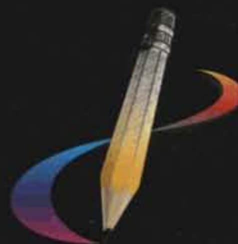
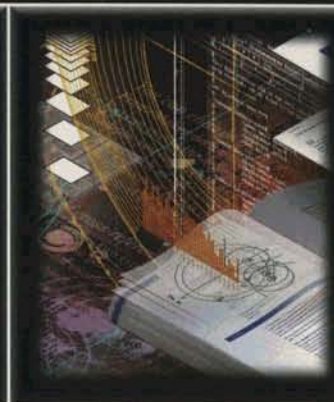
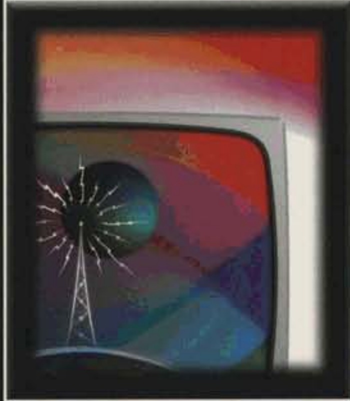
ADOBE SYSTEMS INCORPORATED ANNUAL REPORT 1996

Adobe®







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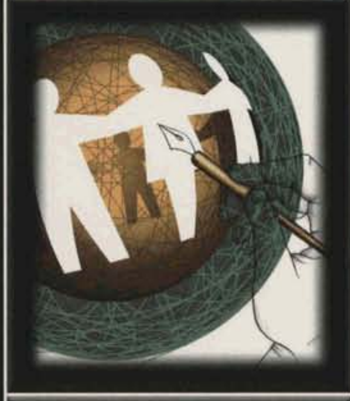
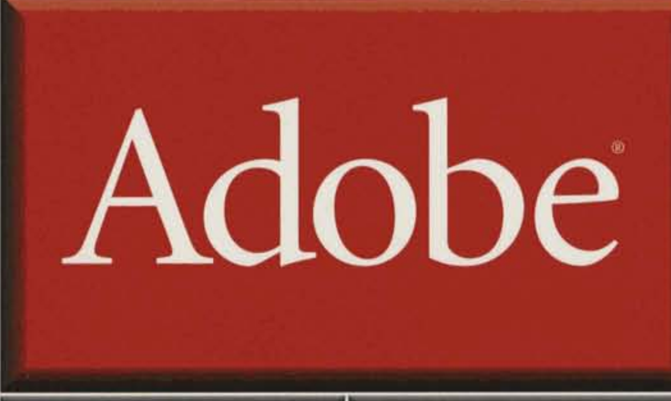
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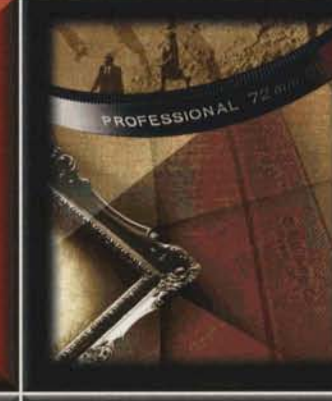
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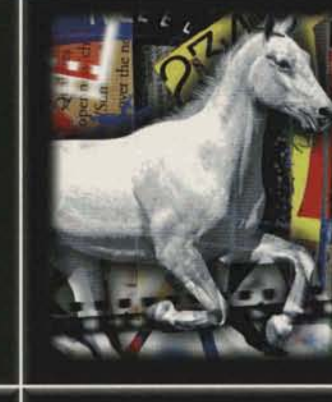


We make tools that launch ideas.

1996

To Our Shareholders

For Adobe, 1996 was a year of building toward future growth in a rapidly changing industry. We are pleased to have put in place new market initiatives, technology directions, and organizational changes that position us to take full advantage of long-term opportunities, while achieving solid financial results.

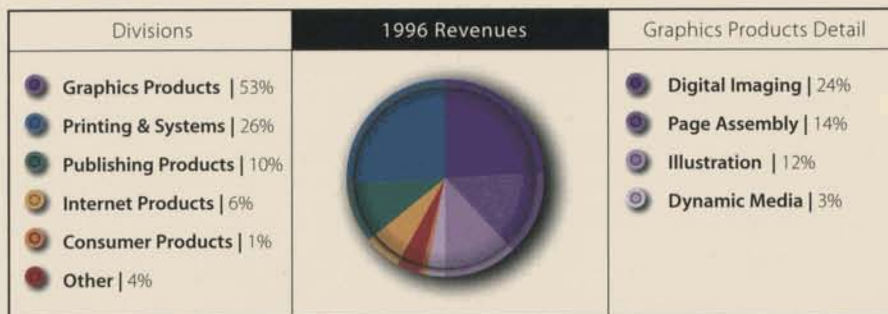
Financial Results In 1996, revenue reached $786.6 million, and reported net income totaled $153.3 million, or $2.04 per share, compared with 1995 revenue of $762.3 million, net income of $93.5 million, and earnings per share of $1.26. These figures resulted both from normal recurring operations and from substantial returns on the company's venture investment program. Normalized net income for 1996—excluding expenses from divested or discontinued businesses and net gains from external investments—totaled $128.2 million, compared with $135.6 million in 1995, while earnings per share were $1.71, compared with $1.80.

During 1996, the company declared cash dividends on its common stock totaling $0.20 per share. We repurchased 3.3 million shares of common stock during the year, offsetting dilution from expected issuances under our employee stock plans. At year end, the number of outstanding shares of common stock totaled 71.5 million. Our financial position remains strong, with cash, cash equivalents, and short-term investment balances of $564.1 million.

Success of Investment Program Adobe's investment program, which includes Adobe Ventures L.P., direct investments, and other activities, annually introduces us to hundreds of innovative companies that are strategic to our software business. The program gives us a window on emerging technologies and markets, and funds companies that make a broader set of products and services available to our customers. Now three years old, the venture investment program generated significant returns in 1996, primarily because several companies in our portfolio—most notably Netscape Communications—made public stock offerings. The returns from these activities are funding internal development programs, further external investments, and other corporate initiatives.

Growth of Printing Products Revenue from the licensing of Adobe PostScript and other printing technologies reached $196.7 million, compared with the $183.4 million posted in 1995. This growth reflects increased shipments of color printers, Japanese printers, and implementations of the Configurable PostScript Interpreter (CPSI). In all, Adobe delivered more than 300 implementations of PostScript technology this year.

The next generation of our founding technology, Adobe PostScript Level 3 software is designed to meet the printing needs of Internet users. We are working



with our more than 70 OEM customers to deliver PostScript Level 3 solutions in the second half of 1997.

Our new Adobe PrintGear architecture dramatically improves the quality and performance of low-cost printers for the fast-growing small office/home office market. The first OEM product to include PrintGear technology, the NEC SuperScript 860 monochrome laser printer, launched midyear and has won more than 17 industry awards. We expect PrintGear technology to ship in color inkjet printers in 1997.

For on-demand digital printing in commercial and corporate settings, Adobe has developed a new production printing architecture code-named "Supra." Already, more than 30 OEM customers are supporting this architecture, with IBM demonstrating the first production printing system in October. Several manufacturers are scheduled to ship similar products in 1997.

Shipment of Key Applications Application products revenue rose to $589.9 million, compared with $578.9 million in 1995. Strong revenue from our major graphics applications indicates that our strategy of developing tightly integrated products with common features and functionality is appealing to customers. We released new versions of many key applications, including Adobe Photoshop, Adobe Acrobat, Adobe FrameMaker+SGML, Adobe Illustrator, and Adobe PageMill. A new version of Adobe PageMaker began shipping in early fiscal 1997. We also delivered entirely new products such as Adobe PhotoDeluxe, a digital imaging program based on Adobe Photoshop and aimed at consumers.

The shipment of Adobe Photoshop 4.0 was our first simultaneous, cross-platform product release. In a two-week period, we delivered Windows and Macintosh versions.

Cross-Platform Presence At Adobe, we are committed to offering cross-platform implementations of our application products, giving users maximum choice and compatibility. Today we are capitalizing quickly on new opportunities in the Windows market. Having already incorporated full Windows 95 support into our applications, we now are collaborating with hardware manufacturers and other third parties to deliver powerful, creative capabilities to users of the Windows NT operating system. Adobe products such as Photoshop and PhotoDeluxe, for example, are among the first to support the Intel MMX processor, which optimizes image-handling speeds. New versions of Adobe FrameMaker and Adobe PageMaker include support for symmetric multiprocessing computers and other performance-enhancing features. Additional Windows NT product upgrades are scheduled to enter the market in 1997, aided by worldwide advertising and promotional campaigns.

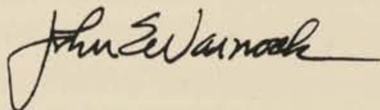
In light of these activities, revenue from Adobe products for the Windows platform continued to rise in 1996, now representing approximately 40 percent of our total product revenue. We expect this upward trend to continue.

Internet Inroads In just a few years, Adobe has come to offer the broadest, most popular set of tools for creating content on the World Wide Web. We have so effectively integrated Internet features into our established product line, in fact, that applications such as Adobe Photoshop and Adobe Illustrator consistently lead industry polls identifying favorite Web authoring software. At the same time, a new Macintosh version of Adobe PageMill, which is designed expressly for the Web, has quickly achieved best-in-class status in its emerging category.

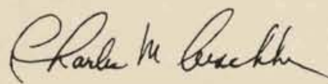
Files preserved in Adobe's Portable Document Format (PDF) have proliferated on Web sites of all kinds. To access those files, Internet users can download the Adobe Acrobat Reader free from our Web site and other sites. So far, more than 10 million users—some 20,000 a day—have taken us up on the offer. Acrobat is the fastest, easiest way to generate documents for distribution on the Web, corporate intranets, and CD-ROMs. It is reaching critical mass in publishing firms, government agencies, and other businesses, and smoothing the path of everyone from students to CEOs into the world of electronic communication.

New Management Structure Adobe continues to adapt its organization to meet changing technologies and customer needs. In 1996, we divided our operations into five business units that can focus more closely on emerging and fast-growth markets, while continuing to expand opportunities for established product lines. We also added key members to our executive team. Our senior vice president of marketing oversees a consolidated worldwide marketing organization. A new chief financial and administrative officer joined us during the fourth quarter, and a new senior vice president and general manager of the Graphics Division came on board in December 1996.

Adobe now has all the tools in place to capitalize on the exciting market opportunities before us—from Windows support, to Internet products, to new printing technologies. We eagerly look forward to 1997.



JOHN E. WARNOCK
Chairman of the Board and Chief Executive Officer



CHARLES M. GESCHKE
President

JANUARY 1997

John E. Warnock
Chairman of the Board & Chief Executive Officer

Charles M. Geschke
President

David B. Pratt
Executive Vice President & Chief Operating Officer

Jack Bell
Executive Vice President, Chief Financial Officer & Chief Administrative Officer

Robert A. Roblin
Senior Vice President Corporate Marketing

Colleen M. Pouliot
Vice President, General Counsel & Secretary

ADOBE PRODUCTS BY DIVISION

Printing & Systems	Internet	Graphics	Publishing	Consumer
Adobe PostScript	Adobe PageMill	Adobe Photoshop	Adobe FrameMaker	Adobe PhotoDeluxe
Adobe PrintGear	Adobe SiteMill	Adobe Illustrator	Adobe Type Library	
Adobe "Supra"	Adobe Acrobat	Adobe Premiere		
	Adobe Persuasion	Adobe After Effects		
		Adobe PageMaker		

The Webmaster

The Internet and its World Wide Web have revolutionized the way business communicates. At the same time, they have spawned a need for tools for quickly creating easily accessible, visually pleasing, informative, and entertaining Web sites. While other companies offer point solutions, no company offers a more complete line of integrated tools for creating, authoring, and distributing content for the Web than Adobe. And the Web team at UPN 21, a United Paramount Network (UPN) TV station, is putting those tools to the test.

"Viewer relationships are a top priority for us," says Rick Mills, UPN 21 general manager, "so we decided to create a Web site to make it easier to communicate with our audiences."

UPN 21 Web designers used Adobe **Illustrator** and **Photoshop** to create appealing images for viewers of all ages. With Adobe **PageMill**—our tool for Web page creation—they imported the images, then customized the layouts for the Web. "PageMill enabled us to get our site up quickly and makes updating it a breeze. Our designers find that it's intuitive and has the same easy feel as other Adobe products. We're extremely pleased with the results," says producer/director Jodee Bixler.

Today, viewers find programming information, a kids' area, entertainment news, and e-mail on UPN 21's site. "Our site has created a sense of community between the station and viewers," says Bixler. "It makes communicating much easier, more immediate, and more personal."

Jodee Bixler, producer/director, UPN 21 TV, Dallas/Ft. Worth, Texas: "We focus on entertainment, with a strong emphasis on the family, so our site had to be easy to use, fast to download, and appealing to viewers of all ages. We were able to quickly create our entire site from start to finish using Adobe products."

Adobe + UPN 21

Jun Ito, president, Itohei Design, Kyoto, Japan: "In Karaori, images are woven into cloth, giving them a three-dimensional quality that is enhanced by light. Adobe technologies are enabling us to apply these traditional images in new ways so more people can understand and appreciate their beauty and drama."

Adobe + Itohei

The Designer

Worldwide, Adobe products are empowering designers to apply their creativity in ways they could barely have imagined just a few years ago. Itohei Design in Kyoto, Japan, serves as a remarkable example of how Adobe technologies are putting a centuries-old craft within easy reach of both designers and consumers.

Itohei—whose clients range from Japan's Imperial Household Agency to one of its major schools of the tea ceremony—creates Karaori, a type of design traditionally used for theater costumes and kimonos. "My goal is to bring a 500-year-old tradition to the attention of the contemporary world," says Jun Ito, the fourth-generation president whose great-grandfather established the firm.

Itohei designers use the full range of Adobe products. For example, they use Adobe **Illustrator** to create Karaori, then apply the designs to hand fans, lacquerware, dishes, and neckties. "Before, patterns had to be customized manually if proportions changed," says Jun Ito. "Now, Illustrator manages our original designs in a database, allowing them to be reused with minimum modification. The ability to reuse original designs to produce textiles with different specifications reduces our design costs to one-tenth what they were previously."

Itohei uses Adobe **Photoshop** to convert the dotted textile images; Adobe **Streamline** to import original image outlines; and Adobe **Dimensions** to simulate 3D designs. With Adobe **Acrobat** and **PDF**, the process literally has entered another dimension, as Itohei invites worldwide designers using both PC and Macintosh systems to collaborate on Karaori designs on the Web.

The Intranet Manager

Westinghouse Electric Corporation—multinational supplier of technology and services to businesses and governments and, through its CBS unit, the largest U.S. radio and television broadcaster—employs nearly 50,000 people worldwide.

According to Frank Dittrich, vice president of information technology, industries and technology group, "Distributing printed materials across a company this size is a formidable task." Source W, an electronic publishing and multimedia division of Westinghouse, took on the challenge of streamlining and reducing the cost of internal communications by setting up a secure, corporate intranet.

"They started reauthoring documents in HTML. But it could take hours, and the pages didn't match the printed designs," explains Dittrich. Already experts in using Adobe **PageMaker**, **Illustrator**, **Photoshop**, and **Acrobat** for customer documents and presentations, Source W turned to Acrobat products—including Acrobat **Capture**, for scanning older, printed materials—to convert documents to **PDF**. PDF enables employees to instantly access the same, high-quality documents they used to wait up to a week to receive by mail. The Adobe **PostScript** page-description language allows the documents to be printed exactly as shown on-screen.

Westinghouse plans to use its intranet to enable employees to complete forms on-line, distribute information to sales and engineering reps worldwide, and provide customers original-quality documents. "We still spend a lot of time and money exchanging hard copy," says Dittrich. "With Adobe tools, we can put more materials on-line—further increasing our efficiency and reducing costs."

Frank D. Dittrich, vice president, information technology—industries and technology group, Westinghouse Electric Corporation: "We use almost every Adobe product to create the multimedia products we develop for our customers, so using them to create our corporate intranet was a natural. With Acrobat and PDF, employees worldwide can instantly access the original-quality documents they used to wait a week to receive in the mail."

Adobe + Westinghouse

Wendell Wilson, vice president of operations and product management, Kinko's®: "Adobe products are core elements of our computer services product offering. We are designing our infrastructure to support these products because we see them as crucial to the graphics and print-on-demand industries."

Adobe + Kinko's

The Publisher

Has the rampant growth of on-line information access and distribution signaled the demise of paper-based printing and publishing? On the contrary. In today's electronic information landscape, people are printing even more. And thanks to Kinko's—one of the world's largest chains of document copying and business services stores—just about anyone can create and print high-quality documents, 24 hours a day.

Customers come to Kinko's to use Adobe's wide range of desktop publishing and design tools, including Adobe **PageMaker**, **Photoshop**, **Illustrator**, **Dimensions**, **Font Folio**, and **PageMill**. "The integration and consistent interface of these products makes them easier for our customers to use," says Wendell Wilson, vice president of operations and product management at Kinko's, Inc. "Alternatively, customers use Adobe **Acrobat** software and the **Portable Document Format (PDF)** to transmit remotely created files for printing. PDF ensures full formatting and quality, and files are easily created regardless of the application used for the original document. Finally, Kinko's uses Adobe **PostScript** based Xerox DocuColor 40 printers to deliver professional-quality printed output."

"We selected these printers for their quality, speed, and direct color service," Wilson continues. "To keep our customers satisfied, we need a printing environment that is error-free and can consistently handle complex files. We get very high-quality output and practically error-free printing in a true Adobe PostScript environment. This translates into greater productivity and more loyal customers."

The Entrepreneur

To maintain its technology leadership, Adobe must create new products, adapt to changing technologies, and explore innovative new products and business models. Adobe participates in several investment programs to support these needs, benefit its core business, and supply additional profits.

Electronic Submission Publishing Systems (ESPS)—an Adobe investment formed in 1994—demonstrates how venture investing can benefit the Company. ESPS developed CoreDossier, a Windows NT application based on Adobe **Acrobat 3.0**, to integrate information from virtually any application and facilitate Web publishing of mission-critical documents. Pharmaceutical companies such as Janssen, AstraMerck, Agouron, Rhône-Poulenc Rorer, and DuPont Merck are using CoreDossier for internal review of new drug applications and for submitting them to regulatory agencies worldwide.

Regulatory filings to market a new drug range from 100,000 to more than one-million pages, which can include text, images—even databases. CoreDossier uses the **Acrobat Portable Document Format (PDF)**—an FDA-accepted standard—to maintain the absolute integrity of the original documents, a critical requirement for regulatory filings. At the same time, PDF makes it easy to reference and manage the information in the documents.

"The new drug application is the most mission-critical process for pharmaceuticals and regulatory agencies, and this is one way Adobe's investment in technology can really pay off," says ESPS CEO Terry Brennan.

For more information, visit our Web site at *www.adobe.com/aboutadobe/adobeventures/*.

Terry Brennan, CEO, Electronic Submission Publishing Systems (ESPS):

"Each day a company accelerates a drug to market can save a million dollars. Our Adobe Acrobat based CoreDossier solution can shave three weeks to several months off the drug development and regulatory review process."

Adobe + ESPS

Corporate Profile

Based in San Jose, California, Adobe Systems Incorporated develops and supports software products to help people express and use information in more imaginative and meaningful ways, across all print and electronic media. For more information, see Adobe's home page at *www.adobe.com* on the World Wide Web.

Financial Highlights

	Fiscal Years				
(In thousands except per share amounts)	**1996**	**1995**	**1994**	**1993**	**1992**
OPERATIONS:					
Revenue	$ 786,563	$762,339	$675,617	$580,103	$520,031
Net income	153,277	93,485	15,337	42,007	57,664
Net income per share	2.04	1.26	0.22	0.62	0.84
Dividends declared per common share	0.20	0.20	0.20	0.20	0.16
FINANCIAL POSITION:					
Cash and short-term investments	564,116	516,040	444,768	344,714	275,522
Total assets	1,012,285	884,732	710,000	597,696	525,849
Shareholders' equity	706,514	698,417	514,315	457,216	418,771

See Note 2 of Consolidated Financial Statements regarding mergers with Aldus Corporation and Frame Technology Corporation.

Financial Review

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 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 1997. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report. 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 create, display, manage, communicate, and print electronic documents. The Company licenses its technology to major computer, printing, and publishing suppliers, and markets a line of application software products and type products for authoring and editing visually rich documents. The Company distributes its products through a network of original equipment manufacturer ("OEM") customers, distributors and dealers, and value-added resellers ("VARs") and system integrators. The Company has operations in North America, Europe, Japan, Asia-Pacific and Latin America.

On October 28, 1995, the Company issued approximately 8.5 million shares of its common stock in exchange for all of the common stock of Frame Technology Corporation ("Frame"). Prior to its acquisition by the Company, on July 28, 1995, Frame acquired all of the common stock of Mastersoft, Inc. ("Mastersoft") in exchange for approximately 0.6 million equivalent shares of Adobe common stock. On August 31, 1994, the Company issued approximately 14.2 million shares of its common stock in exchange for all of the common stock of Aldus Corporation ("Aldus"). These business combinations have been accounted for as poolings of interests, and, accordingly, the consolidated financial statements for periods prior to the combinations have been restated to include the results of operations, financial position, and cash flows of Frame, Mastersoft, and Aldus.

There were no significant transactions among the Company, Frame, and Aldus prior to the combinations which required elimination. Prior to the combination Frame reported revenue and net income of $68.2 million and $10.5 million, respectively, for the nine-month period ended September 1, 1995 and reported revenue and net income of $77.8 million and $11.9 million, respectively, for the year ended November 25, 1994. Prior to the combination, Aldus reported revenue and net income of $172.2 million and $5.1 million, respectively, for the nine-month period ended August 26, 1994. Certain adjustments were made to Frame's tax provision and deferred tax accounts to reflect tax benefits available to the combined company.

In January 1996, the Company divested its prepress applications product business to a newly established company, Luminous Corporation ("Luminous"). Under the terms of the agreement, Luminous continued to develop, market, and distribute Adobe's prepress application products and Adobe maintained ownership of certain core technologies for Adobe prepress products. Revenue from the prepress application business unit was approximately $10.4 million in fiscal year 1995. In October of 1996, the Company sold its remaining interest in Luminous for approximately $6.8 million which was recorded as a realized gain.

Revenue

	1996	Change	1995	Change	1994
Total revenue	**$786.6**	**3%**	$762.3	13%	$675.6

Revenue growth in 1996 and 1995 is attributable to increases in both licensing activity related to the Company's PostScript interpreter and application products shipments resulting from the release of new and enhanced products. In 1995, the increase in application products revenue was partially offset by the divestiture of Aldus FreeHand in January 1995 and the discontinuance of Aldus PhotoStyler in late 1994. Product unit volume (as opposed to price) growth was the principal factor in the Company's revenue growth in application products revenue. No customer accounted for more than 10 percent of the Company's total revenue in 1996, 1995, or 1994.

	1996	Change	1995	Change	1994
Product group revenue — Licensing	**$196.7**	**7%**	$183.4	17%	$156.7
Percentage of total revenue	**25.0%**		24.1%		23.2%

Licensing revenue is derived from shipments by OEM customers of products containing the Adobe PostScript interpreter and the Display PostScript system. Such products include standard roman printers as well as printers that work with Japanese, Chinese, and Korean languages, imagesetters, and workstations. Licensing revenue is also derived from shipments of products containing the Configurable PostScript Interpreter ("CPSI") by OEM customers. CPSI is a fully functional 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 OEMs and software developers to create and market a variety of PostScript products independently of controller hardware development. Adobe PostScript products sell to the small office/home office ("SOHO") market, as well as the corporate enterprise and high-end imagesetter markets.

The number of units shipped by OEMs continued to grow on an annual basis in 1996 and 1995. Royalty per unit is generally calculated as a percentage of the end user list price of a printer, although there are some components of licensing revenue based on a flat dollar amount per unit that typically do not change with list prices. During this period, some OEMs introduced lower end printers or reduced their list prices on lower end printers, which resulted in lower royalties per unit on such printers. However, in 1996 and 1995, this trend was offset by increased demand for CPSI and by increased demand for color capability as well as greater penetration into the Japanese market, all of which have higher royalties per unit.

The Company has seen year-to-year increases in the number of OEM customers from which it is receiving licensing revenue and believes that such increases are attributable to the continued acceptance of PostScript software, as well as to the diversification of the Company's customer base across multiple platforms. In 1997, Adobe will introduce new PrintGear products that will serve the SOHO markets. Also in 1997, one of Adobe's largest PostScript customers, Hewlett-Packard Company, plans to introduce into the corporate enterprise market products that do not contain Adobe PostScript software. These products are expected to contain a non-Adobe clone version of PostScript and are expected to reach the market in July of 1997. All of these factors may impact the Company's ability to maintain or sustain revenue growth in this area.

	1996	Change	1995	Change	1994
Product group revenue — Application products	**$589.9**	**2%**	$578.9	12%	$519.0
Percentage of total revenue	**75.0%**		75.9%		76.8%

Application products revenue is derived from shipments of application software programs marketed through retail and distribution channels; however, Adobe PageMill, Adobe SiteMill, Adobe FrameMaker, and Adobe Acrobat products are becoming more widely distributed through VARs and systems integrators.

Application products revenue growth in 1996 was primarily due to increased demand for Adobe Photoshop, Adobe Illustrator, the Adobe Acrobat family of products, and sales of PageMill and SiteMill. The increase was partially offset by decreased demand for FrameMaker and Adobe PageMaker products. The Company released Photoshop 4.0 for both the Macintosh and Windows platforms, and Acrobat 3.0 near the end of the fourth quarter of 1996. In addition, PageMill and SiteMill, which were both released in late 1995, added revenue in 1996. In 1995, application products revenue increased as a result of higher sales of Photoshop, PageMaker, FrameMaker, and the Acrobat family of products. The Company released Adobe PageMaker 6.0 for the Macintosh platform late in the third quarter of 1995, and for the Windows platform in the fourth quarter of 1995. In addition, the Company released Adobe Photoshop 3.0 for the Windows platform in the first quarter of 1995 and released new Acrobat products or new versions of existing products throughout 1995. The 1995 revenue growth was partially offset by the divestiture of Aldus FreeHand in January 1995 and the discontinuance of Aldus PhotoStyler late in 1994. These two products aggregated $53.2 million of revenue in 1994.

In general, the Company's application products on the Windows platform have experienced greater growth than those on the Macintosh platform during 1996. The Company expects this trend to continue for the foreseeable future.

Direct costs

	1996	Change	1995	Change	1994
Direct costs	**$141.1**	**8%**	$130.3	7%	$122.0
Percentage of total revenue	**17.9%**		17.1%		18.1%

Direct costs include royalties; amortization of acquired technologies; and direct product, packaging, and shipping costs. During 1994, direct costs also included amortization of typeface production costs, which totaled $4.8 million.

Gross margins, in general, are affected by the mix of licensing revenue versus application products revenue as well as the product mix within application products. Direct costs were slightly higher in 1996 compared to 1995 as a percentage of revenue due to higher localization costs. Also, there was a general decline in 1996 in FrameMaker revenue and associated gross margins. In 1995, direct costs decreased as a percentage of revenue from 1994, primarily from the lump sum payment in lieu of all royalty obligations to the developers of the technology underlying Photoshop, which lowered direct costs for that product, as well as a continued benefit from efforts to reduce unit manufacturing costs, royalty agreement rates and typeface production costs amortization.

Gross margins for applications products are expected to increase slightly in 1997 because the Company intends to distribute more application products via CD-ROM media.

Operating expenses

	1996	Change	1995	Change	1994
Software development costs —					
Research and development	**$152.9**	**10%**	$138.6	22%	$113.8
Percentage of total revenue	**19.4%**		18.2%		16.8%

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 expense has increased significantly over the last three years as the Company invested in new technologies, new product development, and the infrastructure to support such activities. The increase reflects 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 Company continues to make significant investments in development of its Adobe PostScript and application software products, including those targeted for the emerging Internet market.

The Company believes that continued investments in research and development are necessary to remain competitive in the marketplace, and are directly related to continued, timely development of new and enhanced products. Accordingly, the Company intends to continue recruiting and hiring experienced software developers. While the Company expects that research and development expenditures in 1997 will increase in absolute dollars, such expenditures are expected to remain approximately the same as a percentage of revenue.

	1996	Change	1995	Change	1994
Software development costs —					
Amortization of capitalized					
software development costs	**$2.5**	**(77)%**	$11.1	(23)%	$14.3
Percentage of total revenue	**0.3%**		1.5%		2.1%

In the implementation of Statement of Financial Accounting Standards ("SFAS") No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed," software development expenditures on Adobe products, after achieving technological feasibility, were deemed to be immaterial. Certain software development expenditures on Frame and Aldus products have been capitalized and are being amortized over the lives of the respective products. Amortization of capitalized software development costs decreased in 1996 and 1995 as a result of achieving full amortization of all Frame products by the end of 1996 and Aldus products by the end of 1995.

For all of 1996, software development expenditures on all products, after reaching technological feasibility, were immaterial and the Company expects this trend to continue in the future.

	1996	Change	1995	Change	1994
Sales, marketing, and customer support	**$255.0**	**5%**	$242.7	3%	$234.8
Percentage of total revenue	**32.4%**		31.8%		34.7%

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

Increases in sales, marketing, and customer support expenses in 1996 are 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. In 1995, reduced costs resulting from the restructuring of the combined company after the acquisition of Aldus in 1994 resulted in a decrease in costs as a percentage of revenue.

For 1997, sales, marketing, and customer support expenditures are expected to increase in absolute dollars, but decrease as a percentage of revenue. The increase in absolute dollars in 1997 will be due to new product releases, increased investment in the Windows market and programs related to furthering worldwide recognition of the Adobe brand.

	1996	Change	1995	Change	1994
General and administrative	**$62.0**	**6%**	$58.5	(3)%	$60.5
Percentage of total revenue	**7.9%**		7.7%		9.0%

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

General and administrative expenses increased during 1996 compared to 1995. The increase resulted primarily from Frame integration costs in the first quarter of 1996 and a higher headcount entering fiscal 1996. In addition, the increase was driven by salary increases and higher rent expense, as well as higher systems and legal costs in 1996. The 1995 decrease compared to 1994 spending reflects savings related to the restructuring of the combined company after the acquisition of Aldus, partially offset by costs related to the acquisition of Frame.

The Company expects general and administrative spending in 1997 to be slightly higher than 1996 levels as a percentage of revenue as the Company continues to incur litigation cost and invest in an expanded and more comprehensive administrative infrastructure.

	1996	Change	1995	Change	1994
Write-off of acquired in-process research and development	**$21.3**	**42%**	$15.0	(3)%	$15.5
Percentage of total revenue	**2.7%**		2.0%		2.3%

During 1996, 1995, and 1994, the Company acquired six software companies, in separate transactions, and accounted for them using the purchase method. In each of these transactions, a portion of the purchase price was allocated to in-process research and development and was expensed at the time of the acquisitions. In 1996, 1995 and 1994, $21.3 million, $15.0 million and $15.5 million was expensed, respectively.

	1996	Change	1995	Change	1994
Merger transaction and restructuring costs	**$ 5.0**	**(84)%**	$31.5	(56)%	$72.2
Percentage of total revenue	**0.6%**		4.1%		10.7%

Merger transaction and restructuring costs for 1996 were $5.0 million. This represents charges of $5.7 million less the reversal of $0.7 million of excess reserves related to restructuring costs recorded in prior years. The 1996 charges were recorded in connection with the disposition of two business units previously owned by Frame.

During the fourth quarters of 1995 and 1994, the Company recorded merger transaction and restructuring costs primarily associated with the acquisitions of Frame and Aldus, respectively, of $31.5 million and $72.2 million, respectively. In 1995, the Company analyzed the remaining accrued restructuring costs related to the acquisition of Aldus as well as the remaining accrued restructuring costs related to a 1993 restructuring implemented by Frame. As a result of this analysis, it was determined that approximately $1.0 million represented excess reserves and, therefore, this amount was reversed and credited to "Merger transaction and restructuring costs" in the Consolidated Statements of Income.

At November 29, 1996, the remaining accrued restructuring balance relates to lease and third-party contract termination payments, resulting from the planned closure of duplicate offices in Europe and the United States. These payments are expected to continue through the lease terms or negotiated early termination date, if applicable.

Nonoperating income

	1996	Change	1995	Change	1994
Investment gain (loss)	**$68.9**	**9,223%**	$(0.8)	(123)%	$(0.3)
Percentage of total revenue	**8.8%**		—		—

Investment gain (loss) consists principally of realized gains or losses from direct investments as well as mark-to-market valuation adjustments for Adobe Ventures LP investments.

Investment gains and losses increased in 1996 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 Communications

Corporation and its entire investment in Luminous Corporation, respectively. Also, a portion of one of the equity investments included in the Adobe Ventures LP portfolio was sold for a gain of $13.9 million during 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.

	1996	Change	1995	Change	1994
Interest and other income	**$29.2**	**(3)%**	$30.0	179%	$10.8
Percentage of total revenue	**3.7%**		3.9%		1.6%

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.

Interest and other income decreased by $0.8 million in 1996 from 1995 and increased $19.3 million in 1995 from 1994. The slight decrease in 1996 from 1995 is primarily due to foreign exchange gains in 1995 combined with foreign exchange losses in 1996. The increase in 1995 from 1994 is primarily due to a larger investment base and generally higher interest rates in 1995 compared to 1994. In addition, the Company increased the weighted average days-to-maturity of its investments in 1995, which generated higher rates of return. Interest and other income was adversely impacted by $1.5 million in 1994, as the Company sold several securities (acquired in the Aldus acquisition) for losses in principal created by increases in interest rates during 1994.

Income tax provision

	1996	Change	1995	Change	1994
Income tax provision	**$91.5**	**30%**	$70.4	87%	$37.6
Percentage of total revenue	**11.6%**		9.2%		5.6%
Effective tax rate	**37.4%**		42.9%		71.0%

The Company's effective tax rate in 1996 decreased from 1995, due primarily to the impact of lower non-deductible merger acquisition costs and lower non-deductible goodwill amortization. The Company's effective tax rate in 1995 decreased significantly from the effective tax rate of 1994, due primarily to smaller one-time, non-deductible merger transaction and restructuring costs and increased tax-exempt income. An analysis of the differences between the statutory and effective income tax rates is provided in Note 8 of Notes to Consolidated Financial Statements.

Net income and net income per share

	1996	Change	1995	Change	1994
Net income	**$153.3**	**64%**	$93.5	510%	$15.3
Percentage of total revenue	**19.5%**		12.3%		2.3%
Net income per share	**$ 2.04**	**62%**	$1.26	473%	$0.22
Weighted shares (in thousands)	**75,064**	**1%**	74,253	6%	70,169

Net income for 1996 represents a 64 percent increase over 1995, while 1995 net income increased 510 percent from that of 1994. Results of operations in each of the three years included several one-time charges and in 1996 significant investment gains that would not normally be included in the Company's operating results. A reconciliation of the reported results of operations to the results of operations excluding these one-time charges for each of the years follows.

	1996			
(In thousands, except per share amounts)	**Income Before Income Taxes**	**Income Tax Provision**	**Net Income**	**Net Income Per Share**
Reported results of operations	**$244,824**	**$91,547**	**$153,277**	**$2.04**
Write-off of acquired in-process research and development costs	**21,251**	**1,837**	**19,414**	**0.26**
Restructuring costs	**4,955**	**1,505**	**3,450**	**0.05**
Other one-time charges	**2,917**	**886**	**2,031**	**0.03**
Net investment gain	**(68,875)**	**(18,873)**	**(50,002)**	**(0.67)**
Results of operations excluding one-time charges (gains)	**$205,072**	**$76,902**	**$128,170**	**$1.71**

	1995			
(In thousands, except per share amounts)	**Income Before Income Taxes**	**Income Tax Provision**	**Net Income**	**Net Income Per Share**
Reported results of operations	$163,853	$70,368	$ 93,485	$1.26
Write-off of acquired in-process research and development	14,983	—	14,983	0.20
Acquisition of Frame:				
Merger transaction costs	11,399	—	11,399	0.15
Restructuring costs	20,135	6,086	14,049	0.19
Other one-time charges	3,160	1,484	1,676	0.02
Effect of fourth quarter antidilutive common stock equivalents	—	—	—	(0.02)
Results of operations excluding one-time charges	$213,530	$77,938	$135,592	$1.80

(In thousands, except per share amounts)	1994			
	Income Before Income Taxes	**Income Tax Provision**	**Net Income**	**Net Income Per Share**
Reported results of operations	$ 52,946	$37,609	$15,337	$0.22
Write-off of acquired in-process research and development	15,469	—	15,469	0.21
Acquisition of Aldus:				
Merger transaction costs	14,618	—	14,618	0.21
Restructuring costs	57,565	19,922	37,643	0.53
Other one-time charges resulting from the acquisition	10,092	3,734	6,358	0.09
Results of operations excluding one-time charges	$150,690	$61,265	$89,425	$1.26

Furthermore, the future effective tax rate for fiscal 1997 is expected to be approximately 36 percent. Had this rate been in effect in 1996, 1995, and 1994, the net income per share, excluding the above one-time charges (gains), would have been $1.73, $1.82, and $1.36 per share, respectively.

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 the ability of the Company to integrate Adobe and Frame product lines; delays in shipment of the Company's new products and major new versions of existing products; market acceptance of new products and upgrades; renegotiation of royalty arrangements; growth in worldwide personal computer and printer sales and sales price adjustments; consolidation in the OEM printer business; industry transitions to new business and information delivery models; and adverse changes in general economic conditions in any of the countries in which the Company does business.

The Company's ability to develop and market products, including upgrades of currently shipping products, that successfully adapt to changing customers 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 products. Delays in product introductions 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 sales or results of operations.

Although the Company generally offers its application products on Macintosh, Windows, and UNIX platforms, a majority of the overall sales of these products to date has been for the Macintosh platform, particularly for the higher end Macintosh computers. If there is a slowdown of customer purchases in the higher end Macintosh

market or if the Company is unable to increase its sales to Windows customers, the Company's operating results could be materially adversely affected. Also, if the Company broadens its customer base to achieve greater penetration in the corporate business and consumer markets, the Company may need to adapt its application software distribution channels. The Company could experience decreases in average selling prices and some transitions in its distribution channel which could materially adversely affect its operating results. 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.

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, including licensing a PostScript language compatible interpreter from a third party, which could result in lower licensing revenue for the Company. During the first quarter of 1996, there was a change in part of the Company's business relationship with Hewlett-Packard Company (Hewlett-Packard). Beginning in the second half of 1997, Hewlett-Packard plans not to incorporate Adobe PostScript software in some Hewlett-Packard LaserJet printers. The Company expects to continue working with Hewlett-Packard printer operations to incorporate Adobe PostScript and other technologies in other Hewlett-Packard products.

Through its acquisitions, the Company has experienced significant growth. 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.

During 1995, the Company entered the Internet market, which has only recently begun to develop. The Internet market is rapidly evolving and is characterized by an increasing number of market entrants who have introduced or developed products addressing authoring and communication 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 the authoring and electronic publishing requirements of the Internet is young and has few proven products. In addition, new models for licensing software to accommodate new information delivery practices will be needed. 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 impact 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, Asia-Pacific, and Latin America. While most of the revenue of these subsidiaries is denominated in U.S. dollars, the majority of their expense transactions are denominated in foreign currencies, including the Japanese yen and most major European currencies. As a result, the Company's operating results are subject to fluctuations in foreign currency exchange rates. To date, the impact of such fluctuations has been insignificant and the Company has not engaged in any significant activities to hedge its exposure to foreign currency exchange rate fluctuations. In addition, the Company generally experiences lower revenue from its European operations in the third quarter because many customers reduce their business activities in the summer months.

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 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 or the securities markets in general will often result in significant volatility of the Company's common stock price.

Recent accounting pronouncements

In March 1995, the Financial Accounting Standards Board issued SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 121 is effective for fiscal years beginning after December 15, 1995, and requires long-lived assets to be evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company will adopt SFAS No. 121 in fiscal 1997 and does not expect its provisions to have a material effect on the Company's consolidated results of operations in the year of adoption.

In October 1995, the Financial Accounting Standards Board issued SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 123 is effective for fiscal years beginning after December 15, 1995, and requires that the Company either recognize in its consolidated financial statements costs related to its employee stock-based compensation plans, such as stock option and stock purchase plans, using a prescribed methodology, or make pro forma disclosure of such costs in a footnote to the consolidated financial statements.

The Company expects to continue to use the intrinsic value based method of Accounting Principles Board Opinion No. 25, as allowed under SFAS No. 123, to account for all of its employee stock-based compensation plans. Therefore, in its consolidated financial statements for fiscal 1997, the Company will make the required pro forma disclosures in a footnote to the consolidated financial statements. SFAS No. 123 is not expected to have a material effect on the Company's consolidated results of operations or financial position.

Financial Condition

Cash, cash equivalents, and short-term investments

	1996	Change	1995	Change	1994
Cash, cash equivalents, and short-term investments	**$564.1**	**9%**	$516.0	16%	$444.8

The Company's cash balances and short-term investments have increased each year due to profitable operations, partially offset by expenditures for the repurchase of stock, capital outlays, other investments, and deposits required under real estate development agreements.

Cash equivalents consist of highly liquid money market instruments. All of the Company's cash equivalents and short-term investments, consisting principally of municipal bonds, auction rate certificate securities, United States government and government agency securities, and asset-

backed securities, are classified as available-for-sale under the provisions of SFAS No. 115. The securities are carried at fair value with the unrealized gains and losses, net of tax, reported as a separate component of shareholders' equity.

Noncurrent liabilities and shareholders' equity

	1996	Change	1995	Change	1994
Noncurrent liabilities and shareholders' equity	**$781.7**	**12%**	$698.4	36%	$514.3

Included above is shareholders' equity and at November 29, 1996, deferred income taxes related to unrealized gains and losses on equity investments, and obligations for put warrants. The Company has no long-term debt. Shareholders' equity as of November 29, 1996 was $706.5 million, compared to $698.4 million as of December 1, 1995 and $514.3 million as of November 25, 1994. The year-to-year increases in shareholders' equity includes issuances of common stock under the Company's stock option and employee stock purchase plans. For 1996, this increase was offset by the repurchase of stock.

Under its stock repurchase program, the Company repurchased 3,321,500 shares at a cost of $124.5 million in 1996. The Company intends to continue to directly repurchase common shares and arrange options to purchase common shares to partially fund the Company's employee stock purchase and stock option plans.

The Company has paid cash dividends on its common stock each quarter since the second quarter of 1988. During 1996, the Company paid cash dividends of $0.20 per common share. The declaration of future dividends is within the discretion of the Company's Board of Directors and will depend upon business conditions, results of operations, the financial condition of the Company, and other factors.

Working capital

	1996	Change	1995	Change	1994
Working capital	**$506.1**	—	$506.5	26%	$402.8

Net working capital was $506.1 million as of November 29, 1996, compared to $506.5 million as of December 1, 1995. Cash flow provided by operations during 1996 was $198.1 million.

Expenditures for property and equipment in 1996 totaled $45.9 million. Such expenditures are expected to continue, including expenditures for computer systems for development, sales and marketing, product support, and administrative staff. In the future, additional cash may be

used to acquire software products or technologies complementary to the Company's business. Net cash used by financing activities during 1996 was $101.5 million, primarily resulting from the repurchase of common stock and payment of dividends partially offset by issuance of common stock under employee stock plans.

The Company's principal commitments as of November 29, 1996 consisted of obligations under operating leases, a real estate development agreement, and various service and lease guarantee agreements with a related party.

During 1994, the Company entered into a real estate development agreement and an operating lease agreement in connection with the construction of an 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 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. During the construction period, 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. During 1996, the Company deposited approximately $30.5 million, and as of November 29, 1996, the Company's deposits under this agreement totaled approximately $66.1 million in United States government treasury notes and money market mutual funds. These deposits are included in "Other assets" in the Consolidated Balance Sheets.

During the third quarter of 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 operating lease will commence on completion of construction in 1998. The Company will have the option to purchase the facility at the end of the lease term. 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 also is required, periodically during the construction period, to deposit funds with the lessor as an interest bearing security deposit to secure the performance of its obligations under the lease. During the second half of 1996, the Company deposited approximately $3.3 million. These deposits are included in "Other assets" in the Consolidated Balance Sheets.

The Company holds a 17 percent equity interest in McQueen Holdings Limited ("McQueen") and accounts for the investment at cost. 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.

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.

Consolidated Balance Sheets

(In thousands)	Nov. 29 1996	Dec. 1 1995
Assets		
Current assets:		
Cash and cash equivalents	**$ 110,745**	$ 58,493
Short-term investments	**453,371**	457,547
Receivables, net of allowances of $5,196 and $3,698, respectively	**126,715**	133,208
Other current assets	**45,875**	43,539
Total current assets	**736,706**	692,787
Property and equipment	**80,231**	51,708
Other assets	**195,348**	140,237
	$1,012,285	$884,732
Liabilities and Shareholders' Equity		
Current liabilities:		
Trade and other payables	**$ 43,056**	$ 25,639
Accrued expenses	**93,957**	94,848
Accrued restructuring costs	**10,854**	28,151
Income taxes payable	**67,210**	19,420
Deferred revenue	**15,537**	18,257
Total current liabilities	**230,614**	186,315
Deferred income taxes	**3,809**	—
Put warrants	**71,348**	—
Shareholders' equity:		
Preferred stock, no par value; 2,000 shares authorized; none issued	**—**	—
Common stock, no par value; 200,000 shares authorized; 71,476 and 72,834 shares issued and outstanding, respectively	**148,602**	293,258
Retained earnings	**529,546**	390,793
Unrealized gains on investments	**33,514**	18,831
Cumulative translation adjustment	**(5,148)**	(4,465)
Total shareholders' equity	**706,514**	698,417
	$1,012,285	$884,732

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Income

(In thousands, except per share data)	Years Ended		
	Nov. 29 1996	**Dec. 1 1995**	**Nov. 25 1994**
Revenue:			
Licensing	**$196,693**	$183,437	$156,652
Application products	**589,870**	578,902	518,965
Total revenue	**786,563**	762,339	675,617
Direct costs	**141,147**	130,301	122,023
Gross margin	**645,416**	632,038	553,594
Operating expenses:			
Software development costs:			
Research and development	**152,914**	138,616	113,797
Amortization of capitalized software development costs	**2,504**	11,095	14,329
Sales, marketing, and customer support	**254,972**	242,713	234,771
General and administrative	**62,034**	58,526	60,531
Write-off of acquired in-process research and development	**21,251**	14,983	15,469
Merger transaction and restructuring costs	**4,955**	31,534	72,183
Total operating expenses	**498,630**	497,467	511,080
Operating income	**146,786**	134,571	42,514
Nonoperating income:			
Investment gain (loss)	**68,875**	(755)	(338)
Interest and other income	**29,163**	30,037	10,770
Total nonoperating income	**98,038**	29,282	10,432
Income before income taxes	**244,824**	163,853	52,946
Income tax provision	**91,547**	70,368	37,609
Net income	**$153,277**	$ 93,485	$ 15,337
Net income per share	**$ 2.04**	$ 1.26	$ 0.22
Shares used in computing net income per share	**75,064**	74,253	70,169

See accompanying Notes to Consolidated Financial Statements.

Consolidated Statements of Shareholders' Equity

(In thousands)	Common Stock		Retained Earnings	Unrealized Gains (Losses) on Investments	Cumulative Translation Adjustment	Total
	Shares	Amount				
Balances as of November 26, 1993	66,420	$145,189	$316,331	$ —	$(4,304)	$457,216
Stock issued under employee stock and stock option plans	3,381	47,180	—	—	—	47,180
Tax benefit from employee stock option plans	—	14,418	—	—	—	14,418
Stock compensation expense	—	1,064	—	—	—	1,064
Adjustment for change in Aldus Corporation fiscal year-end	(131)	(3,265)	(4,394)	—	487	(7,172)
Dividends declared	—	—	(10,418)	—	—	(10,418)
Subchapter S distributions of Mastersoft	—	—	(1,245)	—	—	(1,245)
Shares issued in connection with acquisition	105	2,105	—	—	—	2,105
Repurchase of common stock	(385)	(10,283)	—	—	—	(10,283)
Proceeds from sales of put warrants	—	719	—	—	—	719
Reclassification of put warrant obligations	—	6,906	—	—	—	6,906
Unrealized losses on investments	—	—	—	(1,277)	—	(1,277)
Cumulative translation adjustment	—	—	—	—	(235)	(235)
Net income	—	—	15,337	—	—	15,337
Balances as of November 25, 1994	69,390	204,033	315,611	(1,277)	(4,052)	514,315
Stock issued under employee stock and stock option plans	3,914	70,367	—	—	—	70,367
Tax benefit from employee stock option plans	—	32,445	—	—	—	32,445
Stock compensation expense	—	4,433	—	—	—	4,433
Adjustment for change in Frame Technology Corporation fiscal year-end	(10)	(171)	(1,784)	—	—	(1,955)
Dividends declared	—	—	(13,177)	—	—	(13,177)
Subchapter S distributions of Mastersoft	—	—	(3,342)	—	—	(3,342)
Repurchase of common stock	(460)	(17,849)	—	—	—	(17,849)
Unrealized gains on investments	—	—	—	20,108	—	20,108
Cumulative translation adjustment	—	—	—	—	(413)	(413)
Net income	—	—	93,485	—	—	93,485
Balances as of December 1, 1995	72,834	$293,258	$390,793	$18,831	$(4,465)	$698,417

(In thousands)	Common Stock		Retained Earnings	Unrealized Gains (Losses) on Investments	Cumulative Translation Adjustment	Total
	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)
Reclassification of put warrant obligations	—	(71,348)	—	—	—	(71,348)
Unrealized gains on investments	—	—	—	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**

See accompanying Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

(In thousands)	Years Ended Nov. 29 1996	Dec. 1 1995	Nov. 25 1994
Cash flows from operating activities:			
Net income	**$ 153,277**	$ 93,485	$ 15,337
Adjustments to reconcile net income to net cash provided by operating activities:			
Stock compensation expense	**2,772**	4,433	1,064
Depreciation and amortization	**55,621**	60,435	57,794
Deferred income taxes	**(6,715)**	(6,828)	(11,663)
Equity in net income of Adobe Ventures	**(19,001)**	755	—
Gains on sales of equity securities	**(53,216)**	—	—
Provision for losses on accounts receivable	**1,927**	2,038	1,963
Tax benefit from employee stock option plans	**10,828**	32,445	14,418
Write-off of acquired in-process research and development	**21,251**	14,983	15,469
Noncash restructuring costs	**2,525**	4,714	25,735
Changes in operating assets and liabilities:			
Receivables	**6,629**	(26,586)	(17,648)
Other current assets	**(1,173)**	628	(312)
Trade and other payables	**8,534**	(7,032)	11,979
Accrued expenses	**(7,198)**	3,161	14,505
Accrued restructuring costs	**(20,229)**	1,835	23,384
Income taxes payable	**46,063**	(5,184)	2,452
Deferred revenue	**(3,781)**	4,474	1,259
Net cash provided by operating activities	**198,114**	177,756	155,736
Cash flows from investing activities:			
Purchases of short-term investments	**(2,363,993)**	(2,614,349)	(1,766,916)
Maturities and sales of short-term investments	**2,363,793**	2,403,631	1,724,612
Acquisitions of property and equipment	**(45,869)**	(34,071)	(32,700)
Additions to other assets	**(65,399)**	(96,721)	(28,616)
Acquisitions, net of cash acquired	**(8,027)**	(15,158)	(14,750)
Proceeds from sales of equity securities	**72,630**	—	—
Net cash used for investing activities	**$ (46,865)**	$ (356,668)	$ (118,370)

(In thousands)	Years Ended Nov. 29 1996	Dec. 1 1995	Nov. 25 1994
Cash flows from financing activities:			
Proceeds from issuance of common stock	**$ 39,870**	$ 70,367	$ 47,180
Proceeds from sales of put warrants	**—**	—	719
Repurchase of common stock	**(126,778)**	(17,849)	(10,283)
Payment of dividends	**(14,586)**	(12,310)	(9,906)
Payment of Subchapter S distributions of Mastersoft	**—**	(3,342)	(1,245)
Net cash provided by (used for) financing activities	**(101,494)**	36,866	26,465
Effect of foreign currency exchange rates on cash and cash equivalents	**2,497**	10	(1,297)
Net increase (decrease) in cash and cash equivalents	**52,252**	(142,036)	62,534
Adjustment for change in acquired companies' fiscal year-ends	**—**	(3,591)	(3,554)
Cash and cash equivalents at beginning of year	**58,493**	204,120	145,140
Cash and cash equivalents at end of year	**110,745**	58,493	204,120
Supplemental disclosures:			
Cash paid during the year for income taxes	**30,463**	44,470	26,121
Noncash investing and financing activities:			
Dividends declared but not paid	**3,582**	3,645	2,778
Reclassification of put warrants	**71,348**	—	(6,906)
Issuance of notes for acquisition	**$ 9,473**	$ —	$ —

See accompanying Notes to Consolidated Financial Statements.

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 create, display, manage, communicate, and print electronic documents. The Company licenses its technology to major computer, printing, and publishing suppliers, and markets a line of application software products and type products for authoring and editing visually rich documents. Additionally, the Company markets a line of powerful, easy-to-use 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 system integrators. The Company has operations in North America, Japan, 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 wholly-owned subsidiaries, after elimination of all significant intercompany accounts and transactions.

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 non-current 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 shareholders' equity.

Foreign currency translation

Assets and liabilities of certain foreign subsidiaries, whose functional currency is the local currency, are translated at year-end exchange rates. Income and expense items 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 shareholders' 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 (two to seven years) or lease terms (five to nine years) of the respective assets.

Other assets

Purchased technology, goodwill, and certain other intangible assets are stated at cost less accumulated amortization. Amortization is provided on the straight-line method over the estimated useful lives of the respective assets, generally three to seven years. Capitalization of computer software development costs begins upon the establishment of technological feasibility. 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 of 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.

The Company owns a minority interest in certain technology companies and a majority interest in a limited partnership, established to invest in technology companies, and accounts for such investments under the cost and equity methods, respectively.

Revenue recognition

Application products revenue is recognized upon shipment. Revenue from distributors is subject to agreements allowing limited rights of return and price protection. The Company provides for estimated future returns at the time the related revenue is recorded.

Licensing revenue is recognized when the Company's OEM customers ship their products incorporating Adobe's software. Revenue associated with adapting the Company's software products to the OEMs' hardware products is recognized based on the percentage-of-completion method and is included in 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 royalties, amortization of typeface production costs, amortization of acquired technologies, and direct product, packaging, and shipping costs.

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. The Company does not provide deferred income taxes for unremitted earnings of foreign subsidiaries, as it is management's intent to reinvest these earnings indefinitely.

Net income per share

Net income per share is based upon weighted average common and dilutive common equivalent shares outstanding using the treasury stock method. Dilutive common equivalent shares include stock options and restricted stock. The difference between primary and fully diluted net income per share is not significant in all periods presented.

Recent accounting pronouncements

On November 30, 1996 the Company will adopt Statement of Financial Accounting Standards ("SFAS") No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS No. 121 requires long-lived assets to be evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company does not expect the adoption of SFAS No. 121 to have a material effect on the Company's consolidated results of operations.

The Company accounts for its stock option plans, employee stock purchase plan, and restricted stock plan in accordance with the provisions of the Accounting Principles Board Opinion ("APB") No. 25, "Accounting

for Stock Issued to Employees." In 1995, the Financial Accounting Standards Board released SFAS No. 123 "Accounting for Stock Based Compensation." SFAS No. 123 provides an alternative to APB No. 25 and is effective for fiscal years beginning after December 15, 1995. The Company intends to continue to account for its employee stock and stock option plans in accordance with APB No. 25. Accordingly, SFAS No. 123 is not expected to have a material impact on the Company's consolidated results of operations.

Reclassifications

Certain reclassifications were made to the 1995 and 1994 consolidated financial statements to conform to the 1996 presentation.

Note 2. Acquisitions

Poolings of interests

On October 28, 1995, the Company issued approximately 8.5 million shares of its common stock in exchange for all of the common stock of Frame. Prior to its acquisition by the Company, on July 28, 1995, Frame acquired all of the common stock of Mastersoft in exchange for approximately 0.6 million equivalent shares of Adobe common stock. On August 31, 1994, the Company issued approximately 14.2 million shares of its common stock in exchange for all of the common stock of Aldus. These business combinations have been accounted for as poolings of interests, and, accordingly, the consolidated financial statements for periods prior to the combinations have been restated to include the results of operations, financial position, and cash flows of Frame, Mastersoft, and Aldus.

There were no significant transactions among the Company, Frame, and Aldus prior to the combinations which required elimination. Prior to the combination Frame reported revenue and net income of $68.2 million and $10.5 million, respectively, for the nine-month period ended September 1, 1995, and reported revenue and net income of $77.8 million and $11.9 million, respectively, for the year ended November 25, 1994. Prior to the combination, Aldus reported revenue and net income of $172.2 million and $5.1 million, respectively, for the nine-month period ended August 26, 1994. Certain adjustments were made to Frame's tax provision and deferred tax accounts to reflect tax benefits available to the combined company.

Purchases

During 1996, 1995 and 1994, the Company acquired six software companies, in separate transactions, for an aggregate consideration of approximately $54.3 million in cash, notes payable and the assumption of certain liabilities. These acquisitions were accounted for using the purchase method of accounting and resulted in the write-off of acquired in-process research and development of $21.3 million, $15.0 million, and $15.5 million during fiscal 1996, 1995, and 1994, respectively. The operating results of the acquired companies have been included in the accompanying consolidated financial statements from their dates of acquisition. The operating results of each company acquired are not considered material to the consolidated financial statements of Adobe and, accordingly, pro forma information has not been presented.

Note 3. Cash Equivalents and Investments

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

	As of November 29, 1996			
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Classified as current assets:				
Money market mutual funds	$ 39,381	$ —	$ —	$ 39,381
United States government treasury notes and agency discount notes	90,617	424	(247)	90,794
State and municipal bonds and notes	358,612	1,894	(36)	360,470
Corporate and bank notes	38,598	405	(33)	38,970
Auction-rate securities	10,000	—	—	10,000
Asset-backed securities	11,740	91	(110)	11,721
Total current	548,948	2,814	(426)	551,336
Classified as noncurrent assets:				
Money market mutual funds	15,977	—	—	15,977
United States government treasury notes	50,327	—	(183)	50,144
Equity securities	3,882	54,216	(19)	58,079
Total noncurrent	70,186	54,216	(202)	124,200
Total securities	$619,134	$57,030	$(628)	$675,536

	As of December 1, 1995			
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Classified as current assets:				
Money market mutual funds	$ 23,387	$ —	$ —	$ 23,387
United States government treasury notes and agency discount notes	129,350	2,356	—	131,706
State and municipal bonds and notes	245,758	1,911	(80)	247,589
Corporate and bank notes	54,493	710	(26)	55,177
Auction-rate securities	13,700	—	—	13,700
Asset-backed securities	15,131	122	(182)	15,071
Total current	481,819	5,099	(288)	486,630
Classified as noncurrent assets:				
Money market mutual funds	353	—	—	353
United States government treasury notes	35,237	44	—	35,281
Equity securities	2,000	26,835	—	28,835
Total noncurrent	37,590	26,879	—	64,469
Total securities	$519,409	$31,978	$(288)	$551,099

Approximately $97.9 million and $29.1 million in investments are classified as cash equivalents as of November 29, 1996 and December 1, 1995, respectively, and all non-current investments are included in other assets. Unrealized gains (losses) on all securities are reported as a separate component of shareholders' equity, net of taxes of $23.0 million and $12.9 million as of November 29, 1996 and December 1, 1995, respectively. Net realized gains for the years ended November 29, 1996 and December 1, 1995 of $48.4 million and $1.4 million, respectively, are included in investment gain.

As of November 29, 1996, the cost, which approximated fair value, of debt securities with a maturity of one year or less, was $102.7 million, and the cost and estimated fair value of debt securities with maturities ranging from one to five years was $424.5 million and $426.9 million, respectively. Other debt securities include asset-backed securities of $11.7 million with multiple maturity dates and auction-rate securities of $10.0 million. Included in auction-rate securities are Auction Rate Certificate Securities whose stated maturities exceed ten years. However, the Company has the option of adjusting the respective interest rates or liquidating these investments at auction on stated auction dates every 35 days.

Note 4. Property and Equipment

Property and equipment consisted of the following:

	Nov. 29 1996	Dec. 1 1995
Land	**$ 782**	$ 782
Building	**4,615**	4,615
Equipment	**121,044**	122,794
Furniture and fixtures	**18,126**	18,962
Leasehold improvements	**13,036**	8,790
	157,603	155,943
Less accumulated depreciation and amortization	**77,372**	104,235
	$ 80,231	$ 51,708

Note 5. Other Assets

Other assets consisted of the following:

	Nov. 29 1996	Dec. 1 1995
Equity investments	**$ 97,679**	$ 53,091
Purchased technology and licensing agreements	**32,211**	51,945
Restricted funds and security deposits	**69,443**	35,634
Miscellaneous other assets	**35,470**	66,606
	234,803	207,276
Less accumulated amortization	**39,455**	67,039
	$195,348	$140,237

Included above in equity investments at November 29, 1996, are unrealized gains and losses. The equity investment in Netscape Communications Corporation was marked-to-market for an unrealized gain of $47.7 million. In addition, during 1996, the Company recorded 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 Communications Corporation and its entire investment in Luminous Corporation, respectively.

Note 6. Accrued Expenses

Accrued expenses consisted of the following:

	Nov. 29 1996	Dec. 1 1995
Accrued compensation and benefits	**$24,673**	$26,730
Sales and marketing allowances	**24,644**	24,586
Other	**44,640**	43,532
	$93,957	$94,848

Note 7. Accrued Restructuring Costs

In 1995 and 1994, the Company acquired Frame and Aldus, respectively, described in "Note 2 — Acquisitions," and initiated a plan to combine the operations of the companies. In connection with these acquisitions, in 1995 and 1994 the Company recorded charges of $31.5 million and $72.2 million, respectively, to operating expenses related to merger transaction and restructuring costs. In addition, Frame undertook certain restructuring measures in 1993 due to lower than anticipated revenues.

Merger transaction and restructuring costs are summarized below:

	Merger transaction cost	Severance and out-placement	Redundant information systems and equipment	Assets associated with duplicate product lines	Cancellation of facility leases and other contracts	Total
Balances as of November 27, 1993	$ —	$ 1,600	$ —	$ —	$ 6,704	$ 8,304
Additions related to Aldus acquisition	14,618	20,784	10,778	14,957	11,046	72,183
Non-cash write-offs	—	—	(10,778)	(14,957)	—	(25,735)
Cash payments	(8,755)	(10,836)	—	—	(3,473)	(23,064)
Balances as of November 25, 1994	5,863	11,548	—	—	14,277	31,688
Additions related to Frame acquisition	11,399	10,958	4,452	—	5,664	32,473
Non-cash write-offs	—	—	(4,452)	—	(3,617)	(8,069)
Cash payments	(12,204)	(9,462)	—	—	(5,336)	(27,002)
Change in estimate	—	(3,432)	—	—	2,493	(939)
Balances as of December 1, 1995	5,058	9,612	—	—	13,481	28,151
Change in estimate	(328)	948	—	—	4,335	4,955
Non-cash write-offs	—	—	—	—	(2,525)	(2,525)
Cash payments	(4,730)	(10,560)	—	—	(4,437)	(19,727)
Balances as of November 29, 1996	**$ —**	**$ —**	**$ —**	**$ —**	**$10,854**	**$10,854**

At November 29, 1996, the remaining accrued restructuring balance primarily relates to lease and third-party contract termination payments, resulting from the planned closure of duplicate offices in Europe and the United States. These payments are expected to continue through the contract terms or negotiated early termination date, if applicable.

Note 8. Income Taxes

Income before income taxes includes net income (loss) from foreign operations of approximately $25.4 million, $19.2 million, and $(8.7) million for the years ended November 29, 1996, December 1, 1995, and November 25, 1994, respectively.

The provision for income taxes consisted of the following:

	Years Ended		
	Nov. 29 1996	Dec. 1 1995	Nov. 25 1994
Current:			
United States federal	**$65,118**	$21,466	$22,048
Foreign	**12,290**	18,418	8,336
State and local	**12,731**	5,206	7,170
Total current	**90,139**	45,090	37,554
Deferred:			
United States federal	**(6,825)**	(6,305)	(10,683)
Foreign	**(780)**	(986)	(1,785)
State and local	**(1,815)**	124	(1,895)
Total deferred	**(9,420)**	(7,167)	(14,363)
Charge in lieu of taxes attributable to employee stock plans	**10,828**	32,445	14,418
	$91,547	$70,368	$37,609

Total income tax expense differs from the expected tax expense (computed by multiplying the United States federal statutory rate of approximately 35 percent for 1996, 1995, and 1994 to income before income taxes) as a result of the following:

	Years Ended		
	Nov. 29 1996	Dec. 1 1995	Nov. 25 1994
Computed "expected" tax expense	**$85,689**	$57,349	$18,531
State tax expense, net of federal benefit	**9,819**	6,442	3,429
Nondeductible merger costs	**—**	4,078	5,209
Nondeductible write-off of acquired in-process research and development	**5,310**	5,244	5,475
Nondeductible goodwill	**772**	3,689	1,741
Tax-exempt income	**(3,304)**	(3,532)	—
Tax credits	**(4,912)**	(3,904)	(1,755)
Foreign losses, not benefited	**—**	2,706	3,550
Foreign tax rate differential	**(4,003)**	1,130	2,027
Other, net	**2,176**	(2,834)	(598)
	$91,547	$70,368	$37,609

The tax effects of the temporary differences that give rise to significant portions of the deferred tax assets and liabilities as of 1996 and 1995 are presented below:

	Nov. 29 1996	Dec. 1 1995
Deferred tax assets:		
Acquired technology	**$12,037**	$ 4,750
Reserves and deferred revenue	**24,615**	25,025
Depreciation and amortization	**7,662**	3,544
Net operating loss carryforwards	**4,278**	10,625
Tax credits and other carryforwards	**1,614**	5,702
Other	**5,800**	3,468
Total gross deferred tax assets	**56,006**	53,114
Deferred tax asset valuation allowance	**(5,950)**	(10,204)
Total deferred tax assets	**50,056**	42,910
Deferred tax liabilities:		
Investments	**(22,888)**	(12,860)
Other	**(1,943)**	(1,210)
Total deferred tax liabilities	**(24,831)**	(14,070)
Net deferred tax assets	**$25,225**	$28,840

As of November 29, 1996, the Company had tax credit carryforwards of approximately $1.6 million, which expire in years 1997 through 2009. The carryforwards are attributable to the premerger years of Frame and are subject to certain limitations on usage. The Company also has foreign operating loss carryovers in various jurisdictions of approximately $8.2 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 and certain other deferred tax assets relating to foreign operations. 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.

Note 9. Benefit Plans

Stock Option Plans

The employee stock option plan 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. Options generally vest 25 percent after the first year and ratably thereafter such that 50 percent and 100 percent are vested after the second and third year, respectively. The option terms range from five to ten years.

As of November 29, 1996, the Company had reserved 500,000 shares of common stock for issuance under its Outside Directors Stock Option Plan, which provides for the granting of nonqualified stock options to non-

employee directors. Option grants are limited to 10,000 shares per person in each fiscal year except for a new nonemployee director who may be granted 15,000 shares upon joining the Board. All options are immediately exercisable within a ten-year term. Options generally vest over three years: 25 percent in each of the first two years and 50 percent in the third year.

On March 22, 1996, the Company offered its employees a stock option repricing program which allowed the employees to exchange on a two for three share 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 1996, 1995 and 1994 is presented in the following table:

	Options Available for Grant	Options Outstanding	
		Number of Shares	Price per Share
Balances as of November 26, 1993	5,490,588	12,089,494	$ 0.06 – 47.25
Additional shares reserved	349,000	—	—
Options granted	(2,723,550)	2,723,550	3.44 – 36.38
Options exercised	—	(2,627,318)	0.06 – 33.75
Options cancelled	979,842	(979,842)	0.58 – 43.27
Adjustment for change in Aldus' fiscal year-end	142,314	(51,421)	—
Aldus options retired	(968,713)	—	—
Balances as of November 25, 1994	3,269,481	11,154,463	0.25 – 47.25
Additional shares reserved	588,000	—	—
Options granted	(2,391,568)	2,391,568	3.45 – 67.00
Options exercised	—	(3,008,917)	0.25 – 50.75
Options cancelled	430,195	(430,195)	0.57 – 58.25
Adjustment for change in Frame's fiscal year-end	(5,688)	18,873	—
Frame options retired	(228,903)	—	—
Aldus options retired	(65,451)	—	—
Balances as of December 1, 1995	1,596,066	10,125,792	2.60 – 67.00
Additional shares reserved	3,600,000	—	—
Options granted	(2,670,673)	2,670,673	30.88 – 64.13
Options exercised	—	(1,470,762)	2.60 – 50.75
Options cancelled	2,028,515	(2,028,515)	5.77 – 67.00
Frame options retired	(336,467)	—	—
Aldus options retired	(22,252)	—	—
Balances as of November 29, 1996	**4,195,189**	**9,297,188**	**$3.28 – 67.00**

Of the options outstanding for the stock option plans, 5,867,122 were exercisable as of November 29, 1996. All options outstanding were exercisable as of November 29, 1996 under the Restricted Stock Option Plan, described below.

Performance and Restricted Stock Plan

The Performance and Restricted Stock Plan provides for the granting of restricted stock and/or performance units to officers and key employees. As of November 29, 1996, the Company had reserved 1,500,000 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 shareholders are entitled to dividends and voting rights. As of November 29, 1996, 112,742 shares were outstanding and not yet vested.

Performance units issued under this plan entitle the recipient to receive shares or cash upon completion of the performance period subject to attaining identified performance goals. Performance units are generally earned over a three-year period and shares earned are issued at the end of the three-year period. The ultimate value of the performance units is dependent upon the Company's revenue and operating margin growth (as defined by the Plan) during the three-year performance period adjusted by a factor determined by comparing the growth in the Company's stock price to an index of comparable stocks. The projected value of these units is accrued by the Company and charged to expense over the three-year performance period. As of November 29, 1996, and December 1, 1995, performance units for 94,745 and 75,420 shares were outstanding, respectively, and $(0.2) million and $2.5 million was charged to expense in 1996 and 1995, respectively. There were no performance units outstanding during the year ended November 25, 1994.

Employee Stock Purchase Plan

Under the terms of the Company's Employee Stock Purchase Plan, eligible employee participants may purchase shares of the Company's common stock semiannually at 85 percent of the market price, on either the purchase date or the offering date, whichever price is lower. As of November 29, 1996, the Company had reserved 4,000,000 shares of its common stock for issuance under this plan and 932,404 shares remain available for future issuance.

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 percent of their pretax salary, subject to certain limitations. The Company matches approximately 25% of employee contributions and contributed approximately $1.6 million, $1.2 million, and $0.7 million in 1996, 1995, and 1994, respectively. Matching contributions can be terminated at the Company's discretion.

Note 10. Capital Stock

Shareholder Rights Plan

The Company's Shareholder Rights Plan is intended to protect shareholders 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.

Put warrants

In a series of private placements in 1996 and 1994, the Company sold put warrants entitling the holder of each warrant to sell one share of common stock to

the Company at a specified price. The Company received $0.7 million for the sale of put warrants in 1994. The Company's $71.3 million potential buyback obligation, as of November 29, 1996, was removed from shareholders' equity and recorded as put warrants. No put warrants were outstanding as of December 1, 1995. The approximately 2.3 million put warrants outstanding at November 29, 1996 expire on various dates through April 1997 and have exercise prices ranging from $29.70 to $32.41 per share, with an average exercise price of $31.29 per share.

Note 11. Commitments and Contingencies

Lease commitments

The Company has operating leases for its corporate headquarters, field sales offices and certain office equipment that expire at various dates through 2015. Rent expense for these leases aggregated $18.3 million, $21.0 million, and $16.9 million during 1996, 1995, and 1994, respectively. As of November 29, 1996, future minimum lease payments under noncancelable operating leases are as follows: 1997 — $17.2 million; 1998 — $13.6 million; 1999 — $10.3 million; 2000 — $8.0 million; 2001 — $6.9 million; and $14.3 million, thereafter.

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 an 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 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. During the construction period, 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. During 1996, the Company deposited approximately $30.5 million, and as of November 29, 1996, the Company's deposits under this agreement totaled approximately $66.1 million in United States government treasury notes and money market mutual funds. These deposits are included in "Other assets" in the Consolidated Balance Sheets.

During the third quarter of 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 operating lease will commence on completion of construction in 1998. The Company will have the option to purchase the facility at the end of the lease term. 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 also is required, periodically during the construction period, to deposit funds with the lessor as an interest bearing security deposit to secure the performance of its obligations under the lease. During the second half of 1996, the Company deposited approximately $3.3 million. These deposits are included in "Other assets" in the Consolidated Balance Sheets.

Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain products. While royalty expense is generally based on a dollar amount per unit shipped, ranging from $0.005 to $40.83, certain royalties are based on a percentage, ranging from 0.05 percent to 50 percent, of the underlying revenue. Royalty expense was approximately $19.8 million, $23.1 million, and $35.2 million for the years ended November 29, 1996, December 1, 1995, and November 25, 1994, respectively.

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 12. Transactions with Affiliate

The Company holds a 17 percent equity interest in McQueen Holdings Limited ("McQueen") and accounts for the investment at cost. 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. Adobe makes minimum annual payments to McQueen for certain services which amounted to $4.8 million in fiscal 1996. Purchases from McQueen amounted to $34.3 million, $23.6 million, and $13.0 million during 1996, 1995 and 1994, respectively.

Note 13. Financial Instruments

Fair value of financial instruments

The Company's cash equivalents, short-term investments, restricted funds, put options, 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 majority interest in Adobe Ventures LP, accounted for using the equity method, is carried at $30.7 million which is believed to approximate the fair value of underlying investments in technology companies. Most of the technology companies in which the limited partnership invests are not publicly traded, and therefore there is no established market for these investments. As such, these investments are valued based on estimates made by the management of Adobe Ventures LP. For investments of the limited partnership that are publicly traded, the fair value of the investments are based on quoted market prices, and mark-to-market adjustments are included in investment income.

Concentration of credit 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 in any one issue, and the Company believes no significant concentration of credit risk exists with respect to these investments.

Credit risk in receivables is limited to OEMs, 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.

Industry segment

Adobe and its subsidiaries operate in one dominant industry segment. The Company is engaged principally in the design, development, manufacture, and licensing of computer software. No customer accounted for more than 10 percent of the Company's total revenue in 1996, 1995 or 1994.

Note 14. Foreign Operations

Geographic information for each of the years in the three-year period ended November 29, 1996, is presented below:

	Years Ended		
	Nov. 29 1996	**Dec. 1 1995**	**Nov. 25 1994**
Revenue:			
North America	**$ 526,251**	$533,332	$494,525
Europe	**134,879**	133,982	124,283
Japan, Asia-Pacific and Latin America	**176,490**	107,357	72,036
Eliminations	**(51,057)**	(12,332)	(15,227)
	786,563	762,339	675,617
Operating income:			
North America	**31,186**	26,446	7,991
Europe	**16,408**	37,319	1,818
Japan, Asia-Pacific and Latin America	**103,002**	70,416	32,745
Eliminations	**(3,810)**	390	(40)
	146,786	134,571	42,514
Identifiable assets:			
North America	**1,024,005**	944,484	670,650
Europe	**69,458**	64,807	60,375
Japan, Asia-Pacific and Latin America	**22,102**	14,258	18,633
Eliminations	**(103,280)**	(138,817)	(39,658)
	$1,012,285	$884,732	$710,000

Independent Auditors' Report

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

We have audited the accompanying consolidated balance sheets of Adobe Systems Incorporated and subsidiaries as of November 29, 1996 and December 1, 1995, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the years in the three-year period ended November 29, 1996. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the consolidated financial statements of Frame Technology Corporation, a company acquired by the Company in a business combination accounted for as a pooling of interests, as described in Note 2 to the consolidated financial statements, which statements reflect total revenue constituting 12 percent of consolidated fiscal 1994 revenue. The financial statements of Frame Technology Corporation were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Frame Technology Corporation, is based solely upon the report of the other auditors.

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 and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, 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 29, 1996 and December 1, 1995, and the results of their operations and their cash flows for each of the years in the three-year period ended November 29, 1996, in conformity with generally accepted accounting principles.

KPMG Peat Marwick LLP

KPMG Peat Marwick LLP
San Jose, California
December 17, 1996

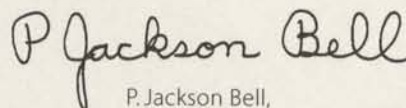
Management's Report

Management is responsible for all the information and representations contained in the consolidated financial statements and other sections of this Annual Report. Management believes that the consolidated financial statements have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances to reflect in all material respects the substance of events and transactions that should be included, and that the other information in this Annual Report is consistent with those statements. In preparing the consolidated financial statements, management makes informed judgments and estimates of the expected effects of events and transactions that are currently being accounted for.

In meeting its responsibility for the reliability of the consolidated financial statements, management depends on the Company's system of internal accounting controls. This system is designed to provide reasonable assurance that assets are safeguarded and transactions are executed in accordance with management's authorization, and are recorded properly to permit the preparation of consolidated financial statements in accordance with generally accepted accounting principles. In designing control procedures, management recognizes that errors or irregularities may nevertheless occur. Also, estimates and judgments are required to assess and balance the relative cost and expected benefits of the controls. Management believes that the Company's accounting controls provide reasonable assurance that errors or irregularities that could be material to the consolidated financial statements are prevented or would be detected within a timely period by employees in the normal course of performing their assigned functions.

The Board of Directors pursues its oversight role for these consolidated financial statements through the Audit Committee, which is comprised solely of Directors who are not officers or employees of the Company. The Audit Committee meets with management periodically to review their work and to monitor the discharge of each of their responsibilities. The Audit Committee also meets periodically with KPMG Peat Marwick LLP, the independent auditors, who have free access to the Audit Committee or the Board of Directors, without management present, to discuss internal accounting control, auditing, and financial reporting matters.

KPMG Peat Marwick LLP is engaged to express an opinion on our consolidated financial statements. Their opinion is based on procedures believed by them to be sufficient to provide reasonable assurance that the consolidated financial statements are not materially misleading and do not contain material errors.



P. Jackson Bell,
Executive Vice President,
Chief Financial Officer,
Chief Administrative Officer,
and Assistant Secretary
(Principal Financial Officer)

December 17, 1996

Quarterly Results of Operations

(in thousands, except per share data)	1996 Quarter Ended Mar. 1 1996	May 31 1996	Aug. 30 1996	Nov. 29 1996	Year Ended Nov. 29
Revenue	**$193,642**	**$204,337**	**$180,909**	**$207,675**	**$786,563**
Gross margin	**158,434**	**168,259**	**147,292**	**171,431**	**645,416**
Merger transaction and restructuring costs	—	—	—	**4,955**	**4,955**
Income before income taxes	**53,861**	**39,787**	**48,686**	**102,490**	**244,824**
Net income	**33,663**	**22,009**	**29,847**	**67,758**	**153,277**
Net income per share	**0.44**	**0.29**	**0.40**	**0.92**	**2.04**
Shares used in computing net income per share	**76,394**	**75,638**	**74,309**	**73,913**	**75,064**
Common stock price per share:					
High	**$ 74.25**	**$ 45.13**	**$ 37.88**	**$ 44.13**	**$ 74.25**
Low	**30.00**	**30.75**	**28.50**	**31.50**	**28.50**

(in thousands, except per share data)	1995 Quarter Ended Mar. 3 1995	June 2 1995	Sept. 1 1995	Dec. 1 1995	Year Ended Dec. 1
Revenue	$188,845	$189,498	$183,120	$200,876	$762,339
Gross margin	154,991	157,188	155,637	164,222	632,038
Merger transaction and restructuring costs	—	—	—	31,534	31,534
Income (loss) before income taxes	57,246	55,913	52,354	(1,660)	163,853
Net income (loss)	36,144	35,245	33,886	(11,790)	93,485
Net income (loss) per share	0.50	0.47	0.44	(0.16)	1.26
Shares used in computing net income (loss) per share	72,888	75,321	76,325	72,477	74,253
Common stock price per share:					
High	$ 36.25	$ 58.75	$ 66.50	$ 70.25	$ 70.25
Low	27.25	34.25	44.38	45.00	27.25

The Company's common stock is traded on The Nasdaq Stock Market under the symbol "ADBE." On December 27, 1996, there were 2,238 holders of record of the Company's common stock.

Corporate Information

Executive Staff

John E. Warnock*
Chairman of the Board & Chief Executive Officer

Charles M. Geschke*
President

David B. Pratt*
Executive Vice President & Chief Operating Officer

Jack Bell*
Executive Vice President, Chief Financial Officer & Chief Administrative Officer

Robert A. Roblin*
Sr. Vice President, Corporate Marketing

Colleen M. Pouliot*
Vice President, General Counsel & Secretary

Ross A. Bott*
Sr. Vice President & General Manager, Graphics Products Division

John H. Brandon*
Vice President, North America Sales & Support

Derek J. Gray*
Sr. Vice President & General Manager, Adobe Systems Europe

Hachiro Kimura*
President, Adobe Systems Japan

John H. Kunze*
Vice President & General Manager, Internet Products Division

Frederick A. Schwedner*
Sr. Vice President & General Manager, Printing & Systems Division

Paul R. Anderson
Vice President & General Manager, Publishing Products Division

Bruce R. Chizen
Vice President & General Manager, Consumer Products Division

Graham K. Freeman
Vice President & General Manager, Asia, Pacific & Latin America

Rebecca M. Guerra
Vice President, Human Resources

Vito A. Laudicina
Vice President & Chief Information Officer

J. Stuart Mitchell
Vice President, OEM Sales

Donald C. (Smokey) Wallace
Vice President, Corporate Engineering

*Executive Officers of Adobe

Board of Directors

John E. Warnock
Chairman of the Board & Chief Executive Officer

Charles M. Geschke
President & Director

Gene P. Carter
Director

William R. Hambrecht
Director

Robert Sedgewick
Director

William J. Spencer
Director

Delbert W. Yocam
Director

Form 10-K

A copy of the Company's Annual Report to the Securities & Exchange Commission (Form 10-K) is available free of charge by writing or calling:

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Or see the Adobe home page at
www.adobe.com

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Harris Trust Company of California, Chicago, Illinois

Stock Exchange Listing

The Nasdaq Stock Market, ticker symbol "ADBE"

Independent Auditors

KPMG Peat Marwick LLP, San Jose, California

This Annual Report contains forward-looking statements that involve risks and uncertainties and actual results may differ materially. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the Letter to Shareholders and Management's Discussion and Analysis of Financial Condition and Results of Operations as well as those discussed elsewhere in the Company's SEC reports. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report. 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.

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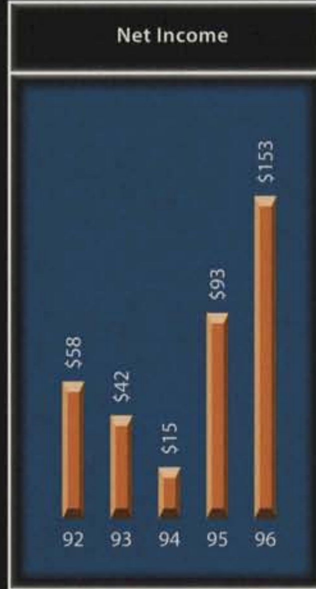
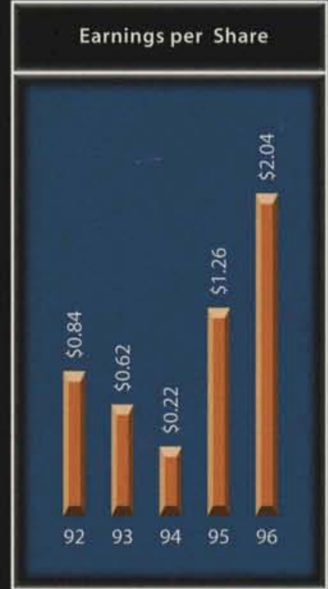
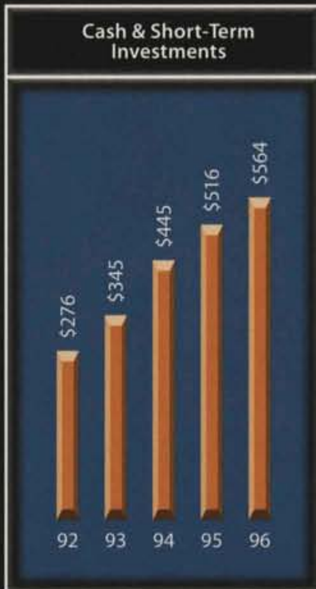
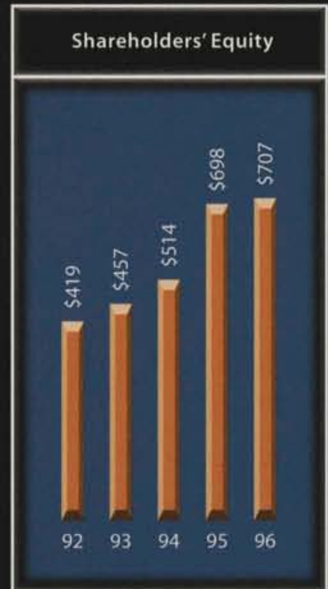
Financial Performance

(dollars in millions)









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