hambrecht & Quist, LLP ("H&Q"), investment banker for Frame, and certain H&Q employees, in connection with the drop in the price of Adobe stock following its announcement of financial results for the quarter ended December 1, 1995. The complaint was filed in the Superior Court of the State of California, County of Santa Clara. The complaint alleges that the defendants misrepresented material adverse information regarding Adobe and Frame and engaged in a scheme to defraud investors. The complaint seeks unspecified damages for alleged violations of California law. Adobe believes that the allegations against it and its officers and directors are without merit and intends to vigorously defend the lawsuit. The case is currently in the discovery phase.

On October 29, 1998, Heidelberger Druckmaschinen AG, a German company, filed a complaint alleging that Adobe is using Heidelberger's US patent number 4,393,399 for the partial electronic retouching of colors. The complaint was filed in the United States District Court for the District of Delaware, and seeks a permanent injunction and unspecified damages. Adobe believes that the allegations against it are without merit and intends to vigorously defend the lawsuit.

Management believes that the ultimate resolution of these matters will not have a material impact on the Company's financial position or results of operations.

Item 4. Submission of Matters to a Vote of Security Holders

Not applicable.

PART II

Item 5. Market for Registrant's Common Stock and Related Stockholder Matters

The Company's common stock is traded on The Nasdaq National Market under the symbol "ADBE." On December 31, 1998, there were 1,694 holders of record of the Company's common stock. Because many of such shares are held by brokers and other institutions on behalf of stockholders, the Company is unable to estimate the total number of stockholders represented by these record holders. The following table sets forth the high and low sales price per share of the Company's common stock, and the cash dividends paid per share, for the periods indicated.

	Price Range		Cash Dividend Per Share
	High	Low	
Fiscal 1998:			
First Quarter	\$44.75	\$33.50	\$0.05
Second Quarter	51.88	39.94	0.05
Third Quarter	45.13	24.06	0.05
Fourth Quarter	48.00	23.63	0.05
Fiscal Year	51.88	23.63	0.20
Fiscal 1997:			
First Quarter	\$44.13	\$34.63	\$0.05
Second Quarter	49.00	32.50	0.05
Third Quarter	45.25	34.00	0.05
Fourth Quarter	53.13	39.75	0.05
Fiscal Year	53.13	32.50	0.20

The Company has paid cash dividends on its common stock each quarter since the second quarter of 1988. In March 1997, the Company established the venture stock dividend program under which the Company may, from time to time, distribute as a dividend-in-kind shares of its equity holdings in investee companies to Adobe stockholders. In 1997, the Company dividended one share of Netscape Communications Corporation ("Netscape") common stock for each 100 shares of Adobe common stock held by stockholders of record on July 31, 1997. An equivalent cash dividend was paid for holdings of less than 2,500 Adobe shares and for fractional Netscape shares. Also, on December 1, 1997, the Company dividended one share of Siebel Systems, Incorporated ("Siebel") common stock for each 300 shares of Adobe common stock held by stockholders of record on October 31, 1997. An equivalent cash dividend was paid for holdings of less than 7,500 Adobe shares and for fractional Siebel shares. The declaration of future dividends, whether in cash or in-kind, is within the discretion of the Board of Directors of the Company and will depend upon business conditions, the Company's results of operations, the financial condition of the Company, and other factors.

Item 6. Selected Financial Data

The following selected consolidated financial data (presented in thousands, except per share amounts and employee data) are derived from the Company's consolidated financial statements. This data should be read in conjunction with the consolidated financial statements and notes thereto, and with Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations.

	Years Ended				
	Nov. 27 1998	Nov. 28 1997	Nov. 29 1996	Dec. 1 1995	Nov. 25 1994
Operations:					
Revenue	\$894,791	\$911,894	\$ 786,563	\$762,339	\$675,617
Income before income taxes	167,694	296,090	244,824	163,853	52,946
Net income(1)	105,144	186,837	153,277	93,485	15,337
Net income per share(1)					
Basic	1.58	2.60	2.12	1.31	0.23
Diluted	1.55	2.52	2.04	1.26	0.22
Cash dividends declared per common					
share(2)	0.20	0.20	0.20	0.20	0.20
Financial position:					
Cash and short-term investments	272,547	502,956	564,116	516,040	444,768
Working capital	204,979	454,299	506,092	506,472	402,837
Total assets	767,331	940,071	1,001,393	872,827	710,000
Stockholders' equity	516,365	715,424	706,514	698,417	514,315
Additional data:					
Worldwide employees	2,664	2,654	2,222	2,322	2,055

- (1) In 1998, includes investment gains of \$15.0 million and restructuring and other charges of \$38.2 million. In 1997, includes investment gains of \$34.3 million, other non-recurring gains of \$0.6 million, and the write-off of \$6.0 million of acquired in-process research and development. In 1996, includes investment gains of \$68.9 million, the write-off of \$21.3 million of acquired in-process research and development, and restructuring charges related to divested products of \$5.0 million. In 1995, reflects restructuring charges of \$31.5 million related to the acquisition of Frame and the write-off of \$15.0 million of acquired in-process research and development. In 1994, reflects restructuring charges of \$72.2 million related to the acquisition of Aldus Corporation ("Aldus") and the write-off of \$15.5 million of acquired in-process research and development.
- (2) Dividends prior to the acquisitions of Frame on October 28, 1995 and Aldus on August 31, 1994 have not been restated to reflect the effects of the poolings of interest.

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

The following discussion (presented in millions, except per share amounts) should be read in conjunction with the consolidated financial statements and notes thereto.

In addition to historical information, this Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties that could cause actual results to differ materially. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations—Factors That May Affect Future Results of Operations." Readers should carefully review the risks described in other documents the Company files from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q to be filed by the Company in 1999. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K. The Company undertakes no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

RESULTS OF OPERATIONS

Overview

Adobe Systems Incorporated ("Adobe" or the "Company") develops, markets, and supports computer software products and technologies that enable users to express and use information across print and electronic media. The Company offers a market-leading line of applications software products, type products, and content for creating, distributing, and managing information of all types; licenses its technology to major hardware manufacturers, software developers, and service providers; and offers integrated software solutions to businesses of all sizes. The Company distributes its products through a network of original equipment manufacturer ("OEM") customers, distributors and dealers, and value-added resellers ("VARs") and systems integrators and has operations in North America, Europe, Japan, and Asia Pacific and Latin America.

Revenue

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Total revenue	\$894.8	(2)%	\$911.9	16%	\$786.6

Total revenue decreased \$17.1 million, or 2%, in fiscal 1998 compared to fiscal 1997, primarily due to the ongoing weakness in the Japanese economy and a decline in licensing revenue related to the Company's PostScript technology. The revenue growth in fiscal 1997 compared to fiscal 1996 was essentially attributable to increased sales of application products resulting from the release of new and enhanced products. In fiscal 1998, revenue from one major distributor of application products accounted for 13.5% of the Company's total revenue. No customer accounted for more than 10% of the Company's total revenue in fiscal 1997 or 1996.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Product revenue:					
Licensing	\$164.1	(16)%	\$196.2	—	\$196.7
Percentage of total revenue	18.3%		21.5%		25.0%

Licensing revenue is made up of royalties received from OEM customers who ship products containing Adobe's PostScript technology, including Adobe PostScript, Adobe PostScript 3, Adobe PrintGear, and PostScript Extreme. Adobe PostScript is a software language for describing to a printer the appearance of a page, including text, graphics, and images. Products containing Adobe PostScript technology that implement the language include: (1) black-and-white printers; (2) color printers; (3) slide recorders;

(4) imagesetters; (5) screen displays; and (6) digital copiers. Adobe PostScript products serve the corporate enterprise, graphic arts, production printing, small office/home office, and high-volume production printing markets. Licensing revenue is also derived from shipments of products containing the Configurable PostScript Interpreter (“CPSI”) by OEM customers. CPSI is a fully functional Adobe PostScript interpreter that resides on the host computer system rather than in a dedicated controller integrated into an output device. The configuration flexibility of CPSI allows OEM customers and software developers to create and market a variety of Adobe PostScript products independently of controller hardware development.

Licensing revenue in fiscal 1998 decreased \$32.1 million, or 16%, compared to fiscal 1997, primarily due to weakness in the Japanese personal computer and printer markets, as well as a reduction in royalty revenue from Hewlett-Packard Company’s (“HP”) desktop monochrome laser printer division which has been incorporating a clone version of Adobe PostScript into some of its products since the fall of 1997.

Licensing revenue in fiscal 1997 was unchanged from fiscal 1996 as increased demand for CPSI, color capability, and Adobe PrintGear products was offset by a number of factors affecting OEM customers, primarily in the Japanese and Macintosh markets. These factors included, but were not limited to, continuing weakness in Macintosh-related printer sales and in Japanese personal computer and printer markets, as well as a slow pace of certain new technologies being brought to market by OEM customers.

The Company continues to be cautious about licensing revenue in the short term because of Japanese market conditions, the uncertain timing of new product releases by OEM customers incorporating Adobe’s latest technologies, and the anticipated full impact of loss of revenue from HP’s monochrome laser printer products. In addition, OEM customers on occasion seek to renegotiate their royalty arrangements. The Company evaluates these requests on a case-by-case basis. If an agreement is not reached, a customer may decide to pursue other options, which could result in lower licensing revenue to the Company. As a result of these conditions, the OEM licensing business is likely to decline in fiscal 1999. However, the Company anticipates growth opportunities in the digital copier marketplace that are expected to increase licensing revenue in the long term.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Product revenue:					
Application products	\$730.6	2%	\$715.7	21%	\$589.9
Percentage of total revenue	81.7%		78.5%		75.0%

Application products revenue is derived predominantly from shipments of application software programs marketed through retail and VAR distribution channels, with the exception of Adobe PhotoDeluxe, which is primarily distributed through OEM bundling agreements with digital camera, scanner, and personal computer manufacturers.

Application products revenue increased \$15.0 million, or 2%, in fiscal 1998 compared to fiscal 1997, due primarily to the release of two major professional publishing products, Adobe Photoshop 5.0 and Adobe Illustrator 8.0; increased revenue from Acrobat 3.0, as the Portable Document Format (“PDF”) upon which Acrobat is based continued to gain acceptance worldwide; and increased revenues from the Company’s new Web products, Adobe ImageStyler and Adobe ImageReady, which have received favorable reviews and market reception. In addition, the release of Adobe PhotoDeluxe Business Edition and Adobe Premiere 5.0, the Company’s video editing product, contributed to the overall increase in application products revenue. These increases were partially offset by a decline in revenues from various products, primarily Adobe PageMaker, Adobe FrameMaker and Adobe Type Manager, all of which did not release upgrades during the year. Overall, the Company’s revenue increase was smaller than expected as a result of adverse economic conditions in Japan.

Application products revenue increased \$125.8 million, or 21%, in fiscal 1997 compared to fiscal 1996, due to major product releases and upgrades, which included Adobe PageMaker, Adobe Illustrator, and Adobe FrameMaker. In addition, increased demand for Adobe Photoshop, the Adobe Acrobat family of products, and Adobe PhotoDeluxe contributed to the increase.

Overall, revenue from the Company's application products on the Windows platform increased by 21% in fiscal 1998 over fiscal 1997, while application products revenue from the Macintosh platform decreased 10% during the same period. In fiscal 1998, the Windows and Macintosh platforms accounted for 58% and 42%, respectively, of application products revenue, excluding platform-independent and UNIX products, compared to 51% and 49%, respectively, in fiscal 1997. The Company expects this trend toward the Windows platform to continue for the foreseeable future.

The Company remains cautious about the economic conditions in Japan as well as the fluctuating economic conditions in other Asian and Latin American countries.

Direct costs:

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Direct costs	\$111.4	(12)%	\$126.3	(11)%	\$141.1
Percentage of total revenue	12.4%		13.8%		17.9%

Direct costs include product packaging, third party royalties, amortization of localization costs and acquired technologies, and reserves for excess and obsolete inventory.

Gross margin (expressed as a percentage of revenue), in general, is affected by the mix of licensing revenue versus application products revenue, as well as the product mix within application products.

Direct costs decreased \$14.9 million, or 12%, in fiscal 1998 compared to fiscal 1997, due to lower packaging costs and the Company's full transition from distribution of its products on disk to CD-ROM media. Direct costs also decreased in fiscal 1998 and fiscal 1997 compared to fiscal 1996 as certain acquired technologies became fully amortized in fiscal 1997 and the Company incurred lower product localization costs.

The Company anticipates that direct costs will increase in fiscal 1999 due to increased costs necessary to support higher anticipated application products revenue. However, on a percentage of revenue basis, direct costs are expected to be the same or slightly lower than fiscal 1998.

Operating expenses:

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Research and development	\$207.3	21%	\$170.9	10%	\$155.4
Percentage of total revenue	23.2%		18.7%		19.8%

Research and development expenses consist principally of salaries and benefits for software developers, contracted development efforts, related facilities costs, and expenses associated with computer equipment used in software development.

Research and development expenses increased in absolute dollars over the past three years due to the expansion of the Company's engineering staff and related costs required to support its continued emphasis on developing new products and enhancing existing products. The increase also reflects the Company's increased investments in new technologies, new product development, and the infrastructure to support such activities. The increase in research and development expenses in fiscal 1998 was partially offset by certain cost reduction initiatives related to the restructuring program that was implemented during the

third quarter of fiscal 1998. The Company also experienced reduced outside labor costs and professional fees as certain research and development programs were discontinued (see Management's Discussion and Analysis of Restructuring and other charges).

The Company believes that investments in research and development, including the recruiting and hiring of software developers, are critical to remain competitive in the marketplace and are directly related to continued timely development of new and enhanced products. The Company will continue to make significant investments in the development of its application software products, including those targeted for the growing Internet market. While the Company expects that research and development expenditures in fiscal 1999 will increase in absolute dollars, such expenditures as a percentage of revenue are expected to remain approximately the same or lower than fiscal 1998.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Sales and marketing	\$316.7	4%	\$303.3	19%	\$255.0
Percentage of total revenue	35.4%		33.3%		32.4%

Sales and marketing expenses include salaries and benefits, sales commissions, travel expenses, and related facilities costs for the Company's sales, marketing, customer support, and distribution personnel. Sales and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows, and other market development programs.

Sales and marketing expenses increased \$13.4 million, or 4%, in fiscal 1998 compared to fiscal 1997, due to higher employee costs related to increased staffing, increased customer support costs to support new products and customers, and increased marketing and advertising activities. As a result of the increase in sales and marketing staff, as well as the growth in application products revenue, higher commissions were paid in fiscal 1998 compared to fiscal 1997. Additionally, sales and marketing expenses included higher outside labor costs to support user education related to new product releases and for the development of the Company's Web site, as well as new public relations activities in connection with the employment of a national public relations agency. These increased expenses were partially offset by cost reduction initiatives related to the restructuring program implemented during the third quarter of fiscal 1998 that eliminated certain advertising campaigns and other marketing activities related to the divestiture of a business unit (see Management's Discussion and Analysis of Restructuring and other charges).

Sales and marketing expenses increased in fiscal 1997 compared to fiscal 1996 due to increased advertising and promotional expenditures for upgrades of existing products and further development of customer and technical support services to support a growing installed base of customers.

While the Company expects that sales and marketing expenditures will increase in absolute dollars in fiscal 1999, such expenditures as a percentage of revenue are expected to remain approximately the same or lower than fiscal 1998.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
General and administrative	\$95.7	27%	\$75.4	21%	\$62.0
Percentage of total revenue	10.7%		8.3%		7.9%

General and administrative expenses consist principally of salaries and benefits, travel expenses, and related facilities costs for the finance, human resources, legal, information services, and executive personnel of the Company. General and administrative expenses also include outside legal and accounting fees, provision for bad debts, amortization of goodwill, and expenses associated with computer equipment and software used in the administration of the business.

General and administrative expenses increased \$20.4 million, or 27%, in fiscal 1998 compared to fiscal 1997, due to increased expenses for outside legal and investment banking services associated with

responding to an unsolicited acquisition proposal, as well as increased employee costs and related depreciation and building expenses associated with increased staff. Additionally, the provision for uncollectible accounts increased to reserve for accounts receivable from certain customers that were deemed potentially uncollectible. These increased expenses were partially offset by cost reduction initiatives related to the restructuring program implemented in the third quarter of fiscal 1998 that included a reduction in general office and other administrative expenses (see Management's Discussion and Analysis of Restructuring and other charges).

General and administrative expenses increased in fiscal 1997 compared to fiscal 1996 due primarily to higher information system costs, legal costs, and employee costs primarily associated with a more comprehensive administrative infrastructure.

The Company expects general and administrative spending in fiscal 1999 to increase in absolute dollars over fiscal 1998 to support future administrative infrastructure needs. However, on a percentage of revenue basis, general and administrative expenses are not expected to be materially different than fiscal 1998.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Write off of acquired in-process research and development	—	(100)%	\$6.0	(72)%	\$21.3
Percentage of total revenue	—		0.7%		2.7%

During fiscal 1997, the Company acquired three software companies, in separate transactions, for an aggregate consideration of approximately \$8.5 million. These acquisitions were accounted for using the purchase method of accounting, and approximately \$6.0 million of the purchase price was allocated to in-process research and development and expensed at the time of the acquisitions. One of the in-process technologies acquired for \$2.5 million was discontinued in fiscal 1998. The project associated with an additional \$2.8 million of the purchased in-process technology was canceled as part of the restructuring in the third quarter of fiscal 1998 and subsequently sold to a management-led buyout group.

During fiscal 1996, the Company acquired Ares Software for approximately \$15.5 million. The acquisition was accounted for using the purchase method of accounting and approximately \$15.3 million of the purchase price was allocated to in-process research and development and expensed at the time of the acquisition. The value assigned to purchased in-process technology was based on a valuation prepared by an independent third party, estimating both the cost of developing and incorporating the in-process technology into future versions of PostScript and the future cash flows from the enhanced PostScript product, using a discount factor which takes into consideration the uncertainty surrounding the successful development of the purchased in-process technology. The in-process technology was completed in fiscal 1997 and incorporated into PostScript 3. Actual revenues, in aggregate, to date, together with revised forecasted revenues, are expected to exceed the original estimate of revenues used to value the in-process technology.

In November 1996, the Company also acquired in-process research and development from Swell Software for approximately \$6.0 million. The research project was discontinued prior to reaching technological feasibility in early fiscal 1997.

The Company reclassified \$3.4 million and \$3.5 million of in-process research and development recognized during the first half of fiscal 1998 to research and development and general and administrative expenses, respectively, for the fiscal year ending November 27, 1998 financial statements.

Restructuring and other charges:

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Restructuring and other charges	\$38.2	NA	\$(0.6)	(112)%	\$5.0
Percentage of total revenue	4.3%		(0.1)%		0.6%

In the third quarter of fiscal 1998, the Company implemented a restructuring program aimed at streamlining its underlying cost structure to better position the Company for growth and profitability. As part of the restructuring program, the Company implemented a reduction in force of 364 positions, primarily in its North American operations. The reductions came predominantly from overhead areas, divested business units and redundant marketing activities, and as of August 31, 1998, the majority of these terminations were completed. In addition to severance and related charges associated with the reduction in force, the restructuring program included charges for divesting two business units, vacating leased facilities, and canceling certain contracts. These actions and other non-restructuring related items resulted in charges of \$38.2 million, of which approximately \$9.1 million were non-cash charges. For detailed information regarding the Company's restructuring program, see Note 7 of the Notes to the Consolidated Financial Statements.

The Company estimates that, as a result of the restructuring program, annualized pre-tax savings of \$60.0 million will be realized. Approximately 50% of the savings are the result of the reduction in force and the remaining 50% savings are the result of reductions in marketing and facilities expense, as well as other discretionary savings, such as travel and outside services.

Restructuring and other charges in fiscal 1997 include a gain of \$2.4 million related to the divestiture of a product line partially offset by a \$1.8 million charge related to the acquisition of intellectual property.

Restructuring and other charges in fiscal 1996 include charges of \$5.7 million related to the disposition of two business units previously owned by an acquired company less the reversal of \$0.7 million of excess reserves related to restructuring costs recorded in prior years.

Nonoperating income:

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Investment gain	\$15.0	(56)%	\$34.3	(50)%	\$68.9
Percentage of total revenue	1.7%		3.8%		8.8%

Investment gain consists principally of realized gains or losses from direct investments as well as mark-to-market valuation adjustments for investments held by Adobe Incentive Partners, L.P. ("AIP").

In fiscal 1998, the Company recorded a realized gain of \$6.7 million related to the Company's investment in McQueen International Limited ("McQueen") due to the acquisition of McQueen by Sykes Enterprises, Incorporated ("Sykes"), a publicly traded company. In addition, the Company liquidated its investment in Siebel Systems, Incorporated ("Siebel") through the distribution to its stockholders of approximately 165,000 shares of Siebel common stock as a dividend-in-kind and the sale of its remaining Siebel shares. A gain was recognized on the transaction of approximately \$5.7 million. The remaining net realized gain recorded by the Company in fiscal 1998 represents valuation adjustments recorded by the Company related to its venture investments held by AIP.

In fiscal 1997, the investment gain related primarily to the Company's liquidation of its investment in Netscape Communications Corporation ("Netscape") through the distribution to its stockholders of 554,660 shares of Netscape common stock as a dividend-in-kind and the sale of its remaining Netscape shares.

The fiscal 1996 gain arose primarily as a result of realized gains of approximately \$43.6 million and approximately \$6.8 million for the sale of a portion of the Company's investment in Netscape and its entire investment in Luminous Corporation, respectively. Also, a portion of one of the equity investments included in the Adobe Ventures L.P. portfolio was sold for a gain of \$13.9 million during fiscal 1996, and at November 29, 1996, the remaining portion of this investment was marked-to-market for an unrealized gain of approximately \$3.7 million. These and other gains were partially offset by write-downs on certain other investments.

The Company is uncertain of future investment gains or losses as they are primarily dependent upon the operations of the underlying investee companies.

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Interest and other income	\$27.4	(12)%	\$31.0	6%	\$29.2
Percentage of total revenue	3.1%		3.4%		3.7%

Interest and other income consists principally of interest earned on cash, cash equivalents, and short-term investments as well as foreign exchange transaction gains and losses.

The decrease in interest and other income during fiscal 1998 compared to fiscal 1997 is due to lower average cash and short-term investment balances in fiscal 1998, primarily as a result of cash used for stock repurchases in fiscal 1998 and late fiscal 1997. The increase in interest and other income in fiscal 1997 from fiscal 1996 is related to higher average cash balances.

Interest income is expected to decrease in fiscal 1999 due to lower average cash balances resulting from stock repurchases conducted in fiscal 1998. Further, the Company's cash balances could also be reduced in fiscal 1999 due to the purchase of software companies, products, or technologies complementary to the Company's business.

Income tax provision:

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Income tax provision	\$62.6	(43)%	\$109.3	19%	\$91.5
Percentage of total revenue	7.0%		12.0%		11.6%
Effective tax rate	37.3%		36.9%		37.4%

The Company's effective tax rate increased in fiscal 1998 from fiscal 1997 principally as a result of the nondeductible write-off of goodwill and lower tax-exempt interest income. The fiscal 1997 tax rate decreased from fiscal 1996 primarily due to lower nondeductible charges for the write-off of acquired in-process research and development and higher tax-exempt income.

The Company anticipates that the tax rate in fiscal 1999 will not be materially different than the tax rate in fiscal 1998.

Factors That May Affect Future Results of Operations

The Company believes that in the future its results of operations could be affected by various factors, such as delays in shipment of the Company's new products and major new versions of existing products, lack of market acceptance of new products and upgrades, the introduction of competitive products by third parties, weakness in demand for Macintosh application software and Macintosh-related printers, renegotiation of royalty arrangements, growth in worldwide personal computer and printer sales and sales price adjustments, consolidation in the OEM printer business, ongoing weakness in the Company's printing business due to product transitions, industry transitions to new business and information delivery models, ongoing weakness in the Japanese and other Asian economies, "Year 2000" issues (as discussed later

under “Year 2000 Issues”), and adverse changes in general economic conditions in any of the countries in which the Company does business.

The Company has stated that in fiscal 1999 its annual revenue growth target is 15% and its operating margin target is 25% of total revenue. These targets are used to assist the Company’s management in making decisions about the allocation of resources and investments, not as predictions of future results. The targets reflect a number of assumptions, including assumptions about the Company’s pricing, manufacturing costs and volumes and the mix of application products and licensing revenue, full and upgrade products, distribution channels and geographic distribution. These and many other factors described herein affect the Company’s financial performance and may cause the Company’s future results, including results for the current quarter, to vary materially from these targets.

The Company’s ability to develop and market products, including upgrades of current products that successfully adapt to changing customer needs, may also have an impact on the results of operations. The Company’s ability to extend its core technologies into new applications and to anticipate or respond to technological changes could affect its ability to develop these products. A portion of the Company’s future revenue will come from these new applications. Delays in product or upgrade introductions, whether by the Company or its OEM customers, could have an adverse effect on the Company’s revenue, earnings, or stock price. The Company cannot determine the ultimate effect that these new products or upgrades will have on its revenue or results of operations.

The market for the Company’s graphics applications, particularly the consumer products, is intensely and increasingly competitive and is significantly affected by product introductions and market activities of industry competitors. Additionally, Microsoft Corporation has stated its intention to increase its presence in the digital imaging/graphics market by mid-1999; the Company believes that, due to Microsoft’s market dominance, any new Microsoft digital imaging products will be highly competitive with the Company’s products. If competing new products achieve widespread acceptance, it would have a significant adverse impact on the Company’s operating results.

Although the Company generally offers its application products on Macintosh, Windows, and UNIX platforms, a majority of the overall revenue from these products prior to fiscal 1997 has been from the Macintosh platform, particularly for the higher end Macintosh computers. In the last two years, Windows-based application revenue exceeded that from the Macintosh platform, and for the past several quarters, Macintosh platform sales of application products have continued to decline year over year while Windows platform sales have continued to rise. If there is a continuing slowdown of customer purchases in the higher end Macintosh market, or if the Company is unable to continue to increase its revenue from Windows customers commensurate with such a slowdown, the Company’s operating results could be materially adversely affected. In addition, to the extent that there is a slowdown of customer purchases of personal computers in general, the Company’s operating results could be materially adversely affected. Also, as the Company seeks to further broaden its customer base to achieve greater penetration in the corporate business and consumer markets, the Company may not successfully adapt its application software distribution channels, which could materially adversely affect the Company’s operating results. The Company could experience decreases in average selling prices and some transitions in its distribution channels that could materially adversely affect its operating results.

The Company continues to expand into third-party distribution channels, including value-added resellers and systems integrators, in its effort to further broaden its customer base. As a result, the financial health of these third parties, and the Company’s continuing relationships with them, are becoming more important to the Company’s success. Some of these companies are thinly capitalized and may be unable to withstand changes in business conditions. The Company’s financial results could be adversely affected if the financial condition of certain of these third parties substantially weakens or if the Company’s relationships with them deteriorate.

The Company's printing revenue experienced a 16% decline in fiscal 1998 compared to fiscal 1997. Product transitions, as the Company transitions its customers from Adobe PostScript Level 2 to Adobe PostScript 3 and PostScript Extreme, along with weakness in the Japanese market, primarily caused the revenue decline. If this trend continues, the Company's financial results could be adversely affected. In addition, in the fall of fiscal 1997, HP began to ship a clone version of Adobe PostScript in some printers, resulting in lower licensing revenue to the Company in fiscal 1998, even though the Company continues to work with HP printer operations to incorporate Adobe PostScript and other technologies in other HP products. The Company expects lower licensing revenue from HP in fiscal 1999. Further, OEM customers on occasion seek to renegotiate their royalty arrangements. The Company evaluates these requests on a case-by-case basis. If an agreement is not reached, a customer may decide to pursue other options, which could result in lower licensing revenue for the Company.

During late fiscal 1997 and throughout fiscal 1998, the Company experienced a decline in both application and licensing revenue from the Japanese market due to a weak Japanese computer market and general economic conditions in Japan. In addition, at the end of fiscal 1997, inventory levels for application products at the Company's Japanese distributors remained higher than what the Company considers normal. During fiscal 1998, the Company worked with its major distributors in Japan to reduce channel inventory to what the Company considers a reasonable level. The Company expects these adverse economic conditions to continue in the short term, and they may continue to adversely affect the Company's revenue and earnings. Although there are also adverse conditions in other Asian and Latin American economies, the countries affected represent a much smaller portion of the Company's revenue and thus have less impact on the Company's operational results.

The Company has recently implemented a restructuring of its business and reduced its workforce by more than 10%. However, the Company plans to continue to invest in certain areas, which will require it to hire additional employees. Competition for high quality personnel, especially highly skilled engineers, is extremely intense. The Company's ability to effectively manage its growth will require it to continue to improve its operational and financial controls and information management systems, and to attract, retain, motivate, and manage employees effectively. The failure of the Company to effectively manage growth and transition in multiple areas of its business could have a material adverse effect on its results of operations.

The Internet market is rapidly evolving and is characterized by an increasing number of market entrants that have introduced or developed products addressing authoring and communications over the Internet. As is typical in the case of a new and evolving industry, demand and market acceptance for recently introduced products and services are subject to a high level of uncertainty. The software industry addressing authoring and communications over the Internet is young and has few proven products. Standards defining web graphics have not yet been finally adopted. In addition, new models for licensing software will be needed to accommodate new information delivery practices. Moreover, critical issues concerning the commercial use of the Internet (including security, reliability, ease of use and access, cost, and quality of service) remain unresolved and may affect the growth of Internet use, together with the software standards and electronic media employed in such markets.

The Company derives a significant portion of its revenue and operating income from its subsidiaries located in Europe, Japan, and Asia Pacific and Latin America. The Company generally experiences lower revenue from its European operations in the third quarter because many customers reduce their purchasing activities in the summer months. Additionally, the Company is uncertain whether the recent weakness experienced in the Japan and Asia Pacific and Latin America markets will continue in the foreseeable future due to possible currency devaluation and liquidity problems in these regions. While most of the revenue of the European subsidiaries is denominated in U.S. dollars, the majority of revenue derived from Japan is denominated in yen and the majority of all subsidiaries' operating expenses are denominated in their local currencies. As a result, the Company's operating results are subject to fluctuations in foreign currency exchange rates. To date, the accounting impact of such fluctuations has been insignificant. The Company's hedging policy attempts to mitigate some of these risks, based on management's best judgment

of the appropriate trade-offs among risk, opportunity, and expense. The Company has established a hedging program to hedge its exposure to foreign currency exchange rate fluctuations, primarily of the Japanese yen. The Company's hedging program is not comprehensive, and there can be no assurance that the program will offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates.

On January 1, 1999, eleven of the fifteen member countries of the European Union adopted the euro as their common legal currency and established fixed conversion rates between their existing sovereign currencies and the euro. The euro trades on currency exchanges and is available for non-cash transactions. Based on its preliminary assessment, the Company does not believe the conversion will have a material impact on the competitiveness of its products in Europe, where there already exists substantial price transparency, or increase the likelihood of contract cancellations. Further, the Company expects that modifications to comply with euro requirements have been and will continue to be made to its business operations and systems on a timely basis and does not believe that the cost of such modifications will have a material adverse impact on the Company's results of operations or financial condition. There can be no assurance, however, that the Company will be able to continue to complete such modifications on a timely basis; any failure to do so could have a material adverse effect on the Company's results of operations or financial condition. In addition, the Company faces risks to the extent that suppliers, manufacturers, distributors, and other vendors upon whom the Company relies and their suppliers are unable to make appropriate modifications to support euro transactions. The inability of such third parties to support euro transactions could have a material adverse effect on the Company's results of operations or financial condition.

In connection with the enforcement of its own intellectual property rights or in connection with disputes relating to the validity or alleged infringement of third-party rights, the Company has been and may in the future be subject to complex, protracted litigation as part of its policy to vigorously defend its intellectual property rights. Intellectual property litigation is typically very costly and can be disruptive to business operations by diverting the attention and energies of management and key technical personnel. Although the Company has successfully defended past litigation, there can be no assurance that it will prevail in any ongoing or future litigation. Adverse decisions in such litigation could subject the Company to significant liabilities, require the Company to seek licenses from others, prevent the Company from manufacturing or selling certain of its products, or cause severe disruptions to the Company's operations or the markets in which it competes, any one of which could have a material adverse effect on the results of operations or financial condition of the Company.

The Company prepares its financial statements in conformity with generally accepted accounting principles ("GAAP"). GAAP are subject to interpretation by the American Institute of Certified Public Accountants (the "AICPA"), the Securities and Exchange Commission (the "SEC") and various bodies formed to interpret and create appropriate accounting policies. A change in these policies can have a significant effect on the Company's reported results, and may even affect the reporting of transactions completed before a change is announced. Accounting policies affecting many other aspects of the Company's business, including rules relating to software revenue recognition, purchase and pooling-of-interests accounting for business combinations, the valuation of in-process research and development, employee stock purchase plans and stock option grants have recently been revised or are under review by one or more groups. Changes to these rules, or the questioning of current practices, may have a significant adverse effect on the Company's reported financial results or in the way in which the Company conducts its business.

Due to the factors noted above, the Company's future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Any shortfall in revenue or earnings from levels expected by securities analysts could have, and has had in the past, an immediate and significant adverse effect on the trading price of the Company's common stock in any given period. Additionally, the Company may not learn of such shortfalls until late in the fiscal quarter, which could result in an even

more immediate and adverse effect on the trading price of the Company's common stock. Finally, the Company participates in a highly dynamic industry. In addition to factors specific to the Company, changes in analysts' earnings estimates for the Company or its industry and factors affecting the corporate environment, the Company's industry, or the securities markets in general will often result in significant volatility of the Company's common stock price.

“Year 2000” Issues

The Company is addressing a broad range of issues associated with the programming code in existing computer systems as the year 2000 approaches. The “Year 2000” problem is complex, as many computer systems will be affected in some way by the rollover of the two-digit year value to 00. Systems that do not properly recognize such information could generate erroneous data or cause a system to fail. The Year 2000 issue creates risk for the Company from unforeseen problems in its products or its own computer and embedded systems and from third parties with whom the Company deals on financial and other transactions worldwide. Failure of the Company's and/or third parties' computer systems or Year 2000 defects in the Company's products could have a material impact on the Company's ability to conduct its business.

The Company has commenced a phased program to inventory, assess, remediate, test, implement and develop contingency plans for all mission-critical applications and products potentially affected by the Year 2000 issue (the “Y2K Program”). To accelerate overall completion, activities in each phase are often concurrent rather than serial, but all phases, except developing contingency plans, are expected to be completed by mid-1999. Additionally, the Company has opened a dedicated Year 2000 test laboratory for both internal business process and product testing. All Company business groups are involved in the Y2K Program efforts.

The Company has identified three potential areas of impact for review: (1) the software and systems, including embedded systems, used in the Company's internal business processes; (2) third party vendors, manufacturers and suppliers; and (3) the Company's software products offered to customers. The Company's current estimate of the aggregate costs to be incurred for the Y2K Program is approximately \$3.0 million, which is expected to be funded from operating cash flows. If the Company encounters significant unforeseen Year 2000 problems, either in its products or internal business systems or in relation to third party vendors, manufacturers or suppliers, actual costs could materially exceed this estimate.

Internal Business Processes. The Company has substantially completed its inventory of Year 2000 impacted software and is assessing its centralized computer and embedded systems to identify any potential Year 2000 issues. The Company's financial information systems include an SAP system recently implemented in the United States, Japan, and Asia Pacific and Latin America, and an Oracle system in Europe that has recently been upgraded to a recent version. SAP and Oracle have informed the Company, and the Company believes, that these systems are Year 2000 compliant. The Company has a number of projects underway to replace or upgrade hardware and software that are known to be Year 2000 non-compliant. The Company currently expects to substantially complete remediation, validation and implementation of its internal systems by mid-1999. In addition, in order to protect against the acquisition of additional products that may not be Year 2000 ready, the Company has implemented a policy requiring Year 2000 review of products sold or licensed to the Company prior to their acquisition. However, if implementation of replacement or upgraded systems or software is delayed, or if significant non-compliance issues are identified, the Company's results of operations or financial condition could be materially adversely affected.

Third Party Vendors, Manufacturers and Suppliers. The Company is also in the process of contacting its critical suppliers, manufacturers, distributors and other vendors to determine that their operations and the products and services that they provide to the Company are Year 2000 compliant. Where practicable, the Company will attempt to mitigate its risks with respect to the failure of third parties to be Year 2000

ready, including developing contingency plans. However, such failures, including failures of any contingency plan, remain a possibility and could have a materially adverse impact on the Company's results of operations or financial condition.

Products. In addition, the Year 2000 issue could affect the products that the Company licenses. The Company is continuing to test its products and gather information about Company technologies and products impacted by the Year 2000 transition. Current information about the Company's products is available on the Company's Year 2000 Web site (www.adobe.com/newsfeatures/year2000). Information on the Company's Web site is provided to customers for the sole purpose of assisting in planning for the transition to the Year 2000. Such information is the most currently available concerning the Company's products and is provided "as is" without warranty of any kind. There can be no assurance that the Company's current products do not contain undetected errors or defects associated with Year 2000 that may result in material costs to the Company.

Contingency Plans. The Company has not yet developed contingency plans to address situations that may result if the Company is unable to achieve Year 2000 readiness of its critical operations, including operations under the control of third parties. Additionally, the most reasonably likely worst case scenario has not yet been clearly identified. Development of such contingency plans is in progress and is expected to be completed by September 1999. There can be no assurance that the Company will be able to develop contingency plans that will adequately address all Year 2000 issues that may arise.

Some commentators have stated that a significant amount of litigation will arise out of Year 2000 compliance issues, and the Company is aware of a growing number of lawsuits against other software vendors. Because of the unprecedented nature of such litigation, it is uncertain whether or to what extent the Company may be affected by it. The impact of the Year 2000 on future Company revenue is difficult to discern but is a risk to be considered in evaluating future growth of the Company.

Recent Accounting Pronouncements

In June 1997, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and displaying comprehensive income and its components in the financial statements. It does not, however, require a specific format for the disclosure but requires the Company to display an amount representing total comprehensive income for the period in its financial statements. The Company will be required to implement SFAS No. 130 for its first quarter of fiscal year 1999.

Also in June 1997, the FASB issued SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No. 131 establishes standards for the manner in which public companies report information about operating segments in annual and interim financial statements. The Company is currently evaluating the operating segment information that it will be required to report. The Company will be required to implement SFAS No. 131 for its fiscal year 1999.

In October 1997, the American Institute of Certified Public Accountants (the "AICPA") issued Statement of Position ("SOP") 97-2, "Software Revenue Recognition." SOP 97-2, as amended by SOP 98-4, establishes standards relating to the recognition of all aspects of software revenue. Based on the Company's ongoing assessment of the impact SOP 97-2 may have on its consolidated results of operations, the Company is modifying certain aspects of its business model such that any impact will not be significant. The Company will adopt SOP 97-2 for its fiscal year 1999.

In December 1998, the AICPA issued SOP 98-9, "Modifications of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions," which amends SOP 97-2 and supercedes SOP 98-4. The Company will adopt SOP 98-9 in fiscal 2000, with the exception of certain provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 which are effective December 15, 1998. The adoption of SOP 98-9 is not expected to have a significant impact on the Company.

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative financial instruments and for hedging activities and requires the Company to recognize all derivatives as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses resulting from changes in fair value would be accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting. The Company will be required to implement SFAS No. 133 for its fiscal year 2000. The Company has not determined the impact that SFAS No. 133 will have on its financial statements and believes that such determination will not be meaningful until closer to the date of initial adoption.

LIQUIDITY AND CAPITAL RESOURCES

	<u>1998</u>	<u>Change</u>	<u>1997</u>	<u>Change</u>	<u>1996</u>
Cash, cash equivalents, and short-term investments	\$272.5	(46)%	\$503.0	(11)%	\$564.1
Working capital	\$205.0	(55)%	\$454.3	(10)%	\$506.1
Stockholders' equity	\$516.4	(28)%	\$715.4	1%	\$706.5

The Company's cash, cash equivalents, and short-term investments, consisting principally of municipal bonds, money market mutual funds, U.S. Treasury notes, and auction rate certificate securities, decreased \$230.4 million in fiscal 1998 from fiscal 1997. All of the Company's cash equivalents and short-term investments are classified as available-for-sale under the provisions of SFAS No. 115, and accordingly, the securities are carried at fair value with the unrealized gains and losses, net of tax, reported as a separate component of stockholders' equity.

Major sources of cash during fiscal 1998 included cash generated from operations of \$203.5 million, sale of short-term investments, net of purchases, of \$69.6 million, and the proceeds from the reissuance of treasury stock of \$70.9 million, primarily related to the exercise of stock options and sale of stock under the Employee Stock Purchase Plan. Major uses of cash during fiscal 1998 included \$379.2 million to repurchase Adobe common stock, additions to other assets of \$57.5 million, capital expenditures totaling \$59.7 million, and the payment of dividends of \$16.3 million.

The Company expects to continue its investing activities, including expenditures for computer systems for research and development, sales and marketing, product support, and administrative staff. Furthermore, cash reserves may be used to acquire software companies, products, or technologies complementary to the Company's business.

In September 1997, the Company's Board of Directors authorized, subject to certain business and market conditions, the purchase of up to an additional 15 million shares of the Company's common stock over a two-year period. This new stock repurchase program was in addition to an existing program, whereby the Company has been authorized to repurchase shares to offset issuances under employee stock option and stock purchase plans. The Company repurchased approximately 10.5 million shares and approximately 6.3 million shares of its common stock in fiscal 1998 and 1997, respectively. These stock repurchase programs are intended to enhance stockholder value by reducing the number of outstanding shares, absolutely, and, for the previously existing program, to net offsetting increases due to employee stock purchases and stock option exercises. As of November 27, 1998, management is authorized to repurchase an additional 836,000 shares under the 15 million share repurchase program. The Company has sold put warrants which will expire in the first quarter of fiscal 1999 for all but 228 of those remaining authorized shares. The timing and size of any future stock repurchases are subject to market conditions, stock prices and the Company's cash position and other cash requirements going forward.

The Company has paid cash dividends on its common stock each quarter since the second quarter of 1988. The Board of Directors of the Company declared a cash dividend on the Company's common stock of \$.05 per common share for each quarter of fiscal 1998. Also, on December 1, 1997, the Company dividended one share of Siebel Systems, Incorporated ("Siebel") common stock for each 300 shares of Adobe common stock held by stockholders of record on October 31, 1997. An equivalent cash dividend was paid for holdings of less than 7,500 Adobe shares and for odd-lot and fractional Siebel shares. The declaration of future dividends, whether in cash or in-kind, is within the discretion of the Company's Board of Directors and will depend upon business conditions, the Company's results of operations and financial condition, and other factors.

To facilitate the Company's stock repurchase program, the Company sold put warrants in a series of private placements in fiscal 1998 and 1997. Each put warrant entitles the holder to sell one share of Adobe's common stock to the Company at a specified price. Approximately 4.0 million and 4.6 million put warrants were written in fiscal 1998 and 1997, respectively. At November 27, 1998, approximately 836,000 put warrants were outstanding that expire on various dates through February 1999 that have exercise prices ranging from \$27.00 to \$32.38 per share, with an average exercise price of \$30.30 per share.

In addition, in fiscal 1998 and 1997, the Company purchased call options that entitle the Company to buy 1.6 million and 2.3 million shares, respectively, of its common stock. At November 27, 1998, approximately 583,000 call options were outstanding that expire on various dates through February 1999 and have exercise prices ranging from \$29.36 to \$35.00 per share, with an average exercise price of \$32.24 per share. Under these arrangements, the Company, at its option, can settle with physical delivery or net shares equal to the difference between the exercise price and the value of the option as determined by the contract.

The Company believes that existing cash, cash equivalents, and short-term investments, together with cash generated from operations, will provide sufficient funds for the Company to meet its operating cash requirements in the foreseeable future.

Commitments

The Company's principal commitments as of November 27, 1998 consisted of obligations under operating leases, real estate development agreements, and various service agreements with a previously related party.

During 1994, the Company entered into a real estate development agreement and an operating lease agreement in connection with the construction of a headquarters office facility. In August 1996, the construction was completed and the operating lease commenced. The Company will have the option to purchase the facility at the end of the lease term in October 2001. In the event the Company chooses not to exercise this option, the Company is obligated to arrange for the sale of the facility to an unrelated party and is required to pay the lessor any difference between the net sales proceeds and the lessor's net investment in the facility, in an amount not to exceed that which would preclude classification of the lease as an operating lease, approximately \$57.3 million. Pursuant to the agreement, the Company was required to pledge certain interest-bearing instruments to the lessor as collateral to secure the performance of its obligations under the lease. As of November 27, 1998, the Company's collateral under this agreement totaled \$66.0 million in money market mutual funds. These deposits are included in "Other assets" on the Consolidated Balance Sheet.

In 1996, the Company exercised its option under the development agreement to begin a second phase of development for an additional office facility. In August 1996, the Company entered into a construction agreement and an operating lease agreement for this facility. The construction was completed and the operating lease commenced in August 1998. The Company will have the option to purchase the facility at the end of the lease term in August 2003. In the event the Company chooses not to exercise this option, the Company is obligated to arrange for the sale of the facility to an unrelated party and is required to pay the

lessor any difference between the net sales proceeds and the lessor's net investment in the facility, in an amount not to exceed that which would preclude classification of the lease as an operating lease, approximately \$64.3 million. The Company was required to deposit funds with the lessor as an interest-bearing security deposit pursuant to its obligations under the lease. As of November 27, 1998, the Company's deposits under this agreement totaled approximately \$64.3 million. These deposits are included in "Other assets" on the Consolidated Balance Sheet.

During 1998, the Company entered into a real estate development agreement for the construction of an office building in Edinburgh, Scotland. As of November 27, 1998, the Company has paid \$11.5 million for land, fees, and construction costs. The expected completion date of the building is August 1999.

At November 28, 1997, the Company held a 13% equity interest in McQueen International Limited ("McQueen") and accounted for the investment using the cost method. During 1994, the Company entered into various agreements with McQueen, whereby the Company contracted with McQueen to perform product localization and technical support functions and to provide printing, assembly, and warehousing services. Effective December 31, 1997, McQueen was acquired by Sykes Enterprises, Incorporated ("Sykes"), a publicly traded company. In connection with the acquisition, the Company exchanged its shares of McQueen for 486,676 shares of Sykes' common stock and recorded a gain on the exchange of \$6.7 million in fiscal 1998. In the third quarter of fiscal 1998, these shares were sold. The Company expects that Sykes will continue to provide services to the Company for the foreseeable future.

Derivatives and Financial Instruments

(Item 7a. Quantitative and Qualitative Disclosures About Market Risk)

Foreign currency hedging instruments

The Company transacts business in various foreign currencies, primarily in certain European countries and Japan. Accordingly, the Company is subject to exposure from movements in foreign currency exchange rates. This exposure is primarily related to yen denominated licenses in Japan and local currency denominated operating expenses in Europe, where the Company licenses primarily in U.S. Dollars.

The Company's Japanese operating expenses are in yen, which mitigates a portion of the exposure related to yen denominated licenses in Japan. In addition, the Company hedges firmly committed transactions using primarily forward contracts with maturities of less than three months. The Company also hedges a percentage of forecasted international revenue with purchased options. At November 27, 1998, total outstanding contracts include \$19.8 million in foreign currency forward exchange contracts and purchased Japanese yen put option contracts with a notional value of \$12.5 million. All contracts expire at various times through March 1999. The Company's hedging policy is designed to reduce the impact of foreign currency exchange rate movements, and any gain or loss in the hedging portfolio is expected to be offset by a corresponding gain or loss in the underlying exposure being hedged.

A sensitivity analysis was performed on the Company's hedging portfolio as of November 27, 1998. This sensitivity analysis is based on a modeling technique that measures the hypothetical market value resulting from a 10% and 15% shift in the value of exchange rates relative to the U.S. Dollar. An increase in the value of the U.S. Dollar (and a corresponding decrease in the value of the hedged foreign currency asset) would lead to an increase in the fair value of the Company's financial hedging instruments by \$1.9 million and \$2.9 million, respectively. Conversely, a decrease in the value of the U.S. Dollar would result in a decrease in the fair value of these financial instruments by \$1.2 million and \$1.7 million, respectively.

The Company's accounting policies for these instruments are based on the Company's designation of such instruments as hedging transactions. Gains and losses associated with the mark-to-market of outstanding foreign exchange forward contracts that are designated and effective as hedges of existing transactions, for which a firm commitment has been attained, are recognized in income in the current

period. Corresponding gains and losses on the foreign currency denominated transactions being hedged are recognized in income in that same period. In this manner, the gains and losses on foreign currency denominated transactions will be offset by the gains and losses on the foreign currency contracts. The Company does not anticipate any material adverse effect on its consolidated financial position, results of operations, or cash flows as a result of these instruments. The Company uses yen options to hedge anticipated exposures.

The Company does not use derivative financial instruments for speculative trading purposes, nor does the Company hedge its foreign currency exposure in a manner that entirely offsets the effects of changes in foreign exchange rates.

The Company currently does not use financial instruments to hedge local currency denominated operating expenses in Europe. Instead, the Company believes that a natural hedge exists, in that local currency revenue from product upgrades substantially offsets the local currency denominated operating expenses. The Company assesses the need to utilize financial instruments to hedge European currency exposure on an ongoing basis.

The Company regularly reviews its hedging program and may as part of this review determine at any time to change its hedging program.

Fixed income investments

At November 27, 1998, the Company had an investment portfolio of fixed income securities, including those classified as cash equivalents, and restricted funds and security deposits of \$372.1 million. These securities are subject to interest rate fluctuations. An increase in interest rates could adversely affect the market value of the Company's fixed income securities.

A sensitivity analysis was performed on the Company's investment portfolio as of November 27, 1998. This sensitivity analysis is based on a modeling technique that measures the hypothetical market value changes that would result from a parallel shift in the yield curve of plus 50, plus 100, or plus 150 basis points over six-month and twelve-month time horizons. The market value changes for a 50, 100, or 150 basis point increase in short-term treasury security yields were not material due to the limited duration of the Company's portfolio.

The Company does not use derivative financial instruments in its investment portfolio to manage interest rate risk. The Company does, however, limit its exposure to interest rate and credit risk by establishing and strictly monitoring clear policies and guidelines for its fixed income portfolios. At the present time, the maximum duration of all portfolios is limited to 2.3 years. The guidelines also establish credit quality standards, limits on exposure to one issue, issuer, as well as the type of instrument. Due to the limited duration and credit risk criteria established in the Company's guidelines, the exposure to market and credit risk is not expected to be material.

Facility Leases

The Company is exposed to interest rate risk associated with leases of on its facilities whose payments are tied to the London Interbank Offered Rate ("LIBOR") and has evaluated the hypothetical changes in lease obligations arising from selected hypothetical changes in the LIBOR rate. Market changes reflected immediate hypothetical parallel shifts in the LIBOR curve of plus or minus 50, 100, and 150 basis points for a twelve-month period. Based on this analysis, such charges would not be material to the Company's results of operations or financial position.

Item 8. Financial Statements and Supplementary Data

FINANCIAL STATEMENTS

The Company's financial statements required by this item are submitted as a separate section of this Form 10-K. See Item 14.(a)1 for a listing of financial statements provided in the section titled "FINANCIAL STATEMENTS".

SUPPLEMENTARY DATA

The following tables (presented in thousands, except per share amounts) set forth quarterly supplementary data for each of the years in the two-year period ended November 27, 1998.

	1998				
	Quarter Ended				Year Ended
	Feb. 27	May 29	Aug. 28	Nov. 27	Nov. 27
Revenue	\$197,813	\$227,310	\$222,932	\$246,736	\$894,791
Gross profit	167,827	200,018	196,151	219,358	783,354
Income before income taxes	42,635	44,645	242	80,172	167,694
Net income	26,744	27,980	152	50,268	105,144
Basic net income per share	0.39	0.42	—	0.80	1.58
Shares used in computing basic net income per share	67,762	66,735	67,278	63,115	66,433
Diluted net income per share	0.38	0.41	—	0.78	1.55
Shares used in computing diluted net income per share	69,585	68,990	68,412	64,207	67,974
	1997				
	Quarter Ended				Year Ended
	Feb. 28	May 30	Aug. 29	Nov. 28	Nov. 28
Revenue	\$226,459	\$228,264	\$230,039	\$227,132	\$911,894
Gross profit	192,170	195,606	197,350	200,497	785,623
Income before income taxes	73,167	63,204	85,528	74,191	296,090
Net income	46,484	40,106	53,428	46,819	186,837
Basic net income per share	0.65	0.56	0.73	0.66	2.60
Shares used in computing basic net income per share	71,493	72,085	72,766	71,345	71,962
Diluted net income per share	0.63	0.54	0.72	0.64	2.52
Shares used in computing diluted net income per share	73,939	74,416	74,528	73,651	74,160

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

There were no disagreements on any matter of accounting principles, financial statement disclosure, or auditing scope or procedure to be reported under this item.

PART III

Item 10. Directors and Executive Officers of the Registrant

DIRECTORS

Information with respect to Directors may be found in the section captioned "Election of Directors" appearing in the definitive Proxy Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held on April 15, 1999. Such information is incorporated herein by reference.

EXECUTIVE OFFICERS

Information with respect to executive officers may be found in Item 1. Business.

Item 11. Executive Compensation

Information with respect to this item may be found in the section captioned "Executive Compensation" appearing in the definitive Proxy Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held on April 15, 1999. Such information is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Information with respect to this item may be found in the section captioned "Security Ownership of Certain Beneficial Owners and Management" appearing in the definitive Proxy Statement to be delivered to stockholders in connection with the Annual Meeting of Stockholders to be held April 15, 1999. Such information is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

None.

PART IV

Item 14. Exhibits, Financial Statements Schedule, and Reports on Form 8-K

(a) Documents filed as part of this report

1. Financial statements
 - Management's Report
 - Independent Auditors' Report
 - Consolidated Balance Sheets
November 27, 1998 and November 28, 1997
 - Consolidated Statements of Income
Years Ended November 27, 1998, November 28, 1997, and November 29, 1996
 - Consolidated Statements of Stockholders' Equity
Years Ended November 27, 1998, November 28, 1997, and November 29, 1996
 - Consolidated Statements of Cash Flows
Years Ended November 27, 1998, November 28, 1997, and November 29, 1996
 - Notes to Consolidated Financial Statements
2. Financial statement schedule
 - Schedule II—Valuation and Qualifying Accounts
3. Exhibits
 - a. Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
3.1	The Registrant's (as successor in-interest to Adobe Systems (Delaware) Incorporated by virtue of a reincorporation effective 5/30/97) Certificate of Incorporation, as filed with the Secretary of State of the State of Delaware on 5/9/97.	10-Q	05/30/97	3.1	
3.2.10	Amended and Restated Bylaws as currently in effect.	8-K	9/3/98	3.2	
3.3	Certificate of Designation of the Series A Preferred Stock	10-K	05/30/97	2.1	
3.4	Agreement and Plan of Merger effective 5/30/97 (by virtue of a reincorporation), by and between Adobe Systems Incorporated, a California corporation and Adobe Systems (Delaware) Incorporated, a Delaware corporation.	10-Q	05/30/97	2.1	
4.1	Third Amended and Restated Rights Agreement between the Company and Harris Trust Company of California	8-K	12/15/98	1	
10.1.6	1984 Stock Option Plan, as amended*	10-Q	07/02/93	10.1.6	
10.21.3	Revised Bonus Plan*	10-Q	02/28/97	10.21.3	
10.24.1	Amended 1994 Performance and Restricted Stock Plan*	10-Q	05/29/98	10.24.1	
10.25.0	Form of Indemnity Agreement*	10-K	11/30/90	10.17.2	
10.25.1	Form of Indemnity Agreement*	10-Q	05/30/97	10.25.1	

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
10.32	Sublease of the Land and Lease of the Improvements By and Between Sumitomo Bank Leasing and Finance Inc. and Adobe Systems Incorporated (Phase 1)	10-K	11/25/94	10.32	
10.36	1996 Outside Directors Stock Option Plan*	10-Q	05/31/96	10.36	
10.37	Confidential Resignation Agreement*	10-Q	05/31/96	10.37	
10.38	Sublease of the Land and Lease of the Improvements By and Between Sumitomo Bank Leasing and Finance Inc. and Adobe Systems Incorporated (Phase 2)	10-Q	08/30/96	10.38	
10.39	1997 Employee Stock Purchase Plan, as amended*	S-8	05/30/97	10.39	
10.40	1994 Stock Option Plan, as amended*	S-8	05/30/97	10.40	
10.42	Amended and Restated Limited Partnership Agreement of Adobe Incentive Partners, L.P.*	10-Q	8/28/98	10.42	
10.43	Resignation Agreement*	10-K	11/28/97	10.43	
10.44	Forms of Retention Agreement*	10-K	11/28/97	10.44	
10.45	Confidential Executive Resignation Agreement And General Release of Claims*	10-Q	8/28/98	10.45	
10.46	Confidential Executive Resignation Agreement And General Release of Claims*	10-Q	8/28/98	10.46	
10.47	Confidential Executive Resignation Agreement And General Release of Claims*	10-Q	8/28/98	10.46	
10.48	Letter of Release and Waiver*				X
21	Subsidiaries of the Registrant				X
23	Consent of Independent Auditors				X
27.1	Financial Data Schedule				X
27.2	Financial Data Schedule				X
27.3	Financial Data Schedule				X

* Compensatory plan or arrangement

The Company will furnish any exhibit listed above that is not included herein upon the specific request of a stockholder, upon such stockholder's payment of the Company's reasonable expenses in furnishing such exhibit. Stockholders should call or write:

Investor Relations Department
345 Park Avenue
San Jose, CA 95110-2704
408-536-6000

Many of the above exhibits are also available through the Company's EDGAR filings at www.sec.gov.

(b) Reports on Form 8-K

<u>Date of Report</u>	<u>Filing Date</u>	<u>Item Reported</u>
September 3, 1998	September 3, 1998	5

On September 3, 1998 the Company filed a Report on Form 8-K under Item 5 to report the amendment of the Company's Amended and Restated Bylaws related to (i) the advance notice requirements for stockholder proposals to be brought before meetings of stockholders, (ii) nominations of persons for election of directors, and (iii) fixing record dates.

Signature

Title

/s/ CAROL MILLS BALDWIN
Carol Mills Baldwin

Director

/s/ HAROLD L. COVERT
Harold L. Covert

Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

SUMMARY OF TRADEMARKS

The following trademarks of Adobe Systems Incorporated or its subsidiaries, which may be registered in certain jurisdictions, are referenced in this Form 10-K:

Adobe
Acrobat
After Effects
Aldus
Frame
FrameMaker
GoLive CyberStudio
Illustrator
ImageReady
ImageStyler
PageMaker
PageMill
PhotoDeluxe
Photoshop
PostScript
Premiere
PrintGear
SiteMill
Type Library

All other brand or product names are trademarks or registered trademarks of their respective holders.

FINANCIAL STATEMENTS

As required under Item 8. Financial Statements and Supplementary Data, the consolidated financial statements of the Company are provided in this separate section. The consolidated financial statements included in this section are as follows:

<u>Financial Statement Description</u>	<u>Page</u>
• Management's Report	39
• Independent Auditors' Report	40
• Consolidated Balance Sheets November 27, 1998 and November 28, 1997	41
• Consolidated Statements of Income Years Ended November 27, 1998, November 28, 1997, and November 29, 1996	42
• Consolidated Statements of Stockholders' Equity Years Ended November 27, 1998, November 28, 1997, and November 29, 1996	43
• Consolidated Statements of Cash Flows Years Ended November 27, 1998, November 28, 1997, and November 29, 1996	44
• Notes to Consolidated Financial Statements	45

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of Adobe Systems Incorporated:

We have audited the accompanying consolidated financial statements of Adobe Systems Incorporated and subsidiaries as listed in the accompanying index. In connection with our audits of the consolidated financial statements, we also have audited the accompanying financial statement schedule. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Adobe Systems Incorporated and subsidiaries as of November 27, 1998 and November 28, 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended November 27, 1998, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

KPMG LLP

Mountain View, California
December 14, 1998

ADOBE SYSTEMS INCORPORATED
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	<u>November 27 1998</u>	<u>November 28 1997</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 110,871	\$ 267,576
Short-term investments	161,676	235,380
Receivables, net of allowances for doubtful accounts of \$6,399 and \$3,634, respectively	141,180	130,974
Deferred income taxes	32,028	25,824
Other current assets	10,190	19,192
Total current assets	<u>455,945</u>	<u>678,946</u>
Property and equipment, net	93,887	80,978
Deferred income taxes	16,647	16,999
Other assets	200,852	163,148
	<u>\$ 767,331</u>	<u>\$ 940,071</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade and other payables	\$ 48,681	\$ 57,857
Accrued expenses	117,539	97,295
Accrued restructuring charges	8,867	8,383
Income taxes payable	64,546	48,343
Deferred revenue	11,333	12,769
Total current liabilities	<u>250,966</u>	<u>224,647</u>
Stockholders' equity:		
Preferred stock, \$0.0001 par value; 2,000 shares authorized; none issued . .	—	—
Common stock, \$0.0001 par value; Authorized: 200,000 shares; Issued: 73,941 shares in 1998 and 1997; and additional paid-in capital	306,859	291,281
Retained earnings	732,730	663,861
Unrealized gains on investments, net	823	3,590
Cumulative translation adjustment	(2,702)	(4,620)
Treasury stock, at cost (13,050 and 5,176 shares in 1998 and 1997, respectively), net of reissuances	<u>(521,345)</u>	<u>(238,688)</u>
Total stockholders' equity	<u>516,365</u>	<u>715,424</u>
	<u>\$ 767,331</u>	<u>\$ 940,071</u>

See accompanying Notes to Consolidated Financial Statements.

ADOBE SYSTEMS INCORPORATED
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Revenue:			
Licensing	\$164,145	\$196,230	\$196,693
Application products	730,646	715,664	589,870
Total revenue	<u>894,791</u>	<u>911,894</u>	<u>786,563</u>
Direct costs	<u>111,437</u>	<u>126,271</u>	<u>141,147</u>
Gross profit	<u>783,354</u>	<u>785,623</u>	<u>645,416</u>
Operating expenses:			
Research and development	207,339	170,862	155,418
Sales and marketing	316,691	303,268	254,972
General and administrative	95,732	75,358	62,034
Write-off of acquired in-process research and development . .	—	5,969	21,251
Restructuring and other charges	38,245	(590)	4,955
Total operating expenses	<u>658,007</u>	<u>554,867</u>	<u>498,630</u>
Operating income	<u>125,347</u>	<u>230,756</u>	<u>146,786</u>
Nonoperating income, net:			
Investment gain	14,994	34,290	68,875
Interest and other income	27,353	31,044	29,163
Total nonoperating income, net	<u>42,347</u>	<u>65,334</u>	<u>98,038</u>
Income before income taxes	167,694	296,090	244,824
Income tax provision	62,550	109,253	91,547
Net income	<u>\$105,144</u>	<u>\$186,837</u>	<u>\$153,277</u>
Basic net income per share	<u>\$ 1.58</u>	<u>\$ 2.60</u>	<u>\$ 2.12</u>
Shares used in computing basic net income per share	<u>66,433</u>	<u>71,962</u>	<u>72,454</u>
Diluted net income per share	<u>\$ 1.55</u>	<u>\$ 2.52</u>	<u>\$ 2.04</u>
Shares used in computing diluted net income per share	<u>67,974</u>	<u>74,160</u>	<u>75,132</u>

See accompanying Notes to Consolidated Financial Statements.

ADOBE SYSTEMS INCORPORATED
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Common Stock and Additional Paid in Capital		Retained Earnings	Unrealized Gains on Investments, Net	Cumulative Translation Adjustment	Treasury Stock		Total
	Shares	Amount				Shares	Amount	
Balances as of December 1, 1995	72,834	\$ 293,258	\$390,793	\$ 18,831	\$(4,465)	—	\$ —	\$ 698,417
Stock issued under employee stock and stock option plans	2,032	39,870	—	—	—	—	—	39,870
Tax benefit from employee stock option plans	—	10,828	—	—	—	—	—	10,828
Stock compensation expense	—	2,772	—	—	—	—	—	2,772
Dividends declared	—	—	(14,524)	—	—	—	—	(14,524)
Repurchase of common stock	(3,390)	(126,778)	—	—	—	—	—	(126,778)
Put warrant obligations	—	(71,348)	—	—	—	—	—	(71,348)
Adjustment to unrealized gains on investments, net	—	—	—	14,683	—	—	—	14,683
Cumulative translation adjustment	—	—	—	—	(683)	—	—	(683)
Net income	—	—	153,277	—	—	—	—	153,277
Balances as of November 29, 1996	71,476	148,602	529,546	33,514	(5,148)	—	—	706,514
Stock issued under employee stock and stock option plans	3,631	70,995	—	—	—	—	—	70,995
Tax benefit from employee stock option plans	—	29,607	—	—	—	—	—	29,607
Stock compensation expense	—	1,329	—	—	—	—	—	1,329
Dividends declared	—	—	(52,522)	—	—	—	—	(52,522)
Repurchase of common stock	(1,166)	(36,956)	—	—	—	(5,176)	(238,688)	(275,644)
Proceeds from sale of put warrants	—	6,356	—	—	—	—	—	6,356
Reclassification of put warrant obligations	—	71,348	—	—	—	—	—	71,348
Adjustment to unrealized gains on investments, net	—	—	—	(29,924)	—	—	—	(29,924)
Cumulative translation adjustment	—	—	—	—	528	—	—	528
Net income	—	—	186,837	—	—	—	—	186,837
Balances as of November 28, 1997	73,941	291,281	663,861	3,590	(4,620)	(5,176)	(238,688)	715,424
Tax benefit from employee stock option plans	—	12,595	—	—	—	—	—	12,595
Stock compensation expense	—	215	—	—	—	—	2,298	2,513
Dividends declared	—	—	(12,962)	—	—	—	—	(12,962)
Purchase of treasury stock	—	—	—	—	—	(10,513)	(379,203)	(379,203)
Reissuance of treasury stock under employee stock and stock option plans	—	—	(23,313)	—	—	2,639	94,248	70,935
Proceeds from sale of put warrants	—	2,768	—	—	—	—	—	2,768
Adjustment to unrealized gains on investments, net	—	—	—	(2,767)	—	—	—	(2,767)
Cumulative translation adjustment	—	—	—	—	1,918	—	—	1,918
Net income	—	—	105,144	—	—	—	—	105,144
Balances as of November 27, 1998	73,941	\$ 306,859	\$732,730	\$ 823	\$(2,702)	(13,050)	\$(521,345)	\$ 516,365

See accompanying Notes to Consolidated Financial Statements.

ADOBE SYSTEMS INCORPORATED
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Cash flows from operating activities:			
Net income	\$ 105,144	\$ 186,837	\$ 153,277
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	56,264	59,384	55,621
Deferred income taxes	(6,774)	(4,172)	(9,420)
Equity in net (income) loss of Adobe Ventures I and II	(2,365)	1,326	(19,001)
Gains on sales of equity securities	(12,972)	(35,616)	(53,216)
Tax benefit from employee stock option plans	12,595	29,607	10,828
Stock compensation expense	2,513	1,329	2,772
Write-off of acquired in-process research and development	—	5,969	21,251
Noncash restructuring and other charges	9,077	—	2,525
Changes in operating assets and liabilities:			
Receivables	(11,054)	(15,151)	8,556
Other current assets	6,886	(2,351)	(1,173)
Trade and other payables	(8,461)	14,802	8,534
Accrued expenses	32,947	4,216	(7,198)
Accrued restructuring charges	3,914	(2,471)	(20,229)
Income taxes payable	17,125	(32,294)	48,768
Deferred revenue	(1,370)	(2,768)	(3,781)
Net cash provided by operating activities	<u>203,469</u>	<u>208,647</u>	<u>198,114</u>
Cash flows from investing activities:			
Purchases of short-term investments	(1,278,178)	(2,657,302)	(2,363,993)
Maturities and sales of short-term investments	1,347,800	2,875,294	2,363,793
Acquisitions of property and equipment	(59,745)	(33,882)	(45,869)
Additions to other assets	(57,520)	(42,122)	(65,399)
Acquisitions, net of cash acquired	(3,544)	(6,121)	(8,027)
Proceeds from sales of equity securities	10,886	30,993	72,630
Net cash provided by (used for) investing activities	<u>(40,301)</u>	<u>166,860</u>	<u>(46,865)</u>
Cash flows from financing activities:			
Proceeds from issuance of common stock	—	70,995	39,870
Purchase of treasury stock	(379,203)	(275,644)	(126,778)
Proceeds from reissuance of treasury stock	70,935	—	—
Proceeds from sale of put warrants	2,768	6,356	—
Payment of dividends	(16,291)	(20,911)	(14,586)
Net cash used for financing activities	<u>(321,791)</u>	<u>(219,204)</u>	<u>(101,494)</u>
Effect of foreign currency exchange rates on cash and cash equivalents	1,918	528	2,497
Net increase (decrease) in cash and cash equivalents	(156,705)	156,831	52,252
Cash and cash equivalents at beginning of year	267,576	110,745	58,493
Cash and cash equivalents at end of year	<u>\$ 110,871</u>	<u>\$ 267,576</u>	<u>\$ 110,745</u>
Supplemental disclosures:			
Cash paid during the year for income taxes	\$ 22,471	\$ 85,062	\$ 30,463
Noncash investing and financing activities:			
Cash dividends declared but not paid	\$ 3,062	\$ 3,558	\$ 3,582
Dividends in-kind declared but not distributed	\$ —	\$ 10,032	\$ —
Dividends in-kind distributed	\$ 7,197	\$ 21,603	\$ —
Issuance of notes for acquisition	\$ —	\$ —	\$ 9,473

See accompanying Notes to Consolidated Financial Statements.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

Operations

Founded in 1982, Adobe Systems Incorporated (“Adobe” or the “Company”) develops, markets, and supports computer software products and technologies that enable users to express and use information across print and electronic media. The Company licenses its technology to major computer, printing, and publishing suppliers, and markets a line of application software products, type products, and content for creating, distributing, and managing information of all types. Additionally, the Company markets a line of products for home and small business users. The Company distributes its products through a network of original equipment manufacturer (“OEM”) customers, distributors and dealers, and value-added resellers (“VARs”) and systems integrators. The Company has operations in North America, Europe, Japan, and Asia Pacific and Latin America.

Fiscal year

The Company’s fiscal year is a 52/53-week year ending on the Friday closest to November 30.

Basis of consolidation

The accompanying consolidated financial statements include those of Adobe and its subsidiaries, after elimination of all significant intercompany accounts and transactions.

Recapitalization

In May 1997, the Company was reincorporated in the State of Delaware. As part of this reincorporation, each outstanding share of the predecessor California Corporation preferred stock and common stock was converted automatically to one share of the new Delaware Corporation \$0.0001 par value preferred stock and common stock. All prior periods presented have been restated to reflect this change.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities, at the date of the financial statements, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash equivalents and short-term investments

Cash equivalents consist of instruments with maturities of three months or less at the time of purchase.

All of the Company’s cash equivalents and short-term investments, and certain restricted funds and noncurrent investments in equity securities, free of trading restrictions or to become free of trading restrictions within one year, are classified as “available-for-sale.” These investments are carried at fair value, based on quoted market prices, and unrealized gains and losses, net of taxes, are reported as a separate component of stockholders’ equity. Realized gains and losses upon sale or maturity of these investments are determined using the specific identification method.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Foreign currency translation

Assets and liabilities of foreign subsidiaries, whose functional currency is the local currency, are translated at year-end exchange rates. Revenues and expenses are translated at the average rates of exchange prevailing during the year. The adjustment resulting from translating the financial statements of such foreign subsidiaries is reflected as a separate component of stockholders' equity. Certain other transaction gains or losses, which have not been material, are reported in results of operations.

Property and equipment

Property and equipment are recorded at cost. Depreciation and amortization are calculated using the straight-line method over the shorter of the estimated useful lives (thirty-five years for the building; two to seven years for furniture and equipment) or lease terms (five to nine years for leasehold improvements) of the respective assets.

Other assets

Purchased technology, goodwill, and certain other intangible assets are stated at cost less accumulated amortization. Amortization is recorded utilizing the straight-line method over the estimated useful lives of the respective assets, generally three to seven years. Capitalization of computer software development costs, when material, begins upon the establishment of technological feasibility, which is generally the completion of a working prototype. Such costs are amortized using the greater of the ratio of current product revenue to the total current and anticipated product revenue or the straight-line method over the software's estimated economic life, generally 9 to 36 months. The Company periodically reviews the net realizable value of its intangible assets and adjusts the carrying amount accordingly.

Long-lived assets

The Company reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of property and equipment is measured by comparison of its carrying amount to future net cash flows the property and equipment are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the property and equipment exceeds its fair market value, as determined by discounted cash flows. The Company assesses the recoverability of enterprise-level goodwill by determining whether the unamortized goodwill balance can be recovered through undiscounted future results of the acquired operation. The amount of enterprise-level goodwill impairment, if any, is measured based on projected discounted future results using a discount rate reflecting the Company's average cost of funds.

Employee stock plans

The Company accounts for its employee stock plans, which consist of fixed stock option plans, an employee stock purchase plan, and a performance and restricted stock plan, using the intrinsic value method.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Revenue recognition

Application products revenue is recognized upon shipment, provided collection is determined to be probable and no significant obligations remain. The Company provides to application product customers free telephone support, for which the expense is accrued, up to a maximum of 90 days beginning upon the customer's first call. The cost of telephone support is deferred and recognized as the obligation is fulfilled. Revenue from distributors is subject to agreements allowing limited rights of return and price protection. The Company provides for estimated future returns, and price protection when given, at the time the related revenue is recorded.

Licensing revenue, primarily royalties, is recorded when the OEM customers ship products incorporating Adobe software, provided collection of such revenue is probable. The Company has no remaining obligation in relation to such licensing revenue.

Deferred revenue includes customer advances under OEM licensing agreements. Additionally, maintenance revenue for application products is deferred and recognized ratably over the term of the contract, generally 12 months.

Direct costs

Direct costs include product packaging, third-party royalties, amortization of localization costs and acquired technologies, and reserves for excess and obsolete inventory.

Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. A valuation allowance is recorded to reduce tax assets to an amount whose realization is more likely than not.

Foreign currency hedging instruments

The Company enters into foreign exchange contracts to hedge its foreign currency risks. Such contracts must be effective at reducing the foreign currency risk associated with the underlying transaction being hedged and must be designated as a hedge at the inception of the contract. The Company, as a matter of policy, does not engage in speculative transactions.

The Company currently uses forward contracts as hedges of firmly committed transactions. For these contracts, mark-to-market gains and losses are recognized as other income or expense in the current period, generally consistent with the period in which the gain or loss of the underlying transaction is recognized. As of November 27, 1998, all forward foreign currency contracts entered into by the Company had maturities of 90 days or less.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Put warrants and call options

The Company utilizes put warrants and call option arrangements to facilitate the repurchase of its common stock. The puts and calls permit, at the Company's option, physical delivery or net share settlement equal to the difference between the exercise price and the value of the option as determined by the contract. Accordingly, in-the-money put warrants do not result in a liability on the balance sheet.

Net income per share

In fiscal 1998, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." Basic earnings per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of employee stock options using the treasury stock method, unvested restricted stock, and assumed net-share settlement of dilutive put warrants. All earnings per share amounts for all periods presented have been restated to conform to SFAS No. 128 requirements.

Recent accounting pronouncements

In June 1997, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 establishes standards for reporting and displaying comprehensive income and its components in the financial statements. It does not, however, require a specific format for the disclosure but requires the Company to display an amount representing total comprehensive income for the period in its financial statements. The Company will implement SFAS No. 130 in the first quarter of fiscal year 1999.

Also in June 1997, the FASB issued SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS No. 131 establishes standards for the manner in which public companies report information about operating segments in annual and interim financial statements. The Company is currently evaluating the operating segment information that it will be required to report. The Company will be required to implement SFAS No. 131 for its fiscal year 1999.

In October 1997, the American Institute of Certified Public Accountants (the "AICPA") issued Statement of Position ("SOP") 97-2, "Software Revenue Recognition." SOP 97-2, as amended by SOP 98-4, establishes standards relating to the recognition of all aspects of software revenue. Based on the Company's ongoing assessment of the impact SOP 97-2 may have on its consolidated results of operations, the Company is modifying certain aspects of its business model such that any impact will not be significant. The Company will adopt SOP 97-2 for its fiscal 1999.

In December 1998, the AICPA issued SOP 98-9, "Modifications of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions," which amends SOP 97-2 and supercedes SOP 98-4. The Company will adopt SOP 98-9 in fiscal 2000, with the exception of certain provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 which are effective December 15, 1998. The adoption of SOP 98-9 is not expected to have a significant impact on the Company.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative financial instruments and hedging activities and requires the Company to recognize all derivatives as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses resulting from changes in fair value would be accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting. The Company will be required to implement SFAS No. 133 for its fiscal year 2000. The Company has not determined the impact that SFAS No. 133 will have on its financial statements and believes that such determination will not be meaningful until closer to the date of initial adoption.

Reclassifications

Certain reclassifications were made to the fiscal 1997 and 1996 consolidated financial statements to conform to the fiscal 1998 presentation. The Company also reclassified \$3.4 million and \$3.5 million of in-process research and development charges recognized during the first half of fiscal 1998 to research and development and general and administrative expenses, respectively, for the fiscal year ending November 27, 1998 financial statements.

NOTE 2. ACQUISITIONS

During fiscal 1997, the Company acquired three software companies, in separate transactions, for an aggregate consideration of approximately \$8.5 million. These acquisitions were accounted for using the purchase method of accounting, and approximately \$6.0 million of the purchase price was allocated to in-process research and development and expensed at the time of the acquisition. One of the in-process technologies acquired for \$2.5 million was discontinued in fiscal 1998. The project associated with an additional \$2.8 million of the purchased in-process technology was canceled as part of the restructuring in the third quarter of fiscal 1998 and subsequently sold to a management-led buyout group.

During fiscal 1996, the Company acquired Ares Software for approximately \$15.5 million. The acquisition was accounted for using the purchase method of accounting, and approximately \$15.3 million of the purchase price was allocated to in-process research and development and expensed at the time of the acquisition. The value assigned to purchased in-process technology was based on a valuation prepared by an independent third-party, estimating both the cost of developing and incorporating the in-process technology into future versions of PostScript and the future cash flows from the enhanced PostScript product, using a discount factor which takes into consideration the uncertainty surrounding the successful development of the purchased in-process technology. The in-process technology was completed in fiscal 1997 and incorporated into PostScript 3.

In November 1996, the Company also acquired in-process research and development from Swell Software for approximately \$6.0 million. The research project was discontinued prior to reaching technological feasibility early in fiscal 1997.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 3. CASH EQUIVALENTS AND INVESTMENTS

All cash equivalents, short-term investments, and certain noncurrent investments consisted of the following:

	<u>As of November 27, 1998</u>			
	<u>Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>
Classified as current assets:				
Money market mutual funds	\$ 34,583	\$ —	\$ —	\$ 34,583
State and municipal bonds and notes	201,877	1,435	(63)	203,249
United States government treasury notes	3,952	7	—	3,959
Total current	<u>240,412</u>	<u>1,442</u>	<u>(63)</u>	<u>241,791</u>
Classified as noncurrent assets:				
Money market mutual funds	66,000	—	—	66,000
Total securities	<u>\$306,412</u>	<u>\$ 1,442</u>	<u>\$ (63)</u>	<u>\$307,791</u>
	<u>As of November 28, 1997</u>			
	<u>Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>
Classified as current assets:				
Money market mutual funds	\$ 53,051	\$ —	\$ —	\$ 53,051
State and municipal bonds and notes	394,295	757	(36)	395,016
Corporate and bank notes	6,400	—	—	6,400
Auction-rate securities	2,800	—	—	2,800
Equity securities	4,082	5,292	—	9,374
Total current	<u>460,628</u>	<u>6,049</u>	<u>(36)</u>	<u>466,641</u>
Classified as noncurrent assets:				
Money market mutual funds	46	—	—	46
United States government treasury notes	66,607	9	(9)	66,607
Total noncurrent	<u>66,653</u>	<u>9</u>	<u>(9)</u>	<u>66,653</u>
Total securities	<u>\$527,281</u>	<u>\$ 6,058</u>	<u>\$ (45)</u>	<u>\$533,294</u>

Approximately \$80.1 million and \$231.2 million in investments are classified as cash equivalents as of November 27, 1998 and November 28, 1997, respectively, and all noncurrent investments are included in other assets. Unrealized gains (losses) on all securities are reported as a separate component of stockholders' equity, net of taxes of \$0.6 million and \$2.4 million as of November 27, 1998 and November 28, 1997, respectively. Net realized gains for the years ended November 27, 1998 and November 28, 1997 of \$7.0 million and \$38.4 million, respectively, are included in nonoperating income.

As of November 27, 1998, the cost and estimated fair value of current debt securities and money market mutual funds with a maturity of one year or less was \$117.8 million and \$118.0 million, respectively, and the cost and estimated fair value of current debt securities with maturities ranging from one to five years were \$122.6 million and \$123.8 million, respectively.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	<u>November 27 1998</u>	<u>November 28 1997</u>
Land	\$ 7,421	\$ 782
Building	4,477	4,477
Equipment	156,324	141,067
Furniture and fixtures	28,464	21,243
Leasehold improvements	24,829	19,916
	<u>221,515</u>	<u>187,485</u>
Less accumulated depreciation and amortization	127,628	106,507
	<u>\$ 93,887</u>	<u>\$ 80,978</u>

NOTE 5. OTHER ASSETS

Other assets consisted of the following:

	<u>November 27 1998</u>	<u>November 28 1997</u>
Investments	\$ 56,332	\$ 35,689
Purchased technology and licensing agreements	3,502	5,043
Restricted funds and security deposits	130,260	102,962
Intangibles and other assets	27,527	45,097
	<u>217,621</u>	<u>188,791</u>
Less accumulated amortization	16,769	25,643
	<u>\$200,852</u>	<u>\$163,148</u>

The Company owns a minority interest in certain companies and a majority interest in Adobe Ventures L.P. and Adobe Ventures II, L.P. The limited partnership investments are accounted for under the equity method as contractually the partnerships are controlled by the general partner, a third party.

The investments in Adobe Ventures L.P. and Adobe Ventures II, L.P., which were established to enable the Company to invest in emerging technology companies strategic to Adobe's software business, totaled \$20.0 million and \$22.3 million, respectively, as of November 27, 1998 and \$18.9 million and \$6.9 million, respectively, as of November 28, 1997. The investments in the limited partnerships are adjusted to reflect the Company's share of Adobe Ventures L.P. and Adobe Ventures II, L.P.'s investment income (loss) and dividend distributions, which totaled \$346,000, \$(1.3) million, and \$17.8 million in fiscal years 1998, 1997, and 1996, respectively. Adobe Ventures L.P. and Adobe Ventures II, L.P. carry their investments in equity securities at an estimated fair market value, and unrealized gains and losses are included in investment income (loss). Substantially all of the technology companies held by the limited partnerships at November 27, 1998 are not publicly traded, and therefore, there is no established market for these investments. As such, these investments are valued based on the most recent round of financing

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 5. OTHER ASSETS (CONTINUED)

involving new non-strategic investors and estimates made by the general partner, a third party. When investments held by the limited partnerships are publicly traded, the fair value of such investments is based on quoted market prices, and mark-to-market adjustments are included in investment income.

The Company owns minority interests in certain technology companies totaling \$14.0 million and \$10.0 million as of November 27, 1998 and November 28, 1997, respectively. Investments in equity securities that are not publicly traded, or are restricted from trading for more than one year, are carried at the lower of cost or market.

At November 28, 1997 the Company held a 13% equity interest in McQueen International Limited (“McQueen”) and accounted for the investment using the cost method. Effective December 31, 1997, McQueen was acquired by Sykes Enterprises, Incorporated (“Sykes”), a publicly traded company. In connection with the acquisition, the Company exchanged its shares of McQueen for 486,676 shares of Sykes’ restricted common stock and recorded a gain on the exchange of \$6.7 million in fiscal 1998.

The Company’s portfolio of equity investments at November 27, 1998 had a cost basis of \$65.9 million and a fair market value of \$56.3 million (see Note 9).

The Company had deposited funds with a lessor as an interest-bearing security deposit totaling \$64.3 million and \$36.3 million as of November 27, 1998 and November 28, 1997, respectively. The Company also had pledged collateral with a lessor comprised of money market mutual funds totaling \$66.0 million as of November 27, 1998, and United States government treasury notes and money market mutual funds totaling \$66.7 million as of November 28, 1997 (see Note 13).

Amortization expense related to purchased technology and other intangibles was \$20.4 million and \$26.2 million in fiscal 1998 and fiscal 1997, respectively.

NOTE 6. ACCRUED EXPENSES

Accrued expenses consisted of the following:

	<u>November 27 1998</u>	<u>November 28 1997</u>
Accrued compensation and benefits	\$ 41,592	\$37,833
Sales and marketing allowances	13,439	15,965
Other	62,508	43,497
	<u>\$117,539</u>	<u>\$97,295</u>

NOTE 7. RESTRUCTURING AND OTHER CHARGES

In the third quarter of fiscal 1998, the Company implemented a restructuring program aimed at streamlining its underlying cost structure to better position the Company for growth and profitability. As part of the restructuring program, the Company implemented a reduction in force of 364 positions, four of which were executive positions, affecting mostly its North American operations. In addition to severance and related charges associated with the reduction in force, the restructuring program included charges for

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 7. RESTRUCTURING AND OTHER CHARGES (CONTINUED)

divesting two business units, vacating leased facilities, and canceling certain contracts. These actions and other non-restructuring related items resulted in charges of \$38.2 million, of which approximately \$9.1 million were non-cash charges. Of the \$28.6 million in total cash charges, \$6.2 million remains accrued at November 27, 1998.

The following table depicts the restructuring and other activity through November 27, 1998:

	Accrued Balance at November 28 1997	Total Charges (Credits)	Cash Payments	Write- downs	Accrued Balance at November 27 1998
Severance and related charges	\$ —	\$14,264	\$(13,370)	\$ —	\$ 894
Lease termination costs	—	4,526	(464)	—	4,062
Impairment of leasehold improvements at vacated facilities .	—	6,382	—	(6,382)	—
Divestiture of business units	—	5,958	—	(5,958)	—
Canceled contracts	—	6,178	(5,235)	—	943
Other charges	—	4,367	(127)	(3,964)	276
	<u>—</u>	<u>41,675</u>	<u>(19,196)</u>	<u>(16,304)</u>	<u>6,175</u>
Accrual related to previous restructuring	8,383	(3,430)	(2,261)	—	2,692
	<u>\$ 8,383</u>	<u>\$38,245</u>	<u>\$(21,457)</u>	<u>\$(16,304)</u>	<u>\$ 8,867</u>

Severance and related charges primarily include involuntary termination and COBRA benefits, outplacement costs, and payroll taxes. The terminations were comprised principally of engineering, marketing, and technical support staff and came primarily from overhead areas, divested business units, and redundant marketing activities. As of August 31, 1998, the majority of these terminations were completed. Also included in severance and related charges are expenses associated with a reduction in force in the Company's Printing and Systems business that was implemented in the first half of fiscal 1998. This reduction in force was part of the Company's initiative to refocus resources on high-growth opportunities in the printing and digital copier markets. As of November 27, 1998, the remaining accrual balance of \$0.9 million in severance and related charges consists primarily of COBRA benefits and outplacement costs and is expected to be paid by the third quarter of fiscal 1999.

Lease termination costs of \$4.5 million include remaining lease liabilities, brokerage fees, and legal fees offset by estimated sublease income related primarily to facilities in San Jose, California that were vacated as part of the restructuring program. The estimated cost of vacating these two facilities, including estimated costs to sublease, was provided by a commercial real estate brokerage firm retained by the Company. As of November 27, 1998, \$4.0 million of lease termination costs, net of anticipated sublease income, remains accrued and is expected to be utilized by the third quarter of fiscal 1999.

Charges related to the impairment of leasehold improvements at vacated facilities of \$6.4 million included the write-down of the net book value of leasehold improvements, telecommunications equipment, and a minimal amount of furniture and equipment used in the vacated facilities. Based on an

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 7. RESTRUCTURING AND OTHER CHARGES (CONTINUED)

analysis performed by a commercial real estate brokerage firm retained by the Company to sublease the facilities, the leasehold improvements and other assets specifically identified under the restructuring program as assets to be disposed of would have no future benefit to the Company as these assets would not enhance the Company's ability to sublease the facilities. Leasehold improvements consisted principally of a product demonstration room, a computer room with a raised floor, and a single building reception area, all of which would not be used by smaller tenants. Therefore, in accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," the leasehold improvements and telecommunications equipment were reported at the lower of the carrying amount or fair value less costs to sell, which was zero. As of September 30, 1998, both of these facilities were fully vacated.

Included in the restructuring charge is \$6.0 million related to the divestiture of two business units. Management and the Board of Directors approved the plan to divest of its Adobe Enterprise Publishing Services, Inc. ("AEPS") subsidiary located in Grand Rapids, Michigan, which provided tools and services to companies implementing solutions based on Adobe Acrobat, and the Image Club Graphics business ("ICG") located in Calgary, Canada, which specialized in the production, electronic distribution and marketing of visual content and typefaces, as they were no longer strategic to the the Company's future direction. The Company divested of these two business units with aggregate net assets of approximately \$6.0 million, including cash of \$3.8 million, in exchange for \$2.5 million in notes receivable and future royalties. The Company fully offset the notes receivable with an allowance for doubtful accounts due to significant uncertainties in collection. The two business units generated combined annual revenues of approximately \$25 million. Operating losses associated with these two business units were not material.

Canceled contracts of \$6.2 million included penalty fees paid to allow the Company to end contractual obligations as part of the divestiture of the ICG business unit, and the cancellation of an advertising campaign supporting the Company's brand marketing strategy, which was discontinued as part of the restructuring program. As of November 27, 1998, \$0.9 million remains accrued and is expected to be paid by the third quarter of fiscal 1999.

Also included in restructuring and other charges is \$0.5 million related to legal and public relations fees incurred in connection with the restructuring program and \$3.9 million of other charges not associated with the Company's restructuring program. The \$3.9 million charge primarily included the write-off of fixed assets resulting from an adjustment related to a physical observation of fixed assets, and the write-off of goodwill as a result of management's strategic decision to change the business and legal function of a previously acquired Japanese operation. The accounting for the write-off was in accordance with SFAS 121. As of November 27, 1998, the remaining \$0.3 million accrual balance related to legal fees associated with the divestiture of the two business units and employee terminations as part of the severance program, and will be paid in the first half of fiscal 1999.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 7. RESTRUCTURING AND OTHER CHARGES (CONTINUED)

As of November 28, 1997, approximately \$8.4 million in accrued restructuring costs remained resulting from the mergers with Aldus and Frame in fiscal 1994 and fiscal 1995, respectively. During fiscal 1998, lease payments of \$2.3 million were made against the accrual and, as a result of the renegotiation of certain facility leases and the sublease of certain facilities in fiscal 1998, \$3.4 million of the restructuring accrual related to the Aldus and Frame acquisitions was reversed in the second half of fiscal 1998. The remaining accrual of \$2.7 million at November 27, 1998 relates to lease termination costs primarily in Europe.

NOTE 8. INCOME TAXES

Income before income taxes includes net income from foreign operations of approximately \$18.8 million, \$59.3 million, and \$25.4 million for the years ended November 27, 1998, November 28, 1997, and November 29, 1996, respectively.

The provision for income taxes consisted of the following:

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Current:			
United States federal	\$34,466	\$ 42,238	\$65,118
Foreign	15,394	29,260	12,290
State and local	6,869	12,320	12,731
Total current	<u>56,729</u>	<u>83,818</u>	<u>90,139</u>
Deferred:			
United States federal	(4,312)	(1,721)	(6,825)
Foreign	(1,500)	(2,071)	(780)
State and local	(962)	(380)	(1,815)
Total deferred	<u>(6,774)</u>	<u>(4,172)</u>	<u>(9,420)</u>
Charge in lieu of taxes attributable to employee stock plans	12,595	29,607	10,828
	<u>\$62,550</u>	<u>\$109,253</u>	<u>\$91,547</u>

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 8. INCOME TAXES (CONTINUED)

Total income tax expense differs from the expected tax expense (computed by multiplying the United States federal statutory rate of approximately 35% for fiscal years 1998, 1997, and 1996 by income before income taxes) as a result of the following:

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Computed "expected" tax expense	\$58,693	\$103,632	\$85,689
State tax expense, net of federal benefit	6,068	10,301	9,819
Nondeductible write-off of acquired in-process research and development	—	1,791	5,310
Nondeductible goodwill	2,011	825	772
Tax-exempt income	(4,190)	(5,559)	(3,304)
Tax credits	(4,708)	(4,604)	(4,912)
Foreign tax rate differential	1,406	1,864	(4,003)
Other, net	3,270	1,003	2,176
	<u>\$62,550</u>	<u>\$109,253</u>	<u>\$91,547</u>

The tax effects of the temporary differences that give rise to significant portions of the deferred tax assets and liabilities as of fiscal 1998 and fiscal 1997 are presented below:

	November 27 1998	November 28 1997
Deferred tax assets:		
Acquired technology	\$14,099	\$12,720
Reserves and deferred revenue	30,655	25,511
Depreciation and amortization	—	3,558
Net operating loss carryforwards	2,171	3,260
Investments	2,988	—
Other	2,562	3,532
Total gross deferred tax assets	52,475	48,581
Deferred tax asset valuation allowance	(2,696)	(3,643)
Total deferred tax assets	<u>49,779</u>	<u>44,938</u>
Deferred tax liabilities:		
Depreciation and amortization	(1,076)	—
Investments	—	(303)
Other	(28)	(1,812)
Total deferred tax liabilities	<u>(1,104)</u>	<u>(2,115)</u>
Net deferred tax assets	<u>\$48,675</u>	<u>\$42,823</u>

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 8. INCOME TAXES (CONTINUED)

The Company provides United States income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered permanently reinvested outside the United States.

As of November 27, 1998, the Company has foreign operating loss carryovers in various jurisdictions of approximately \$2.2 million with various expiration dates. For financial reporting purposes, a valuation allowance has been established to fully offset the deferred tax assets related to foreign operating losses due to uncertainties in utilizing these losses. A valuation allowance has also been established for certain deductions related to investments. Management believes that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the net deferred tax assets.

The Company's federal tax returns have been examined by the Internal Revenue Service for all years through 1993. The Internal Revenue Service has proposed assessments that the Company is contesting in Tax Court. Management believes that any related adjustments that might be required will not have a material effect on the Company's financial position or results of operations.

NOTE 9. BENEFIT PLANS

Pretax savings plan

In 1987, the Company adopted an Employee Investment Plan, qualified under Section 401(k) of the Internal Revenue Code, which is a pretax savings plan covering substantially all of the Company's United States employees. Under the plan, eligible employees may contribute up to 18% of their pretax salary, subject to certain limitations. The Company matches approximately 25% of the first 6% of employee contributions and contributed approximately \$2.4 million, \$1.8 million, and \$1.6 million in fiscal 1998, 1997, and 1996, respectively. Matching contributions can be terminated at the Company's discretion.

Profit Sharing plan

The Company has a profit sharing plan that provides for profit sharing payments to all eligible employees following each quarter in which the Company achieves at least 70% of its budgeted earnings for the quarter. The plan, as well as the annual operating budget on which the plan is based, is approved by the Company's Board of Directors. The Company contributed approximately \$6.8 million, \$11.8 million, and \$9.9 million to the plan in fiscal 1998, 1997, and 1996, respectively.

Adobe Incentive Partners

In March 1997, as part of its venture investing program, the Company established an internal limited partnership, Adobe Incentive Partners, L.P. ("AIP"), which allows certain of the Company's executive officers to participate in cash or stock distributions from Adobe's venture investments. Adobe is both the general partner and a limited partner of AIP. Other limited partners are executive officers of the Company who are involved in Adobe's venture investing activities and whose participation is deemed critical to the success of the program.

Adobe's Class A senior limited partnership interest includes both a liquidation preference and a preference in recovery of the cost basis of each specific investment. The executives' Class B junior limited partnership interest qualifies for partnership distributions only after: (a) Adobe has fully recovered the cost

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 9. BENEFIT PLANS (CONTINUED)

basis of its investment in the specific investee company for which a distribution is made; and (b) the participating executive has vested in his or her distribution rights. The distribution rights generally vest on a monthly basis over three years, such that the rights are 25% vested after one year, 50% vested after two years, and fully vested at the end of three years. The limited partnership investments are restricted to investments in companies that are private at the time of the establishment of AIP or when the investment is made, whichever is later. Partnership interests may be allocated to designated officers only while the investee company is still private. Class B interests may not exceed a maximum of 20% of the venture investments included in AIP.

Assets held by AIP include Adobe's entire interests in Adobe Ventures L.P. and Adobe Ventures II, L.P. and equity securities of privately held companies. At November 27, 1998, the cost basis and recorded fair value of all investments included in AIP were \$65.9 million and \$56.3 million, respectively. In fiscal 1998, AIP recorded net income of \$2.2 million. The participating officers received aggregate cash distributions of \$707,000 in fiscal 1998. The amount of cash distributed to the officers represents their vested portion of investments that were liquidated by AIP. The participating officers receive quarterly cash distributions as their partnership interests vest for investments that have been liquidated by AIP. At November 27, 1998, the minority interest held by the participating officers was \$1.5 million and is included in accrued expenses on the Consolidated Balance Sheet.

NOTE 10. EMPLOYEE STOCK PLANS

Stock option plans

As of November 27, 1998, the Company has reserved 29,200,000 shares of common stock for issuance under its 1994 Stock Option Plan (the "Option Plan") for employees which provides for the granting of stock options to employees and officers at the fair market value of the Company's common stock at the grant date. Initial options granted under the Option Plan generally vest 25% after the first year and ratably thereafter such that 50% and 100% are vested after the second and third year, respectively; subsequent options granted under the Option Plan generally vest ratably over the entire term such that 50% and 100% are vested after the second and third year, respectively. Outstanding option terms under all of the Company's employee stock option plans range from five to ten years.

As of November 27, 1998, the Company has reserved, 500,000 shares of common stock for issuance under its 1996 Outside Directors Stock Option Plan, which provides for the granting of nonqualified stock options to nonemployee directors. Option grants are limited to 10,000 shares per person in each fiscal year, except for a new nonemployee director, who is granted 15,000 shares upon election as a director. All options are exercisable as vested within a ten-year term. Options generally vest over three years: 25% on the day preceding each of the next two annual meetings of stockholders of the Company and 50% on the day preceding the third annual meeting of stockholders of the Company after the grant of the option. The exercise price of the options that are issued is equal to the fair value on the date of grant. In fiscal 1998, the Company granted options for 50,000 shares with exercise prices of \$45.31 and an option for 15,000 shares to a new director with an exercise price of \$42.06. In fiscal 1997 and 1996, options for 50,000 shares were granted each year with exercise prices of \$41.94 and \$32.75, respectively.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 10. EMPLOYEE STOCK PLANS (CONTINUED)

On September 23, 1998, the Board of Directors approved a stock option repricing program whereby each eligible stock option was automatically amended to have an exercise price equal to \$33.8125. As a result, approximately 5,052,000 options were amended by eligible employees for an equal number of repriced options. All other terms of the options, including expiration dates, remain substantially the same.

On March 22, 1996, the Company offered its employees a stock option repricing program that allowed the employees to exchange on a two-for-three basis any options priced above the March 29, 1996 closing price of Adobe stock, which was \$32.25. As a result, approximately 1,252,000 options were surrendered by eligible employees for approximately 834,000 repriced options. The repriced options were not exercisable until November 1, 1996.

Stock option activity for fiscal 1998, 1997, and 1996 is presented below:

	Years Ended					
	November 27 1998		November 28 1997		November 29 1996	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, beginning of year	8,146,235	\$31.74	9,297,188	\$25.68	10,125,792	\$26.30
Granted	10,713,350	35.06	2,452,117	40.85	2,670,673	33.53
Exercised	(1,988,977)	26.17	(3,063,778)	20.29	(1,470,762)	17.37
Canceled	(6,429,788)	39.08	(539,292)	33.75	(2,028,515)	45.15
Outstanding, end of year	<u>10,440,820</u>	31.68	<u>8,146,235</u>	31.74	<u>9,297,188</u>	25.68
Exercisable, end of year	<u>4,368,318</u>	28.57	<u>4,562,954</u>	26.50	<u>6,057,500</u>	21.63
Weighted-average fair value of options granted during the year		\$13.84		\$15.68		\$12.91

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 10. EMPLOYEE STOCK PLANS (CONTINUED)

Information regarding the stock options outstanding at November 27, 1998, is summarized below.

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Shares Exercisable	Weighted Average Exercise Price
\$ 3.45	1,092	1.03 years	\$ 3.45	—	\$ 3.45
\$ 6.56 – \$ 9.50	249,598	1.34 years	8.96	249,598	8.96
\$10.13 – \$15.13	269,252	3.74 years	14.18	269,247	14.18
\$15.75 – \$23.63	395,597	2.99 years	20.62	394,292	20.62
\$23.75 – \$33.75	2,519,330	6.33 years	30.72	2,054,649	30.33
\$33.81	6,770,762	7.39 years	33.81	1,325,524	33.81
\$34.25 – \$50.75	234,349	8.08 years	43.21	74,168	46.02
\$51.75 – \$67.00	840	6.85 years	56.14	840	56.14
\$ 3.45 – \$67.00	<u>10,440,820</u>	6.75 years	\$31.68	<u>4,368,318</u>	\$28.57

Performance and Restricted Stock Plan

The Performance and Restricted Stock Plan (the “Plan”) provides for the granting of restricted stock and/or performance awards to officers and key employees. As of November 27, 1998, the Company had reserved 2,000,000 shares of its common stock for issuance under this plan. Restricted shares issued under this plan generally vest annually over three years but are considered outstanding at the time of grant, as the stockholders are entitled to dividends and voting rights. As of November 27, 1998, 59,824 shares were outstanding and not yet vested.

In fiscal 1998, 1997 and 1996, the Company granted 18,850; 129,550; and 26,750 shares of restricted stock, respectively, and the weighted-average fair value of the shares was \$41.47, \$39.04, and \$37.71, respectively.

Performance awards issued under this plan entitle the recipient to receive, at the discretion of the Company, shares or cash upon completion of the performance period subject to attaining identified performance goals. Performance awards are generally measured over a three-year period, and cliff vest at the end of the three-year period. The projected value of these awards is accrued by the Company and charged to expense over the three-year performance period. As of November 27, 1998, November 28, 1997, and November 29, 1996, performance awards for 201,870; 170,874; and 94,745 shares were outstanding, respectively, and \$(2.2) million, \$1.5 million, and \$(0.2) million was charged (credited) to expense in fiscal 1998, 1997, and 1996, respectively. In fiscal 1998, 1997, and 1996, performance awards were granted for 121,820; 156,500; and 48,965 shares, respectively, and the weighted-average fair value of the shares was \$34.48, \$39.04, and \$64.03, respectively.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 10. EMPLOYEE STOCK PLANS (CONTINUED)

Employee Stock Purchase Plan

The Company's Employee Stock Purchase Plan allows eligible employee participants to purchase shares of the Company's common stock at a discount through payroll deductions. For current offerings, the plan consists of two-year offering periods with four six-month purchase periods in each offering period; in September 1998, the Board of Directors reduced the offering periods of future offering periods to one year with two six-month purchase periods in each offering period. Employees purchase shares at 85% of the market value at either the beginning of the offering period or the end of the purchase period, whichever price is lower. As of November 27, 1998, the Company had reserved 9,500,000 shares of its common stock for issuance under this plan; and 5,253,030 shares remain available for future issuance, although 2,500,000 shares of such reserve were approved by the Board of Directors in September 1998 which are subject to the approval of the Company's stockholders at the next annual meeting.

The weighted-average fair value of the purchase rights granted in fiscal 1998, 1997, and 1996 was \$15.86, \$16.36, and \$14.01, respectively.

Pro forma fair value disclosures

The Company accounts for its employee stock plans, consisting of fixed stock option plans, an employee stock purchase plan, and a performance and restricted stock plan, using the intrinsic value method. The following table sets forth the pro forma amounts of net income and net income per share that would have resulted if the Company accounted for its employee stock plans under the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation."

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Net income:			
As reported	\$105,144	\$186,837	\$153,277
Pro forma	\$ 54,435	\$161,790	\$144,368
Net income per share:			
As reported:			
Basic	\$ 1.58	\$ 2.60	\$ 2.12
Diluted	\$ 1.55	\$ 2.52	\$ 2.04
Pro forma:			
Basic	\$ 0.82	\$ 2.25	\$ 1.99
Diluted	\$ 0.82	\$ 2.21	\$ 1.93

For purposes of computing pro forma net income, the fair value of each option grant, restricted stock grant, and Employee Stock Purchase Plan purchase right is estimated on the date of grant using the Black-

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 10. EMPLOYEE STOCK PLANS (CONTINUED)

Scholes option pricing model. The assumptions used to value the option grants and purchase rights are stated as follows:

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Expected life of options	3 years	3 years	3 years
Expected life of restricted stock	3 years	3 years	3 years
Expected life of purchase rights	1.25 years	1.25 years	1.25 years
Volatility	53%	50%	50%
Risk-free interest rate	4.2–5.7%	5.0–6.6%	5.5–6.7%
Dividend yield	0.5%	0.5%	0.5%

Options and restricted stock grants vest over several years, and new option and restricted stock grants are generally made each year. Because of this, the pro forma amounts shown above may not be representative of the pro forma effect on reported net income in future years.

NOTE 11. STOCKHOLDERS' EQUITY

Stockholder Rights Plan

The Company's Stockholder Rights Plan is intended to protect stockholders from unfair or coercive takeover practices. In accordance with this plan, the Board of Directors declared a dividend distribution of one common stock purchase right on each outstanding share of its common stock held as of July 24, 1990, and on each share of common stock issued by the Company thereafter. Each right entitles the registered holder to purchase from the Company a share of common stock at \$115. The rights become exercisable in certain circumstances including upon an entity acquiring or announcing the intention to acquire beneficial ownership of 20 percent or more of the Company's common stock without the approval of the Board of Directors or upon the Company being acquired by any person in a merger or business combination transaction. The rights are redeemable by the Company prior to exercise at \$0.01 per right and expire on July 24, 2000.

Stock Repurchase Program

In September 1997, the Board of Directors authorized, subject to certain business and market conditions, the purchase of up to 15 million shares of the Company's stock over a two-year period. This new stock repurchase program was in addition to an existing program whereby the Company has been authorized to repurchase shares to offset issuances under employee stock option and stock purchase plans. The Company repurchased approximately 10.5 million shares and approximately 6.3 million shares of its common stock in fiscal 1998 and 1997, respectively, at a cost of \$379.2 million and \$275.6 million, respectively, under its stock repurchase programs. As of November 27, 1998, management is authorized to repurchase an additional 836,000 shares under the 15 million share repurchase program. The Company has sold put warrants which will expire in the first quarter of fiscal 1999 for all but 228 of those remaining shares. In fiscal 1998, the Company reissued approximately 2.6 million treasury shares under its employee

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 11. STOCKHOLDERS' EQUITY (CONTINUED)

stock option and purchase plans. The difference between the average repurchase price of the treasury shares and the average price at which the shares are reissued is treated as an adjustment to Retained Earnings.

Prior to the Company's reincorporation in the State of Delaware in May 1997, the shares purchased were returned to the status of authorized and unissued as required by California law. The 5,175,851 shares purchased in fiscal 1997 at a cost of \$238.7 million subsequent to the Company's reincorporation are presented as treasury stock in the Stockholders' Equity section of the balance sheet.

Put warrants

To facilitate the Company's stock repurchase programs, the Company sold put warrants in a series of private placements in fiscal 1998 and 1997. Each put warrant entitles the holder to sell one share of Adobe's common stock to the Company at a specified price. Approximately 4.0 million and 4.6 million put warrants were written in fiscal 1998 and 1997, respectively. At November 27, 1998, approximately 836,000 put warrants were outstanding that expire on various dates through February 1999 with an average exercise price of \$30.30 per share.

In addition, in fiscal 1998 and 1997, the Company purchased call options that entitle the Company to buy 1.6 million and 2.3 million shares, respectively, of its common stock. At November 27, 1998, approximately 583,000 call options were outstanding that expire on various dates through February 1999 with an average exercise price of \$32.24 per share.

As part of the Company's current stock repurchase programs, the Company may, from time to time, enter into additional put warrant and call option arrangements. Under these arrangements, the Company, at its option, can settle with physical delivery or net shares equal to the difference between the exercise price and the value of the option as determined by the contract. In the future, the Company may consider other methods to acquire the Company's stock including direct purchases, open market purchases, accelerated stock purchase programs, and other potential methods.

Venture stock dividend program

In March 1997, the Company established the venture stock dividend program under which the Company may, from time to time, distribute as a dividend-in-kind shares of its equity holdings in investee companies to Adobe stockholders. In fiscal 1997, the Company dividended one share of Netscape common stock for each 100 shares of Adobe common stock held by stockholders of record on July 31, 1997. An equivalent cash dividend was paid for holdings of less than 2,500 Adobe shares and for fractional Netscape shares. Also on December 1, 1997, the Company dividended one share of Siebel common stock for each 300 shares of Adobe common stock held by stockholders of record on October 31, 1997. An equivalent cash dividend was paid for holdings of less than 7,500 Adobe shares and for fractional Siebel shares. The declaration of future dividends under this program is within the discretion of the Board of Directors of the Company and will depend upon business conditions, the Company's results of operations and financial condition, and other factors.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 12. NET INCOME PER SHARE

The Company adopted SFAS No. 128, "Earnings per Share," in the fiscal year ended November 27, 1998. All prior period share and per share amounts have been restated to comply with SFAS No. 128. Basic net income per share is computed using the weighted average number of common shares outstanding for the period, excluding unvested restricted stock. Diluted net income per share is based upon the weighted average common shares outstanding for the period plus dilutive common equivalent shares including unvested restricted common stock, stock options using the treasury stock method, and put warrants using the reverse treasury stock method.

(In thousands, except per share data)	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Net income	\$105,144	\$186,837	\$153,277
Shares used to compute basic net income per share (weighted average shares outstanding during the period, excluding unvested restricted stock)	66,433	71,962	72,454
Dilutive common equivalent shares:			
Unvested restricted stock	60	120	97
Stock options	1,481	2,055	2,581
Put warrants	—	23	—
Shares used to compute diluted net income per share	67,974	74,160	75,132
Basic net income per share	\$ 1.58	\$ 2.60	\$ 2.12
Diluted net income per share	\$ 1.55	\$ 2.52	\$ 2.04

For the years ended November 27, 1998, November 28, 1997, and November 29, 1996, options to purchase approximately 177,000; 949,000; and 492,000 shares, respectively, of common stock with exercise prices greater than the average fair market value of the Company's stock for the period of \$39.56, \$41.44 and \$38.46, respectively, were not included in the calculation because the effect would have been antidilutive.

NOTE 13. COMMITMENTS AND CONTINGENCIES

Lease commitments

The Company leases certain of its facilities and some of its equipment under non-cancelable operating lease arrangements that expire at various dates through 2015. Rent expense for these leases aggregated \$22.1 million, \$17.8 million, and \$18.3 million during fiscal 1998, 1997, and 1996, respectively. As of November 27, 1998, future minimum lease payments under noncancelable operating leases, net of sublease income, are as follows: 1999—\$21.1 million; 2000—\$16.7 million; 2001—\$14.9 million; 2002—\$3.3 million; 2003—\$2.9 million; and \$10.1 million thereafter.

Included in the future minimum lease payments are the following amounts for leased facilities vacated in connection with the Restructuring plan implemented in the third quarter of fiscal 1998: 1999—

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 13. COMMITMENTS AND CONTINGENCIES (CONTINUED)

\$4.0 million; 2000—\$2.1 million; 2001—\$2.2 million; 2002—\$2.3 million; 2003—\$2.3 million and \$7.3 million thereafter. These amounts, net of anticipated sublease income, are included in accrued restructuring costs at November 27, 1998.

Real estate development agreement

During 1994, the Company entered into a real estate development agreement and an operating lease agreement in connection with the construction of a headquarters office facility. In August 1996, the construction was completed, and the operating lease commenced. The Company will have the option to purchase the facility at the end of the lease term in October 2001. In the event the Company chooses not to exercise this option, the Company is obligated to arrange for the sale of the facility to an unrelated party and is required to pay the lessor any difference between the net sales proceeds and the lessor's net investment in the facility, in an amount not to exceed that which would preclude classification of the lease as an operating lease, approximately \$57.3 million. Pursuant to the agreement, the Company was required to pledge certain interest-bearing instruments to the lessor as collateral to secure the performance of its obligations under the lease. As of November 27, 1998, the Company's collateral under this agreement totaled \$66.0 million in money market mutual funds. These funds are included in "Other assets" on the Consolidated Balance Sheet.

In 1996, the Company exercised its option under the development agreement to begin a second phase of development for an additional office facility. In August 1996, the Company entered into a construction agreement and an operating lease agreement for this facility. The construction was completed and the operating lease commenced in August 1998. The Company will have the option to purchase the facility at the end of the lease term in August 2003. In the event the Company chooses not to exercise this option, the Company is obligated to arrange for the sale of the facility to an unrelated party and is required to pay the lessor any difference between the net sales proceeds and the lessor's net investment in the facility, in an amount not to exceed that which would preclude classification of the lease as an operating lease, approximately \$64.3 million. The Company was required to deposit funds with the lessor as an interest-bearing security deposit pursuant to its obligations under the lease. As of November 27, 1998, the Company's deposits under this agreement totaled approximately \$64.3 million. These deposits are included in "Other assets" on the Consolidated Balance Sheet.

During 1998, the Company entered into a real estate development agreement for the construction of an office building in Edinburgh, Scotland. As of November 27, 1998, the Company has paid \$11.5 million for land, fees, and construction costs. The expected completion date of the building is August 1999.

Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense was approximately \$25.3 million, \$25.0 million, and \$19.8 million in fiscal 1998, 1997, and 1996, respectively.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 13. COMMITMENTS AND CONTINGENCIES (CONTINUED)

Legal actions

The Company is engaged in certain legal actions arising in the ordinary course of business. The Company believes it has adequate legal defenses and that the ultimate outcome of these actions will not have a material effect on the Company's financial position and results of operations.

NOTE 14. TRANSACTIONS WITH AFFILIATE

At November 28, 1997, the Company held a 13% equity interest in McQueen International Limited ("McQueen") and accounted for the investment using the cost method. During 1994, the Company entered into various agreements with McQueen, whereby the Company contracted with McQueen to perform product localization and technical support functions and to provide printing, assembly, and warehousing services.

Effective December 31, 1997, McQueen was acquired by Sykes Enterprises, Incorporated ("Sykes"), a publicly traded company. In connection with the acquisition, the Company exchanged its shares of McQueen for 486,676 shares of Sykes' restricted common stock and recorded a gain on the exchange of \$6.7 million in fiscal 1998. Later in fiscal 1998, these shares were sold at a minimal gain. The Company makes minimum annual payments to Sykes/McQueen for certain services, which amounted to \$2.4 million, \$5.2 million, and \$4.8 million in fiscal 1998, 1997, and 1996, respectively. Purchases from Sykes/McQueen, during the period in which they were an affiliate of the Company, amounted to \$15.7 million, \$35.0 million, and \$34.3 million for fiscal 1998, 1997, and 1996, respectively.

NOTE 15. FINANCIAL INSTRUMENTS

Fair value of financial instruments

The Company's cash equivalents, short-term investments, restricted funds, and marketable equity securities are carried at fair value, based on quoted market prices for these or similar investments (see Note 3).

The Company's portfolio of equity investments at November 27, 1998 had a cost basis of \$65.9 million and a fair market value of \$56.3 million (see Note 5).

Foreign currency hedging instruments

The Company enters into forward exchange contracts to hedge foreign currency exposures on a continuing basis for periods consistent with its committed exposures. These transactions do subject the Company to risk of accounting gains and losses; however, the gains and losses on these contracts offset gains and losses on the assets, liabilities, and transactions being hedged. The Company is exposed to credit-related losses in the event of nonperformance by the counterparties in these contracts. These contracts generally have maturities of less than three months, and the amounts of unrealized gains and losses are immaterial. As of November 27, 1998 and November 28, 1997, the Company held \$19.8 million and \$1.9 million, respectively, of aggregate foreign currency forward exchange contracts for the sale of the Japanese yen. As of November 27, 1998 the Company held \$12.5 million in option contracts also for the sale of Japanese yen.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 15. FINANCIAL INSTRUMENTS (CONTINUED)

Concentration of risk

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily cash, cash equivalents, short-term investments, and accounts receivable.

The Company's investment portfolio consists of investment-grade securities diversified among security types, industries, and issuers. The Company's investments are managed by recognized financial institutions that follow the Company's investment policy. The Company's policy limits the amount of credit exposure to any one issue or issuer, and the Company believes no significant concentration of credit risk exists with respect to these investments.

Credit risk in receivables is limited to OEM customers and to dealers and distributors of hardware and software products to the retail market. The Company adopts credit policies and standards to keep pace with the evolving software industry. Management believes that any risk of accounting loss is significantly reduced due to the diversity of its products, end users, and geographic sales areas. The Company performs ongoing credit evaluations of its customers' financial condition and requires letters of credit or other guarantees, whenever deemed necessary.

A significant portion of the Company's licensing revenue is derived from a small number of OEM customers. The Company's OEM customers on occasion seek to renegotiate their royalty arrangements. The Company evaluates these requests on a case-by-case basis. If an agreement is not reached, a customer may decide to pursue other options, which could result in lower licensing revenue for the Company. Also, in the fall of 1997, one of Adobe's largest PostScript customers, Hewlett-Packard Company, introduced a clone version of Adobe PostScript in one family of monochrome laser printers.

Industry segment

Adobe and its subsidiaries operate in one dominant industry segment, as defined by SFAS No. 14, "Financial Reporting for Segments of a Business Enterprise." The Company is engaged principally in the design, development, manufacture, and licensing of computer software. In fiscal 1998, sales of application products to a major distributor accounted for 13.5% of the Company's total revenue and 14.4% of total receivables. No customer accounted for more than 10% of the Company's total revenue or total receivables in fiscal 1997 or 1996.

ADOBE SYSTEMS INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Continued)

NOTE 16. FOREIGN OPERATIONS

Geographic information for each of the years in the three-year period ended November 27, 1998, is presented below:

	Years Ended		
	November 27 1998	November 28 1997	November 29 1996
Revenue:			
North America	\$ 667,566	\$ 606,633	\$ 526,251
Europe	249,407	226,557	134,879
Japan and Asia Pacific and Latin America	192,145	222,911	176,490
Eliminations	<u>(214,327)</u>	<u>(144,207)</u>	<u>(51,057)</u>
	<u>\$ 894,791</u>	<u>\$ 911,894</u>	<u>\$ 786,563</u>
Operating income:			
North America	\$ 21,928	\$ 87,035	\$ 31,186
Europe	5,189	69,371	16,408
Japan and Asia Pacific and Latin America	119,208	135,657	103,002
Eliminations	<u>(20,978)</u>	<u>(61,307)</u>	<u>(3,810)</u>
	<u>\$ 125,347</u>	<u>\$ 230,756</u>	<u>\$ 146,786</u>
Identifiable assets:			
North America	\$ 758,440	\$ 923,704	\$1,015,065
Europe	105,172	79,291	67,506
Japan and Asia Pacific and Latin America	28,968	32,161	22,102
Eliminations	<u>(125,249)</u>	<u>(95,085)</u>	<u>(103,280)</u>
	<u>\$ 767,331</u>	<u>\$ 940,071</u>	<u>\$1,001,393</u>

NOTE 17. SUBSEQUENT EVENTS

On January 4, 1999, the Company announced the acquisition of substantially all of the assets, including primarily intellectual property, of both GoLive Systems, Inc., a Delaware corporation, and GoLive Systems GmbH and Co. KG, a German limited partnership, for approximately \$31.0 million, plus additional contingency payments based on achieving certain technical and employment milestones totaling \$8.0 million. The acquisition will be accounted for under the purchase method of accounting in accordance with Accounting Principles Board Opinions No. 16.

FINANCIAL STATEMENT SCHEDULE

As required under Item 8, Financial Statements and Supplementary Data, the financial statement schedule of the Company is provided in this separate section. The financial statement schedule included in this section is as follows:

Schedule Number	Financial Statement Schedule Description
Schedule II	Valuation and Qualifying Accounts

ADOBE SYSTEMS INCORPORATED
SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
(In thousands)

**Valuation and Qualifying Accounts which are Deducted in the
Balance Sheet from the Assets to which They Apply**

	<u>Balance at Beginning of Period</u>	<u>Charged to Operating Expenses</u>	<u>Deductions</u>	<u>Balance at End of Period</u>
Allowance for doubtful accounts:				
Year Ended:				
November 27, 1998	\$3,634	\$3,336	\$ 571	\$6,399
November 28, 1997	\$5,196	\$ (440)	\$1,122	\$3,634
November 29, 1996	\$3,698	\$1,927	\$ 429	\$5,196

Deductions related to the allowance for doubtful accounts represent amounts written off against the allowance.

EXHIBITS

As required under Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K, the exhibits filed as part of this report are provided in this separate section. The exhibits included in this section are as follows:

Exhibit Number	Exhibit Description
10.48	Letter of Release and Waiver
21	Subsidiaries of the Registrant
23	Consent of Independent Auditors
27.1	Financial Data Schedule
27.2	Financial Data Schedule
27.3	Financial Data Schedule

ADOBE SYSTEMS INCORPORATED
EXHIBIT 21
SUBSIDIARIES OF THE REGISTRANT

<u>Subsidiary Legal Name</u>	<u>Jurisdiction of Incorporation</u>
The Americas:	
Adobe Systems FSC, Inc.	Territory of Guam
Frame International, Inc.	Delaware
Sandcastle, Inc.	California
Europe:	
Adobe Systems Europe Ltd.	United Kingdom
Adobe Systems Direct Ltd.	United Kingdom
Adobe Systems Nordic AB	Sweden
Adobe Systems Benelux BV	The Netherlands
Adobe Systems GmbH	Federal Republic of Germany
Adobe Systems Software AG	Switzerland
Adobe Systems France EURL	France
Adobe Systems Italia SRL	Italy
Adobe Systems Informatica	Spain
Adobe Systems Norge AS	Norway
Adobe Systems Danmark AS	Denmark
Adobe Systems U.K., Ltd.	United Kingdom
Frame Technology International Limited	Ireland
Japan:	
Adobe Systems Company Ltd.	Japan
Adobe Systems Japan, Inc.	California
Asia Pacific and Latin America:	
Adobe Systems Pty. Ltd.	Australia
Adobe Systems India Pvt. Ltd.	India
Adobe Systems Korea Ltd.	Korea
Adobe Systems Pte. Pty.	Singapore
Adobe Systems Brasil Limitada	Brazil

All subsidiaries of the registrant are wholly owned, directly or indirectly, and do business under their legal names.

ADOBE SYSTEMS INCORPORATED

EXHIBIT 23

CONSENT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders of Adobe Systems Incorporated:

We consent to the incorporation by reference in the Registration Statements (No. 33-10753, No. 33-18986, No. 33-23171, No. 33-30976, No. 33-36501, No. 33-38387, No. 33-48210, No. 33-63518, No. 33-78506, No. 33-83030, No. 33-83502, No. 33-83504, No. 33-84396, No. 33-86482, No. 33-59335, No. 33-63849, No. 33-63851, No. 333-28195, No. 333-28203, No. 333-28207 and No. 333-57589) on *Form S-8* of Adobe Systems Incorporated of our report dated December 14, 1998, relating to the consolidated balance sheets of Adobe Systems Incorporated and subsidiaries as of November 27, 1998 and November 28, 1997, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended November 27, 1998, and related schedule, appearing on page 40 of this *Form 10-K*.

KPMG LLP

Mountain View, California
February 16, 1999

(This page has been left blank intentionally.)

