

*Adobe
Systems
Incorporated*



Annual Report 1986

Corporate Profile

Adobe Systems Incorporated designs, develops and markets systems software used in laser printers, typesetters and other raster output devices to print integrated text and graphics for high quality electronic printing and publishing applications. The Company's principal product, the POSTSCRIPT language interpreter, executes page descriptions generated from applications programs that support the POSTSCRIPT language to produce documents containing multiple typefaces and graphics, including charts, diagrams, drawings and photographic images. Because the POSTSCRIPT page description language is device independent, applications programs that have been written to support POSTSCRIPT can be used interchangeably with any printer that contains a POSTSCRIPT interpreter, from inexpensive, low resolution raster printers to extremely high resolution typesetters.

Financial Highlights

(In thousands except per share and ratio data)

Year Ended November 30,

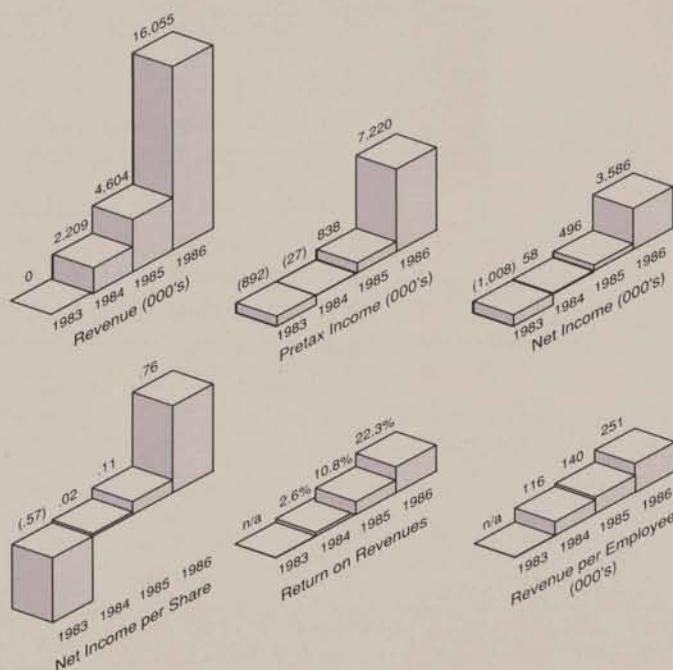
Income Statement	1986	1985	1984	1983
Revenue	\$ 16,055	4,604	2,209	—
Income (loss) before income taxes	7,220	838	(27)	(892)
Net income (loss)	3,586	496	58	(1,008)
Net income (loss) per share	.76	.11	.02	(.57)
Shares used in per share computation	4,728	4,532	3,610	1,758

Balance Sheet

Working capital	\$ 11,474	3,148	3,263	947
Total assets	20,016	6,074	4,543	1,781
Shareholders' equity	13,719	4,646	4,150	1,562

Key Ratios

Current ratio	3.2	3.8	9.3	6.4
Return on revenue	22.3%	10.8%	2.6%	n/a
Revenue per employee	\$ 251	140	116	—



To Our Shareholders

The year 1986 was eventful for the printing and publishing industry and a year of growth for Adobe Systems Incorporated. In almost every computer industry show, conference and trade magazine, the term "Desktop Publishing" became commonplace. This term is used to characterize a rapidly growing group of computer systems and programs that have changed the way printed material is produced in business. This new use of personal, mini and mainframe computers is penetrating almost every aspect of business communication.

Adobe Systems is participating as a strategic component in this rapidly growing market. Our activity is focused in three key areas.

Adobe's POSTSCRIPT® page description language, is being adopted by a growing number of companies for use in their laser printers. POSTSCRIPT's widespread use is making it a *de-facto* standard for controlling laser printers. Seventeen different printers incorporating POSTSCRIPT interpreters are now offered by thirteen companies. Additionally, the language is supported by more than 180 software firms.

Adobe Systems also develops a variety of character styles (typefaces) that are used with laser printers. Because of the large installed base of POSTSCRIPT machines, and our aggressive typeface development schedule, Adobe's business of supplying typefaces to users is growing at a steady rate. This technically difficult and time consuming expansion of our library is also increasing the barrier to entry for companies with competitive language interpreters.

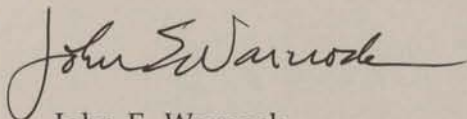
This last year we developed cheaper and faster printer controller designs for use by our customers. We organized our internal development systems so that we can bring customers to market in a more timely manner. And we implemented a variety of printer controller emulators for use with POSTSCRIPT interpreters in our customers' machines.

We have also increased our research and development aimed at new products and technologies. This development effort will diversify our business base, but will also strengthen our current activities.

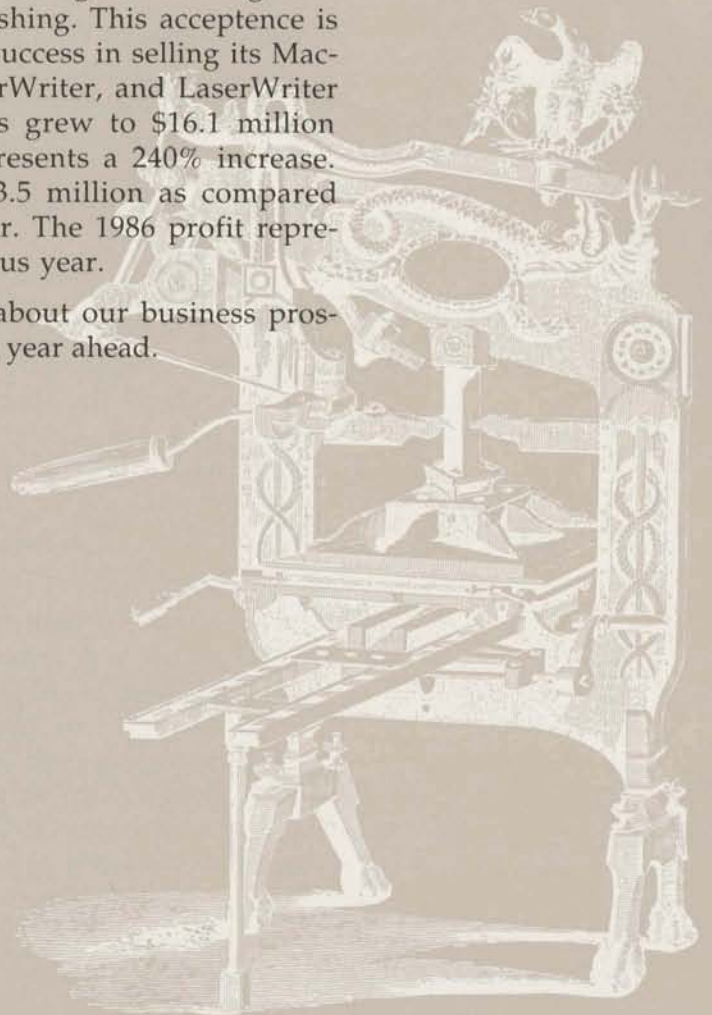
In 1984 XEROX announced Interpress, a competing language to POSTSCRIPT. Although XEROX has delivered a reduced-functionality version of Interpress on a few machines, we believe that the presently available level of Interpress does not compete effectively with POSTSCRIPT. In 1986 Imagen announced DDL, another competing language. This company has not as yet delivered a product to the marketplace. We expect, however, that Imagen's customer, Hewlett Packard, will ship machines in the first half of calendar 1987.

Although the general computer market has experienced a slowdown during 1986, our business has grown through the buyer's acceptance of Desktop Publishing. This acceptance is due primarily to Apple Computer's success in selling its Macintosh computer along with its LaserWriter, and LaserWriter Plus printers. In 1986 our revenues grew to \$16.1 million from \$4.6 million in 1985. This represents a 240% increase. Our net income in 1986 grew to \$3.5 million as compared with \$.5 million in the previous year. The 1986 profit represents a 623% increase over the previous year.

We at Adobe Systems feel positive about our business prospects, and look forward to an exciting year ahead.



John E. Warnock
President, and Chief Executive Officer



POSTSCRIPT

The majority of Adobe's revenue comes from the POSTSCRIPT family of products. POSTSCRIPT is a software system that is configured into the controlling computer built inside a laser printer. This software is responsible for accepting commands, from an application program, describing the appearance of the page, converting those commands into a digital image formatted for the printer, and controlling the printer to produce the image onto paper. The most popular printers incorporating this software are the Apple LaserWriter, and LaserWriter Plus. Other announced printers using POSTSCRIPT include the Agfa-Gevaert P400PS, Apollo Domain/Laser 26, Dataproducts LZR-2665, DEC PrintServer 40, Diconix Dijit 1/PS, ITT Qume ScriptTEN, The Laser Connection PS Jet, Linotype 100 and 300, NEC SilentWriter LC-890, NBI Model 908, QMS PS800 and PS2400, and the Texas Instruments OMNILASER 2108 and 2115.

Adobe licenses POSTSCRIPT to each of its customers on a royalty basis. i.e. For each printer incorporating the POSTSCRIPT interpreter the customer sells, a royalty is paid to Adobe. Currently 13 different companies offer a total of 17 different POSTSCRIPT printers in the marketplace. These printers cover a broad spectrum of resolutions, speeds, and paper formats.

Over the past four years the POSTSCRIPT implementation has evolved through several phases of development. The years 1983-84 were spent designing and developing the initial concepts behind the first implementations of the technology. During the first stage of development the techniques used to size characters over a variety of typefaces were invented. From the beginning, the implementation was engineered in anticipation of a variety of different controller configurations and a broad range of output devices.

In 1985 the first high volume POSTSCRIPT product, the Apple LaserWriter, was announced. During the year, Adobe broadened its base of support for the POSTSCRIPT page description language by extending the implementation to configurations that drive both high resolution typesetters and a variety of different print engines. To facilitate the adoption of POSTSCRIPT by its OEM customers and to minimize the product development cycle, Adobe undertook the design of a family of controllers well suited to driving laser printers

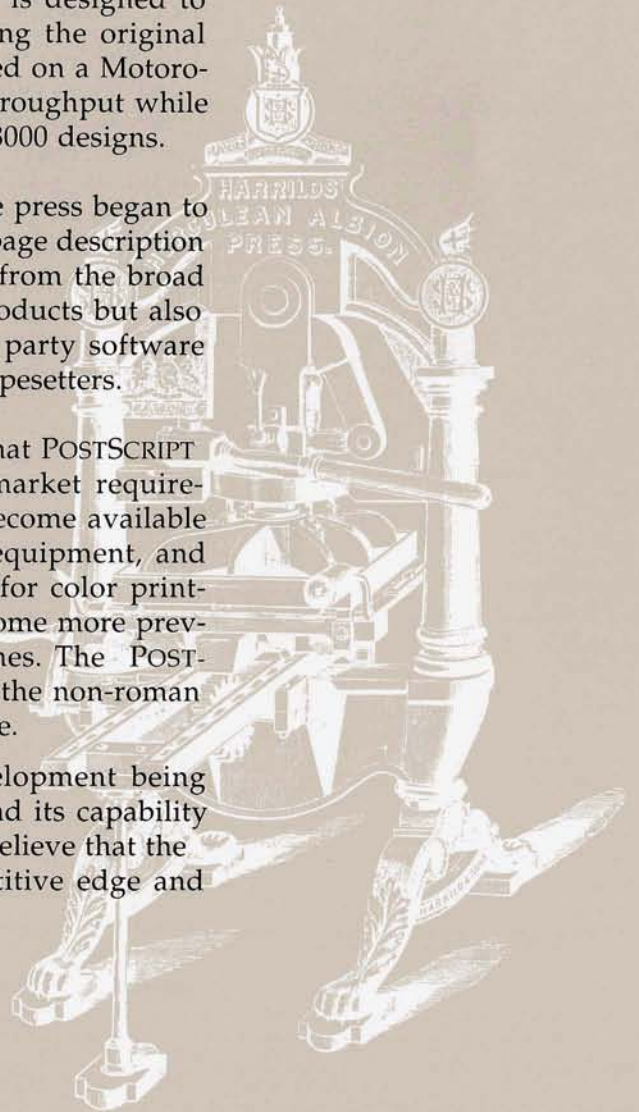
and typesetters. Early in 1985 Adobe made its first printer controller design, based on a Motorola 68000, available to its customers for use in their printers. This original controller design and its successors are now used in the majority of POSTSCRIPT printing systems.

1986 was a year dedicated to increasing the performance of POSTSCRIPT and to reducing the controller costs associated with printer configurations. The software performance of POSTSCRIPT has been substantially increased. In many cases, especially those involving scanned images, performance bottlenecks have been reduced or eliminated. In addition, Adobe Systems introduced in 1986 two new controller designs. One controller, a second generation 68000 design, is designed to minimize the hardware cost while maintaining the original performance goals. The second controller, based on a Motorola 68020 processor, is designed to maximize throughput while maintaining the basic compatibility with the 68000 designs.

During 1986, the printing and publishing trade press began to refer to POSTSCRIPT as the *de-facto* standard of page description languages. This observation results not only from the broad range of companies that offer POSTSCRIPT products but also from the ever-growing support base of third party software packages that drive POSTSCRIPT printers and typesetters.

As we look forward into 1987, we anticipate that POSTSCRIPT products will expand to meet several new market requirements. First, color imaging technology will become available in direct hardcopy devices, in slide-making equipment, and in imagesetters that can produce separations for color printing. Network based printing services will become more prevalent as will higher speed POSTSCRIPT machines. The POSTSCRIPT font technology will be expanded into the non-roman alphabets, most notably to Japanese and Chinese.

Because of Adobe's extensive on going development being performed on the POSTSCRIPT system to expand its capability and keep it abreast of current technology, we believe that the POSTSCRIPT product will maintain its competitive edge and enhance its leadership position.



Typeface Development

At Adobe Systems we believe that developing a large library of high quality typefaces is a very important factor in making the POSTSCRIPT page description language a standard. The availability of a large quantity and variety of typefaces is as important for the Desktop Publishing market as it is for the traditional publishing market.

Adobe Systems continues to make a significant investment in typeface development. During 1986 the Adobe Type Library grew to over 100 typefaces. Many of these typefaces are licensed from the world's leading type suppliers such as Allied Corporation Linotype Group, International Typeface Corporation, Esselte Letraset, and Fundación Tipographica Neufville, and Bigelow & Holmes. Adobe has also developed several new typeface designs during 1986.

Our strategy in developing fonts for the Adobe Type Library is to select typefaces for a broad range of applications. The Adobe Type Library includes text typefaces for books, magazines, newspapers, and newsletters; display typefaces for advertising, promotional materials, headlines; technical and mathematical typefaces; a music composition typeface; signs and symbols for map making; and others. During fiscal 1986 Adobe laid the groundwork for licensing and producing a number of non-Latin typefaces such as Hebrew, Arabic, and Japanese, several of which will become available during fiscal 1987.

The first printers incorporating POSTSCRIPT interpreters contained built-in fonts stored in ROM. In April 1986 Adobe shipped its first downloadable fonts for PostScript printers. These fonts are for use in the Macintosh environment, and can be used on a single printer or typesetter. In December 1986 the first multiple (1 to 5 printer) versions of the downloadable fonts were shipped. The downloadable font sales have shown a strong and steady growth. Sales of downloadable fonts, built-in fonts, and Adobe's TRANSCRIPT™ product accounted for \$2.7 million in revenue for Adobe in fiscal 1986. Downloadable font products for use in the IBM-PC market are expected to be introduced in fiscal 1987.

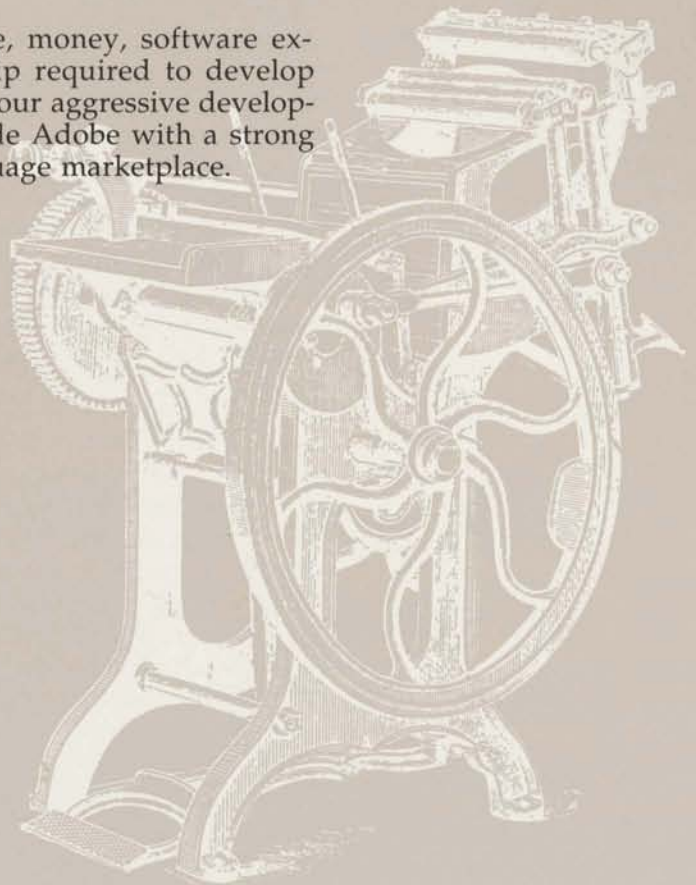
Historically, a font was a product which was limited to use on a single kind of machine, and frequently to a single point size. Adobe's POSTSCRIPT typefaces can be used on all machines with a POSTSCRIPT interpreter regardless of resolution. Each typeface produces characters at an unlimited number of different sizes, rotations, and transformations.

This means that the same typeface will produce a high quality image on a typesetter with a resolution of more than 2500 dots per inch, a laser printer with a resolution of 300 dots per inch, and all resolutions in between.

In order to produce quality typefaces that have this flexibility we have gathered a team of skilled type designers who work in close cooperation with the computer scientists at Adobe. The tools that these typographers use – computer terminals and software – are very different from the tools used by earlier craftsmen, but the commitment to craftsmanship at Adobe continues a long standing tradition in the design and production of fine typefaces.

Each typeface contains a large character set conforming to the International Standards Organization guidelines. The characters are finely tuned by type designers so that they will produce good results over a wide range of resolutions. Along with each typeface Adobe also produces fonts for display screens. These are "bitmap" fonts that have been hand tuned to be legible at display screen resolutions. They are included in multiple point sizes with each typeface product.

The considerable investment of time, money, software expertise, and traditional craftsmanship required to develop the present Adobe Type Library, and our aggressive development schedule have helped to provide Adobe with a strong position in the page description language marketplace.



Research and development at Adobe is concentrated on solving problems in order to bring new products to market. Adobe's strategy is to identify market needs, solve the technical and marketing requirements to satisfy the needs, and then develop products to enter the market. This simple strategy has yielded Adobe's first end-user application product, Adobe Illustrator™. This strategy is also resulting in a product direction for system display software. These new product areas, we believe, will result in considerable strengthening of Adobe's business position.

Adobe Illustrator is a Macintosh application software product that is a highly productive tool for serious illustrators. The product was announced in January 1987, and we anticipate that we will commence shipment in March 1987. We believe that Adobe Illustrator satisfies a great need in the printing and publishing industry for an easy way to produce high quality line art.

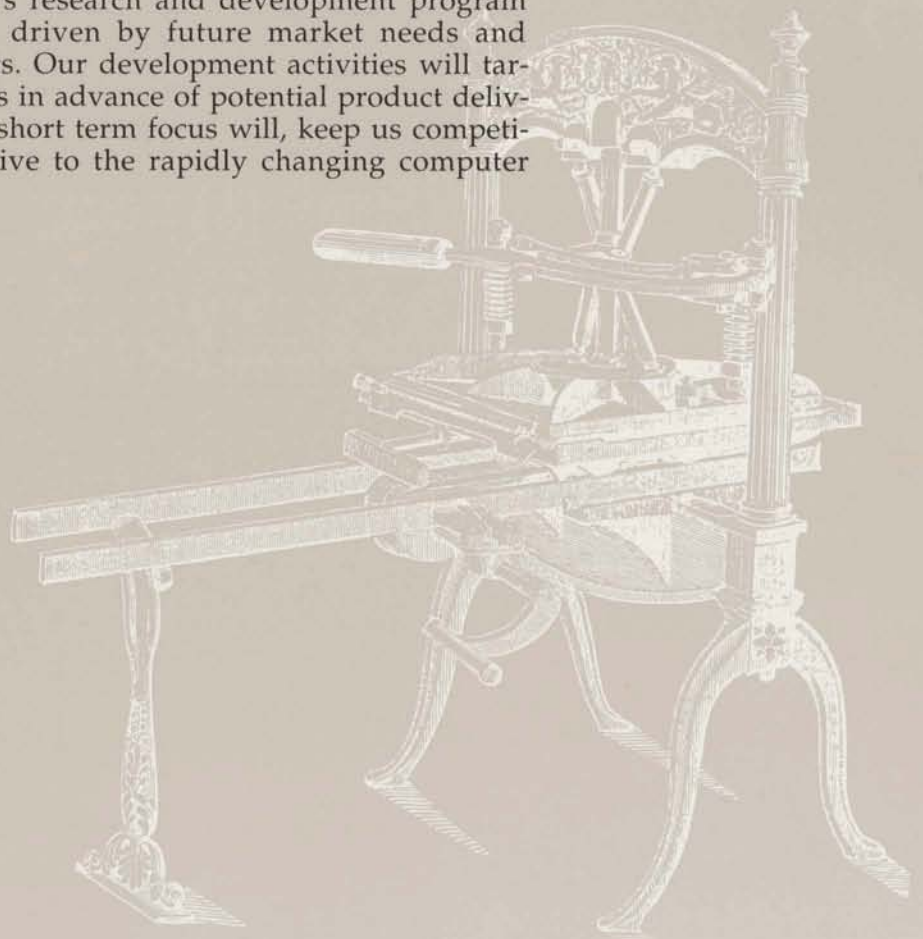
To date most illustration programs intended for the personal computer market fall into one of two categories. There are the "paint" style programs, and there are the "object" oriented programs. "Paint" style programs dictate that the user construct a fixed, resolution dependent "bit map" image through sketching with a mouse. These images have a very characteristic appearance. They are rough images made up of little black squares that produce jagged lines, tints, and patterns. These programs are unsatisfactory for serious illustration work because of the primitive, stylized look of the illustrations that result, and the large size of the files they produce. "Object" oriented programs solve the problem of jagged appearance and large file size, but are typically difficult to use. They restrict the kinds of illustrations that can be created because they are limited to produce only what the underlying computer graphics system will allow.

Adobe Illustrator is an "object" style program that has several advantages over existing products. Once a user is accustomed to the interface, the product is easy to use. Illustrator uses the powerful POSTSCRIPT graphics functions as its underlying graphics system. This allows the program to produce a wide variety of quality images not possible with other systems. The object oriented nature of Adobe Illustrator, combined with the fact that it produces POSTSCRIPT files as its output, make it an ideal program for constructing large

data bases of editable illustrations. Also, Adobe Illustrator files can be used in conjunction with most other Desktop Publishing applications. We believe these advantages will enhance the likelihood of Adobe Illustrator's success in the marketplace.

Another area of advanced development at Adobe Systems concerns the use of POSTSCRIPT's powerful imaging model to drive personal computer and higher-end workstation displays. Our customers have observed that printers containing POSTSCRIPT interpreters have the ability to print many kinds of images that are difficult to display on their graphics screens. For this reason there has been considerable interest among our customers in providing POSTSCRIPT-like support for displays. This support might take several forms as dictated by customer requirements. Adobe's development in this area will increase during fiscal 1987 and Adobe anticipates that its first products in this area will be introduced in, fiscal 1988.

In summary, Adobe's research and development program will continue to be driven by future market needs and product requirements. Our development activities will target one to three years in advance of potential product delivery. We believe this short term focus will, keep us competitive in, and responsive to the rapidly changing computer industry.



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Management's Discussion and Analysis of Financial Condition and Results of Operations

The following table sets forth items from the Consolidated Statements of Income as a percentage of total revenue for the fiscal periods indicated:

	Percentage of Revenue Year Ended November 30,			Percentage Change Year Ended November 30,	
	1986	1985	1984	1985 to 1986	1984 to 1985
Revenue:					
Royalties	76.0%	73.3%	—%	261.6%	n/a
Product sales and enhancements	16.7	8.6	—	579.0	n/a
Contract revenue	7.3	18.1	100.0	40.5	(62.2)
Total revenue	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	248.7	108.4
Costs and expenses:					
Direct costs	10.0	5.8	—	502.2	n/a
Research, development and contract costs	17.6	37.7	64.3	62.6	22.1
Sales, marketing and customer support	22.2	27.5	22.3	181.1	157.5
General and administrative	7.4	15.1	20.7	71.4	52.3
Total costs and expenses	<u>57.2</u>	<u>86.1</u>	<u>107.3</u>	131.7	67.3
Operating income (loss)	<u>42.8</u>	<u>13.9</u>	<u>(7.3)</u>	976.2	n/a
Interest income	2.2	4.3	6.1	77.0	49.3
Income (loss) before income taxes	<u>45.0</u>	<u>18.2</u>	<u>(1.2)</u>	761.6	n/a
Income tax expense (benefit)	22.6	7.4	(3.8)	962.6	n/a
Net income	<u>22.4%</u>	<u>10.8%</u>	<u>2.6%</u>	623.0%	755.2%

Results of Operations

Net revenue for the years ended November 30, 1986, 1985 and 1984 were \$16.1 million, \$4.6 million and \$2.2 million, respectively. In 1984 contract revenue made up all of the Company's revenue, of which \$1,500,000 came from Apple Computer. The balance of contract revenue in that year and the following years was received under agreements with other OEM customers.

Product sales and enhancements revenue has been generated by TRANSCRIPT which was introduced in 1985, by POSTSCRIPT compatible typefaces, which were first introduced in April 1986, by typeface upgrade kit royalties received from Apple, and royalties from book sales.

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In mid-fiscal 1985 Apple Computer began shipments of its LaserWriter printer, the first laser printer utilizing POSTSCRIPT. To date, substantially all of the royalty revenues, which increased from \$3.4 million in 1985 to \$12.2 million in 1986, have been received from Apple. In fiscal 1987 the Company expects that royalties from other OEM customers will increase, resulting in a decrease in the percentage that Apple's royalties comprise of total royalty revenues.

Revenue increases from 1984 to 1986 are attributable to the Company emerging from its research and development stage to the commercial use of its products: POSTSCRIPT, TRANSCRIPT and typefaces.

Royalty revenue from the POSTSCRIPT license with Apple has been the primary revenue growth area as the LaserWriter has gained wide-spread acceptance in the desktop publishing market. In 1986 revenue growth was further enhanced by the introduction of POSTSCRIPT compatible typefaces for the Apple Macintosh computer. The Company anticipates that royalty revenue from POSTSCRIPT licenses with other OEM customers will be the primary revenue growth area in fiscal 1987.

Direct costs consist primarily of royalties paid to third parties for their typeface styles which are incorporated in the POSTSCRIPT interpreter, distributed as enhancements to OEMs and distributed on diskettes to end users. Other direct costs beginning in fiscal 1986 consist of packaging materials for end user typeface sales and the amortization of typeface production costs (see Note 1 to the Consolidated Financial Statements). No direct costs were incurred in 1984 as no royalty or typeface sale revenue was recognized. As royalty revenue was generated in 1985, royalty costs for typeface licenses were incurred. In 1986 direct packaging costs began to be incurred as downloadable typeface packages were first shipped. Consistent with the Company's accounting policies, amortization of capitalized typeface production costs commenced when the typefaces involved were released for sale. The increase in direct costs between 1985 and 1986 reflects these facts and is a function of the increased revenue generated in 1986.

Research, development and contract costs increased by 62.6% from 1985 to 1986 and 22.1% from 1984 to 1985. Research, development and contract costs have increased as a result of planned software development staff increases and expenditures to meet the technical demands of an increasing customer base and new product development efforts. The Company expects expenses in this area to continue to grow as a result of planned increases in the development staff to handle growth and new product development.

Sales and marketing expenses were \$3.6 million, \$1.3 million and \$.5 million in 1986, 1985 and 1984. The Company increased its activity during these periods in all areas of sales, marketing and customer support. Additional staff was added in all areas and particularly in customer support to service the growing installed base of POSTSCRIPT equipped printers and to provide training for customers and for third party software developers. In addition, marketing communication expenses increased because of higher levels of advertising, public relations, trade show participation and new product introduction expenses.

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Sales, marketing and customer support expenses will continue to increase in fiscal 1987 to service the growing number of customers, and to sell and market the Company's new Adobe Illustrator graphics product. The Company also plans to open a regional sales office in the Boston area to better service its East coast customer base.

During 1986, 1985 and 1984 general and administrative expenses were \$1.2 million, \$.7 million and \$.5 million. Growth in these expenses is attributable to expansion in the Company and additions to personnel, necessitating more administrative expenses such as insurance, benefits, and expanded facilities. The Company expects administrative expenses to increase to keep pace with the addition of new personnel.

Non-operating income of \$354,000, \$200,000 and \$134,000 for the years ended November 30, 1986, 1985 and 1984, consists almost entirely of interest income on short term investments and is a function of the average cash and cash equivalent balances held by the Company during the year.

The 1986 and 1985 effective income tax rates were 50.3% and 40.8%. For an analysis of the differences between the statutory and effective income tax rates see Note 6 of Notes to Consolidated Financial Statements. The Company's 1984 income tax benefit exceeded its loss before income taxes because of realization of net operating losses, investment tax credits, and research and experimental tax credits.

Inflation has not had a significant impact on the Company's operations.

Liquidity and Capital Resources

In August 1986 the Company sold 550,000 shares of its common stock in its initial public offering. The Company's proceeds, net of expenses, were \$5.2 million. Prior to its public offering, the Company had funded its growth through cash flow from operations and private sales of equity securities. The Company's cash and short term investments balance at November 30, 1986 was \$12.9 million. In addition, the Company had available a \$1.0 million unsecured line of credit. The Company believes that the existing cash balance together with funds generated from operations will be sufficient to meet its cash requirements through fiscal 1987.

Consolidated Balance Sheets

November 30, 1986 and 1985

	1986	1985
Assets		
Current assets:		
Cash and short-term investments	\$12,941,000	2,804,000
Receivables (Notes 2 and 9)	3,622,000	1,403,000
Other current assets	46,000	68,000
Total current assets	16,609,000	4,275,000
Property and equipment (Note 3)	1,736,000	1,046,000
Typeface production costs	1,665,000	744,000
Other assets	6,000	9,000
	<u>\$20,016,000</u>	<u>6,074,000</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 735,000	188,000
Accrued expenses (Note 5)	958,000	301,000
Income taxes payable (Note 6)	2,802,000	22,000
Unearned contract revenue	640,000	585,000
Deferred income taxes (Note 6)	—	31,000
Total current liabilities	5,135,000	1,127,000
Deferred income taxes (Note 6)	1,162,000	301,000
Shareholders' equity: (Notes 7 and 8)		
Convertible preferred stock	—	3,781,000
Common stock, no par value. 50,000,000 shares authorized; 5,076,760 and 1,581,954 shares issued and outstanding at November 30, 1986 and 1985, respectively	9,418,000	121,000
Retained earnings	4,351,000	765,000
	13,769,000	4,667,000
Less shareholder notes receivable	50,000	21,000
Total shareholders' equity	13,719,000	4,646,000
	<u>\$20,016,000</u>	<u>6,074,000</u>

See accompanying notes to consolidated financial statements.

Consolidated Statements of Income

Years Ended November 30, 1986, 1985 and 1984

	1986	1985	1984
Revenue (Note 9):			
Royalties	\$12,200,000	3,374,000	—
Product sales and enhancements	2,682,000	395,000	—
Contract revenue	1,173,000	835,000	2,209,000
Total revenue	<u>16,055,000</u>	<u>4,604,000</u>	<u>2,209,000</u>
Costs and expenses (Note 10):			
Direct costs	1,614,000	268,000	—
Research, development and contract costs	2,821,000	1,735,000	1,421,000
Sales, marketing and customer support	3,561,000	1,267,000	492,000
General and administrative	1,193,000	696,000	457,000
Total costs and expenses	<u>9,189,000</u>	<u>3,966,000</u>	<u>2,370,000</u>
Operating income (loss)	6,866,000	638,000	(161,000)
Interest income	354,000	200,000	134,000
Income (loss) before income taxes	7,220,000	838,000	(27,000)
Income tax expense (benefit) (Note 6)	3,634,000	342,000	(85,000)
Net income	<u>\$ 3,586,000</u>	<u>496,000</u>	<u>58,000</u>
Net income per share	<u>\$.76</u>	<u>.11</u>	<u>.02</u>
Shares used in computing net income per share	4,728,000	4,532,000	3,610,000

See accompanying notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

Years Ended November 30, 1986, 1985 and 1984

	Shareholders' Equity						
	Limited Partners' Capital	Convertible Preferred Stock	Common Stock		Shareholder Notes Receivable	Retained Earnings	Total Shareholders' Equity
	Shares	Amount					
Balances as of Nov. 30, 1983	\$ 831	450	1,489,838	\$ 108	(38)	211	731
Issuance of 722,648 shares of Series B Preferred Stock in exchange for limited partners' interest	(831)	831	—	—	—	—	831
Issuance of 427,974 shares of Series C Preferred Stock	—	2,500	—	—	—	—	2,500
Issuance of Common Stock to employees under stock purchase plan	—	—	97,740	15	(13)	—	2
Collections on shareholder notes receivable	—	—	—	—	28	—	28
Net income	—	—	—	—	—	58	58
Balances as of Nov. 30, 1984	—	3,781	1,587,578	123	(23)	269	4,150
Repurchase of Common Stock from employees under stock purchase plan	—	—	(5,624)	(2)	1	—	(1)
Collections on shareholder notes receivable	—	—	—	—	1	—	1
Net income	—	—	—	—	—	496	496
Balances as of Nov. 30, 1985	—	3,781	1,581,954	121	(21)	765	4,646
Issuance of 52,466 shares of Series C Preferred Stock upon exercise of warrant	—	153	—	—	—	—	153
Conversion of Preferred Stock	—	(3,934)	2,734,422	3,934	—	—	—
Issuance of Common Stock to employees under stock purchase plan	—	—	9,000	5	(3)	—	2
Repurchase of Common Stock from employees under stock purchase plan	—	—	(30,526)	(3)	1	—	(2)
Issuance of Common Stock under stock option plan	—	—	231,910	78	(36)	—	42
Initial public Common Stock offering, net of expenses	—	—	550,000	5,239	—	—	5,239
Collections on share- holder notes receiv- able	—	—	—	—	9	—	9
Stock option compen- sation expense	—	—	—	44	—	—	44
Net income	—	—	—	—	—	3,586	3,586
Balances as of Nov. 30 1986	\$ —	—	5,076,760	\$ 9,418	(50)	4,351	13,719

See accompanying notes to consolidated financial statements

Consolidated Statements of Changes in Financial Position

Years Ended November 30, 1986, 1985 and 1984

	1986	1985	1984
Cash flows from operating activities:			
Net income	\$ 3,586,000	496,000	58,000
Items not using (providing) cash:			
Stock option compensation expense	44,000	—	—
Depreciation and amortization	705,000	337,000	210,000
Deferred income taxes	861,000	301,000	(42,000)
Cash provided from operations	5,196,000	1,134,000	226,000
Changes in items affecting operations:			
Receivables	(2,219,000)	(1,332,000)	(68,000)
Other current assets	22,000	83,000	(115,000)
Accounts payable	547,000	131,000	(24,000)
Accrued expenses	657,000	215,000	65,000
Income taxes payable	2,780,000	22,000	(75,000)
Unearned contract revenue	55,000	335,000	250,000
Deferred income taxes	(31,000)	31,000	—
Net cash provided from operations	7,007,000	619,000	259,000
Cash flows from investment activities:			
Purchases of property and equipment	(1,226,000)	(507,000)	(452,000)
Capitalized typeface production costs	(1,090,000)	(744,000)	—
Other assets	3,000	2,000	12,000
Cash required by investment activities	(2,313,000)	(1,249,000)	(440,000)
Cash flows from financing activities:			
Proceeds from issuance of Preferred Stock	153,000	—	2,500,000
Proceeds from issuance of Common Stock, net	5,283,000	—	2,000
Collections on shareholder notes receivable	9,000	1,000	28,000
Conversion of Preferred Stock to Common Stock	(3,934,000)	—	—
Issuance of Common Stock in exchange for Preferred Stock	3,934,000	—	—
Repurchase of Common Stock, net	(2,000)	(1,000)	—
Cash generated by financing activities	5,443,000	—	2,530,000
Total cash generated (used)	10,137,000	(630,000)	2,349,000
Cash and short-term investments at beginning of year	2,804,000	3,434,000	1,085,000
Cash and short-term investments at end of year	<u>\$12,941,000</u>	<u>2,804,000</u>	<u>3,434,000</u>

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

November 30, 1986, 1985 and 1984

1. Significant Accounting Policies

a) Basis of Presentation

Adobe Systems Incorporated (Adobe or the Company), formed in 1983, has developed a software product (POSTSCRIPT) that controls the printing of integrated text, graphics and scanned images in a high quality and cost-effective printing system. The accompanying consolidated financial statements include those of Adobe and its wholly-owned subsidiary, Old Adobe Systems, Inc., after elimination of all significant intercompany accounts and transactions.

Through December 20, 1983, the Company operated as a partnership (formed in December 1982) in which Old Adobe Systems, Inc. was the general partner, and the consolidated financial statements have been presented on a combined basis for that period. On December 20, 1983, the limited partners of the partnership exchanged their interests in the partnership for 722,648 shares of Adobe Series B Preferred Stock in a nontaxable exchange.

b) Short-term Investments

Short-term investments primarily comprise certificates of deposit and money market account balances.

c) Property and Equipment

Property and equipment is stated at cost less accumulated depreciation and amortization. Depreciation is provided on the straight-line method over the estimated useful lives of the respective assets, generally three to eight years. Leasehold improvements are amortized using the straight-line method over the lesser of the lease term or the estimated useful lives of the related assets, generally five years.

d) Typeface Production Costs

Typeface production costs, less \$169,000 accumulated amortization in 1986, comprise direct and indirect costs associated with the production of typefaces to be used with POSTSCRIPT. Costs incurred prior to the November 1984 market introduction of POSTSCRIPT were expensed as incurred. Subsequent to the POSTSCRIPT market introduction, Adobe has capitalized the costs related to the production of several product lines of individual new typefaces that are marketed to POSTSCRIPT users. These costs are amortized on a straight-line basis over five years, commencing with the market release of each new typeface product.

(Continued)

Notes to Consolidated Financial Statements

e) Revenue Recognition

Royalties earned from original equipment manufacturers (OEM) relating to licensing agreements whereby the OEM licenses Adobe's proprietary software for redistribution to the OEM's end user customers are recognized when the OEM ships its product incorporating Adobe's software.

Product sales and enhancements revenue comprise direct sales of new typefaces and POSTSCRIPT instruction manuals and royalties earned from Adobe's OEM licensees in connection with OEM sales of products containing additional typefaces. The sales of new typefaces and manuals are recognized upon shipment. The product enhancements royalties are recognized when the OEM ships its product incorporating the enhancements.

Contract revenue relates to Adobe research and development performed under contracts entered into with the Company's OEM licensees. These contracts normally stipulate that Adobe will provide the research and development required to adapt the Company's software products to the OEM's hardware products. In most such contracts, the OEM pays a contract advance to Adobe which is normally not refundable after the Company has completed certain specified research and development milestones. These payments are treated as research and development contract revenue, which is recognized based on the achievement of project objectives on a basis representative of the number of research and development hours incurred to date as a percentage of total estimated contract hours. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. The costs incurred in performing under the contracts are classified as research, development and contract costs in the accompanying consolidated statements of income.

f) Direct Costs

Direct costs comprise royalty fees payable by Adobe, which are accrued concurrent with the Company's recognition of royalty revenue, amortization of typeface production costs and the costs of packaging and shipping.

g) Income Taxes

Income taxes are provided for all items included in the consolidated statements of income, regardless of when such items are reported for tax purposes. Investment tax credits and research and experimental tax credits are treated as a reduction of the provision for Federal income taxes in the year realized.

(Continued)

Notes to Consolidated Financial Statements

h) Net Income Per Share

Net income per share is computed based upon the weighted average number of shares of Common Stock and Common Stock Equivalents outstanding during each year assuming:

- the stock options granted through the date of the Company's initial public offering of Common Stock had been outstanding at November 30, 1983;
- the proceeds from the assumed exercise of the stock options were used to repurchase common shares using the "treasury stock" method; and
- the Series B preferred shares issued in exchange for the limited partners' interest in the partnership were outstanding at November 30, 1983.

2. Receivables

A summary of receivables follows:

	1986	1985
Royalties	\$ 3,043,000	1,109,000
Product sales and enhancements	448,000	98,000
Contracts	105,000	100,000
Employee notes and advances	3,000	75,000
Interest	61,000	36,000
	<u>3,660,000</u>	<u>1,418,000</u>
Less allowance for doubtful accounts	38,000	15,000
	<u>\$ 3,622,000</u>	<u>1,403,000</u>

3. Property and Equipment

A summary of property and equipment follows:

	1986	1985
Computers and peripherals	\$ 1,545,000	1,000,000
Production and development equipment	849,000	367,000
Furniture and fixtures	433,000	247,000
Leasehold improvements	53,000	40,000
	<u>2,880,000</u>	<u>1,654,000</u>
Less accumulated depreciation and amortization	1,144,000	608,000
	<u>\$ 1,736,000</u>	<u>1,046,000</u>

(Continued)

Notes to Consolidated Financial Statements

4. Line of Credit

The Company has available a \$1,000,000 unsecured bank line of credit which expires on August 31, 1987. Interest on borrowings is at the bank's reference rate. At November 30, 1986, there were no borrowings outstanding under this agreement.

5. Accrued Expenses

A summary of accrued expenses follows:

	1986	1985
Royalties	\$ 370,000	43,000
Officers' and employees' bonuses	413,000	216,000
Vacation	75,000	38,000
Other	100,000	4,000
	<u>\$ 958,000</u>	<u>301,000</u>

6. Income Taxes

The components of income tax expense (benefit) are as follows:

	1986	1985	1984
Current:			
Federal	\$ 2,357,000	—	(43,000)
State	603,000	10,000	—
Total current	<u>2,960,000</u>	<u>10,000</u>	<u>(43,000)</u>
Deferred:			
Federal	579,000	260,000	(42,000)
State	95,000	72,000	—
Total deferred	<u>674,000</u>	<u>332,000</u>	<u>(42,000)</u>
	<u>\$ 3,634,000</u>	<u>342,000</u>	<u>(85,000)</u>

(Continued)

Notes to Consolidated Financial Statements

6. Income Taxes (continued)

The actual expense (benefit) differs from the expected tax expense (benefit) (computed by applying the U.S. Federal statutory tax rate of 46% to earnings before income taxes) as follows:

	1986	1985	1984
Tax (benefit) at Federal statutory rate	\$ 3,322,000	385,000	(12,000)
Tax rate differential	—	(20,000)	—
State income taxes, net of			
Federal benefit	377,000	44,000	—
Investment tax credits	(2,000)	(26,000)	(35,000)
Research and experimental			
tax credits	—	(46,000)	(40,000)
Other	(63,000)	5,000	2,000
	<u>\$ 3,634,000</u>	<u>342,000</u>	<u>(85,000)</u>

The sources of deferred tax expense (benefit) and their tax effects, are as follows:

	1986	1985	1984
Typeface production costs	\$ 550,000	380,000	—
Accelerated depreciation	154,000	62,000	(6,000)
State income taxes	(316,000)	(38,000)	—
Investment tax credits	64,000	(26,000)	—
Research and experimental tax credits	217,000	(46,000)	(36,000)
Tax net operating loss carryforward	41,000	—	—
Other	(36,000)	—	—
	<u>\$ 674,000</u>	<u>332,000</u>	<u>(42,000)</u>

7. Convertible Preferred Stock

The Company has authorized 2,000,000 shares of Preferred Stock. In August, 1986 the outstanding 190,356 shares, 722,648 shares and 480,440 shares of Series A, B and C Preferred Stock, respectively, were converted into Common Stock.

8. Common Stock

The Company has authorized 50,000,000 shares of Common Stock. On July 3, 1986, the Company effected a two-for-one stock split. All references to common shares and per share amounts in the accompanying consolidated

(Continued)

Notes to Consolidated Financial Statements

8. Common Stock (continued)

financial statements have been retroactively adjusted to reflect this split.

Under the terms of the Company's stock purchase plan, employees could elect to purchase common shares issued to them by Adobe, at the fair market value of the shares on the issue date, through a 9% note payable to Adobe. Shares issued under this plan vest over five years. In the event of employment termination, unvested shares may be repurchased by the Company at the original purchase price. At November 30, 1986 there were 289,577 unvested shares. The Company does not contemplate issuing any further shares under this plan.

At November 30, 1986, the Company had reserved 700,000 shares of Common Stock for issuance under its stock option plan. This plan provides for the granting of stock options to employees (including officers and directors) at the fair market value of the Company's common stock at the grant date. Options generally vest over three years; 25% of the granted options at the end of each of the first two years and 50% at the end of the third year. On June 16, 1986, the Company accelerated to that date the exercisability of 249,160 outstanding options. Unvested shares remain subject to certain company repurchase rights. All options have a five year term.

The following table summarizes option activity:

	Shares Available For Grant	Options Outstanding	
		Shares	Average Price Per Share
Shares reserved at December 1, 1984	431,710	—	\$ —
Options granted	(209,300)	209,300	.30
Balances at Novem- ber 30, 1985	222,410	209,300	.30
Increase in shares reserved	268,290	—	—
Options granted	(143,860)	143,860	.30 - 22.88
Options exercised	—	(231,910)	.30 - .50
Options cancelled	4,300	(4,300)	.30
Balances at Novem- ber 30, 1986	<u>351,140</u>	<u>116,950</u>	<u>\$.30 - 22.88</u>
(27,750 Shares Exercisable)			

(Continued)

Notes to Consolidated Financial Statements

9. Major Customer

One major customer accounted for 84%, 73% and 68% of Adobe's total revenue for 1986, 1985 and 1984, respectively. Receivables from this customer aggregated approximately \$3,000,000 at November 30, 1986. At November 30, 1986, this customer was also a major shareholder, owning approximately 17% of the Company's common shares.

10. Supplementary Statements of Income Information:

The following items are included in costs and expenses in the accompanying consolidated statements of income:

	1986	1985	1984
Maintenance and repairs	\$ 165,000	72,000	50,000
Depreciation	536,000	337,000	210,000
Amortization of typeface production costs	169,000	—	—
Royalties	1,272,000	182,000	—
Advertising	580,000	171,000	32,000

11. Lease Commitments

The Company occupies its facilities under an operating lease agreement that expires on January 29, 1989. Minimum future rental payments for 1987, 1988 and 1989 are \$677,000, \$707,000 and \$118,000, respectively.

Rent expense for 1986, 1985 and 1984 was \$590,000, \$316,000 and \$193,000, respectively.

Report of Independent Certified Public Accountants

The Board of Directors and Shareholders
Adobe Systems Incorporated:

We have examined the consolidated balance sheets of Adobe Systems Incorporated and subsidiary as of November 30, 1986 and 1985 and the related consolidated statements of income, shareholders' equity and changes in financial position for each of the years in the three-year period ended November 30, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Adobe Systems Incorporated and subsidiary as of November 30, 1986 and 1985 and the results of their operations and the changes in their financial position for each of the years in the three-year period ended November 30, 1986, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

San Jose, California
December 19, 1986

Quarterly Results of Operations (Unaudited)

(In thousands, except per share data)

	1986, Three Months Ended				Year Ended Nov 30
	Feb 28	May 31	Aug 31	Nov 30	
Revenue	\$ 2,392	3,498	4,932	5,233	16,055
Income before income taxes	1,109	1,751	2,358	2,002	7,220
Net income	550	868	1,168	1,000	3,586
Net income per share	\$.12	.19	.25	.19	.76
Shares used in per share calculation	4,532	4,512	4,645	5,162	4,728

	1985, Three Months Ended				Year Ended Nov 30
	Feb 28	May 31	Aug 31	Nov 30	
Revenue	\$ 60	944	1,648	1,952	4,604
Income (loss) before income taxes	(612)	(104)	736	818	838
Net income (loss)	(367)	(62)	438	487	496
Net income (loss) per share	\$ (.08)	(.01)	.10	.11	.11
Shares used in per share calculation	4,537	4,534	4,529	4,528	4,532

Corporate Directory

Board of Directors

Q. T. Wiles

Chairman of the Board of Directors
Adobe Systems Incorporated,
Chairman of the Board Hambrecht & Quist Group,
ADAC Laboratories, Inc., Margaux Controls, Inc.,
Rexon Incorporated, and Silicon General, Inc.,
Chairman and Chief Executive Officer of
MiniScribe Corporation.

John E. Warnock

Director
President and Chief Executive Officer
Adobe Systems Incorporated

Charles M. Geschke

Director
Executive Vice President,
Chief Operating Officer, and Secretary
Adobe Systems Incorporated

Albert A. Eisenstat

Director
Senior Vice President,
General Counsel and Secretary
Apple Computer, Inc.

David Evans

Director
Chairman of the Board, Chief Executive
Officer of Evans & Sutherland,
Computer Corporation
Director of Mosaic Systems, Inc.,
VLSI Technology, Inc., and
Hambrecht & Quist Group

William R. Hambrecht

Director
President and Director of
Hambrecht & Quist Incorporated,
Director of ADAC Laboratories, Inc.,
Auto-Trol Technology Corp., Chalone, Inc.,
Margaux Controls, Inc., Massachusetts Computer
Corporation, MiniScribe Corporation, NBI, Inc.,
People Express Air Lines, Rexon Incorporated,
Silicon General, Inc., and Xidex Corporation.

Corporate Officers

John E. Warnock
President and Chief Executive Officer

Charles M. Geschke
Executive Vice President,
Chief Operating Officer and Secretary

Stephen A. MacDonald
Vice President Sales and Marketing

M. Bruce Nakao
Vice President, Chief Financial Officer,
Treasurer and Assistant Secretary

Legal Counsel

Ware & Freidenrich, A Professional Corporation
Palo Alto, CA

Independent Certified Public Accountants

Peat, Marwick, Mitchell & Co.
San Jose, CA

Registrar and Transfer Agent

Manufacturers Hanover Trust Company
New York, NY

POSTSCRIPT is a registered trademark of Adobe Systems Incorporated.
TRANSCRIPT and Adobe Illustrator are trademarks of Adobe Systems Incorporated.
Interpress is a trademark of XEROX Corporation and DDL is a trademark of Imagen Incorporated.



left to right:
Stephen A. MacDonald, John E. Warnock,
Charles M. Geschke, and M. Bruce Nakao

Annual Meeting

The Annual Meeting of Shareholders of Adobe Systems Incorporated will be held at 10:00 a.m. on Friday, March 27, 1987 at the Palo Alto Hyatt Hotel, Palo Alto, CA. All Adobe Systems shareholders are encouraged to attend.

For additional copies of this annual report contact the Corporate Communications Department, Adobe Systems Incorporated, 1870 Embarcadero Road, Palo Alto, CA 94303

Form 10-K

A copy of the Company's Form 10-K, filed with the Securities and Exchange Commission, is available without charge upon written request to the Corporate Communications Department, Adobe Systems Incorporated, 1870 Embarcadero Road, Palo Alto, CA 94303.

Market Price of Common Stock

Adobe Systems Incorporated's common stock was traded on the NASDAQ National Market System as of February 3, 1987 under the symbol ADBE. Prior to that the stock was traded on the NASDAQ bid and ask market. The high and low sales prices are as reported by NASDAQ beginning August 13, 1986, the date on which the common stock was offered to the public at \$11.00 per share. These over-the-counter market quotations reflect inter-dealer prices without retail mark-up, mark-down or commissions and may not necessarily represent actual transactions.

Fiscal 1986	Highest	Lowest
Fourth Quarter	25	13 1/4
Third Quarter *	15 1/4	11 1/2

* 13 trading days beginning August 13, 1986.

The Company has not paid cash dividends on its common stock and does not plan to pay cash dividends to its shareholders in the near future. The Company presently intends to retain its earnings for use in its business.



ADOBE
SYSTEMS INCORPORATED

1870 Embarcadero Road
Palo Alto, CA 94303