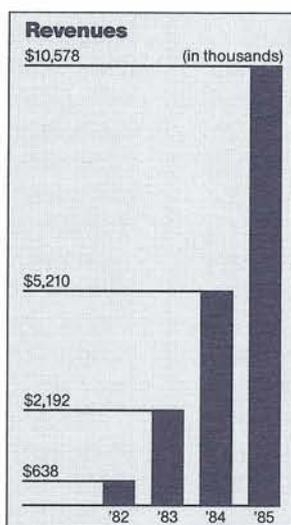


Leading Products
in Growing Markets



Relational Database Systems, Inc. (RDS) is a supplier of UNIX-based data management software. The Company pioneered the development of a fully relational database management system for 16-bit microcomputers in 1980. Since then, it has become a market leader, developing a broad portfolio of application development tools to suit a complete range of user requirements.

RDS was one of the first of any database management system (DBMS) suppliers to design its software to run on both UNIX and MS-DOS based computer systems. As a market leader in the field of relational data management technology, it has developed one of the most comprehensive product lines in the



industry. Its foundation software product, C-ISAM, is emerging both as a worldwide standard and as an integral part of the UNIX operating system. RDS is firmly committed to maintaining and enhancing its leadership role in developing industry-wide database software standards.

As a privately-held corporation, RDS has historically financed its own growth, relying primarily on internally generated capital for funding. In its six-year history, RDS has consistently exceeded its yearly objectives, more than doubling sales revenues each year. At the same time, it has invested substantially in programs which contribute to the long-term development of the Company and which solidify its position as a market leader.

Financial Highlights

Highlights for the Year	1985	1984	% Change
Revenues	\$10,578,000	\$5,210,000	103%
Income Before Taxes	2,118,000	1,015,000	109%
Net Income	1,174,000	620,000	89%
Net Income per Share	\$0.44	\$0.28	57%
At End of Year	1985	1984	% Change
Total Assets	\$ 7,071,000	\$2,459,000	188%
Working Capital	2,866,000	463,000	519%
Shareholders' Equity	3,323,000	1,075,000	209%
Shares Issued and Outstanding	2,757,000	2,273,000	21%

To Our Shareholders:

Relational Database Systems, Inc., made significant growth and progress during 1985 in virtually all facets of its business.

Financially, our Company's revenues grew by 103% from \$5.2 million in 1984 to \$10.6 million in 1985. Net income after taxes increased 89% from \$620 thousand in 1984 to \$1.2 million in 1985. Our financial strength was further augmented by \$1.5 million in capital investment, placed by an outside investor. As a result, working capital increased 519% from \$463 thousand in 1984 to \$2.9 million at the end of 1985. Shareholders' equity grew 209% during the year, while the number of shares outstanding increased by only 21%, a clear sign that the dilution resulting from the increased investment more than proportionally benefited all our present shareholders.

Physically, our Company grew 117% from 57 employees at the end of 1984 to 124 employees at the end of 1985. We moved from an overcrowded 12,000 square foot facility in Palo Alto, California, to a new, spacious, and attractive 35,000 square foot two-story office building in Menlo Park. Our Company's computer facilities are excellent, and they are constantly being upgraded and augmented so that our research and development staff have the equipment necessary to keep RDS' products among the leaders in the field and so that all our employees, who have easy access to workstation terminals, can work in an efficient and up-to-date manner.

Managerially, we augmented our top management team. The new officer position of vice president of sales was created to help us grow and manage our sales organization. In addition, we added several middle management positions to strengthen the infrastructure of the Company.

1985 was also a year in which we broadened the base of our software products. At the beginning of the year we introduced our new INFORMIX-SQL products, which were our first products to incorporate the industry standard SQL database

language syntax. SQL was invented by IBM, and is used by several popular competitive products. Our implementation of SQL is a relatively complete implementation, especially when compared to our competitors. This is crucial to government sales and will become more critical in years to come in private business sales as well.

The RDS product line includes INFORMIX-SQL, with its interactive query language, report writer and form building system, as well as products to provide the SQL syntax embedded in COBOL and C.

We updated our successful C-ISAM product to be compatible with our SQL products at the same time. C-ISAM is our internal library of indexed file search and storage subroutines, which was developed into a separate product in 1981. One indication of C-ISAM's success is that it has been declared the standard ISAM for UNIX by the X/OPEN consortium of European computer hardware manufacturers. X/OPEN includes Olivetti, Siemens, Nixdorf, Ericsson, Bull, ICL and Philips. All of these companies, representing the bulk of the computer manufacturing power in Europe, have accepted C-ISAM as the standard indexed file access method for UNIX.

Also, AT&T has licensed C-ISAM under terms that would allow them to make C-ISAM part of UNIX universally. The success of C-ISAM allows RDS to enjoy an advantage in its database sales, since all of its products are built upon this emerging standard.

During the year we continued development on our new fourth generation language, INFORMIX-4GL, which was released in early 1986. We also began transporting our products to operating systems other than UNIX and MS-DOS, such as the VAX native operating system, VMS. This market has always been interested in relational database systems and has been a primary target for some of our competitors. We feel that by bringing our line of products to this market we will provide a unique solution to these users in the form of compatibility with our products on other systems, as well as superior functionality of the products as compared to competitive products in this environment. Since we have a large installed base of computers that run our software, we believe there are companies that would like to run this same software on their VAX machines that do not run UNIX.

Our MS-DOS sales have become an increasing part of our overall sales during 1985. This is probably due to increased shipments of the IBM PC/AT, which is a high end personal computer. Since our software on PC's is at this high end of the market, this trend makes sense. As this class of customer, mostly corporations, continues to use small computers for more sophisticated tasks, we expect our high end niche to grow, thus increasing our penetration in this very large market. In recent years, many companies had difficulty trying to buy their way into a dominant position in the PC market. We have been successful in increasing our market share with very little advertising support, however, because of our unique niche position.

In 1985 we also began shipping our first network product, INFORMIX-SQL, for the IBM PC Network. This is just the beginning of our ventures into the networking market. The networking together of UNIX minicomputers and PC's is very promising. Since we provide products for both those types of computers, we are in a particularly good position in this small, but growing market segment.

The fact that our products run on PC's running MS-DOS, minicomputers running UNIX, networks of machines, and soon VMS, allows us to solve the large customer's needs in a variety of ways. This fact alone allows us to win sales, and this is fundamentally our strategy as we go forward—that is to continue to solve the big customers' needs in all the ways they require.

Thus, we provide a variety of software building tools, for a variety of popular operating systems and networks, and we believe that this type of customer and these needs will be the fastest growing segment of our industry.



Roger J. Sippl
President and Chairman of the Board

In 1985, numerous commercial applications were built using the RDS family of database management tools on over one hundred different computer systems. From laptops to mainframes, from management to government, hundreds of computer users worldwide use RDS software to increase productivity and to manage information easily. Users were attracted to RDS' support for UNIX, MS-DOS, and networked operating systems, as well as the built-in migration path from one RDS product to another. In addition, RDS software was embedded in well over two hundred diverse products including Integrated Voice Data Workstations, proprietary operating systems, and proprietary languages. The RDS family of DBMS products includes:

INFORMIX—a fast and powerful relational database management system designed for high-end application environments. It offers systems integrators and end users all of the tools necessary to customize, use, and maintain sophisticated applications. INFORMIX offers a complete, fully integrated solution for effective information management.

INFORMIX-SQL—a full functioned RDBMS that combines the performance and ease-of-use of INFORMIX with the power and flexibility of ANSI-standard Structured Query Language (SQL), developed by IBM for the mainframe world. INFORMIX-SQL is based on a new database architecture that uses SQL for data definition, data manipulation, and data control functions. Through a self-contained environment, INFORMIX-SQL provides easy access to sophisticated application development tools, context sensitive help, and data management utilities.

INFORMIX-ESQL/C—(Embedded SQL for C) offers two sets of powerful tools for the C programmer: first, the ability to embed SQL statements in C programs to add new tables, create indexes, perform mass database updates and more; and second, a C programming interface to INFORMIX-SQL's form and report facilities.

INFORMIX-ESQL/COBOL—(Embedded SQL for COBOL) provides high-level tools to build custom applications in COBOL. Using INFORMIX-ESQL/COBOL, a programmer can add new tables, create indexes, perform mass database updates, and more, through simple SQL statements embedded within COBOL source code.

C-ISAM—a standard indexed retrieval method for UNIX, is the foundation on which all RDS products are based. C-ISAM's B+ Tree indexing structure provides extremely rapid data access and retrieval. C-ISAM is available as a separate product primarily for sophisticated users such as language houses, software vendors, systems integrators or corporate data processing professionals who are developing vertical applications.

File-it!—a fully interactive friendly file manager designed for the business professional or casual user. File-it! applications can easily be upgraded to INFORMIX-SQL as the user's needs become more sophisticated. No additional reprogramming or re-entry of data or re-training of personnel is required.

RDS has implemented a balanced distribution strategy that relies on a broad spectrum of channel alternatives in order to efficiently deliver products and services to the end user. This strategy has been designed to maximize product shipments and minimize potential sources of conflict. As a result, important strategic agreements and distribution programs have been formed with other companies at various tiers of the distribution network.

At the hardware OEM level, RDS signed licensing agreements with many of the largest and most well-known computer manufacturers. These manufacturers selected RDS products often as a result of highly competitive evaluations of similar DBMS products. A partial list of computer manufacturers with whom OEM agreements have been signed includes such industry leaders as Altos Computer Systems, AT&T, Data General, IBM, Northern Telecom and Siemens. As part of many of these licensing agreements, RDS' products were often re-packaged and marketed directly through large OEM sales forces that are national in scope.

By the end of the year, the Value-Added Reseller (VAR) channel had begun to reach new segments of the user marketplace. These resellers developed significant products in vertical industries based on a combination of RDS' software and computer hardware. A comprehensive listing of these products is published annually in the RDS Independent Vendor Catalog in order to support the efforts of systems integrators and VARs. This catalog, with over five hundred entries, continues to dramatically increase in size as a result of brisk VAR activity. In addition, a specialized program, called STAR*VAR, was implemented by RDS to address the unique requirements of VARs. Given the fact that a vast number of VARs' product offerings are based on the "super-micro" class computers, traditionally an RDS stronghold, this market holds even greater potential for high-growth in 1986.

Increasingly, major departments of the United States Government have acknowledged the advantages of software standardization based on both UNIX and SQL. RDS has consistently demonstrated its commitment to this standardization as well as its leadership position in the UNIX software marketplace. To directly address the growing demand for RDS products within the Federal Government, and to better serve the needs of RDS systems integrators in the region, a district sales office was established in Washington, D.C., in 1985. RDS products were selected for major procurements by governmental agencies such as the Internal Revenue Service, the U.S. Army, the U.S. Customs Service and NASA.

RDS has also expanded its international distribution base. By developing its marketing capabilities through strategic distributors overseas, RDS is making significant inroads in markets worldwide. To tap into what are often lucrative software markets located abroad, intricate translations of INFORMIX have been written in Japanese Kanji, French, Italian, German and Danish. Reception to RDS' products overseas has been enthusiastic. In many western countries, RDS' products maintain a significant share of the market.

In order to meet its growth objectives, the RDS field organization was expanded to include offices in Boston, Washington, D.C., and Chicago. A telemarketing salesforce was organized, resulting in the expansion of direct sales activities targeted at end user and retail organizations. Consequently, many Fortune 1000 companies, financial services corporations and educational institutions that would not otherwise have had any access to RDS' products are now purchasing directly from RDS.

Advertising and Public Relations

In order to solidify its position as a market leader in an intensely competitive software marketplace, RDS has invested substantially in on-going advertising, promotion and publicity programs. To increase public awareness for products such as INFORMIX-SQL and C-ISAM, an aggressive advertising program was launched and continued throughout the year. RDS advertisements appear in dozens of trade-specific publications including Computerworld, Datamation, Unix/World and Unix Review. Likewise, RDS has also received extensive coverage by the trade news media. In the past year, feature articles about RDS and its products appeared in many well-known publications. Joint press activity among RDS and its sales partners also attracted substantial media attention. In addition, extensive use was made of other marketing and promotional mediums such as direct mail, and thorough market research was conducted to maximize advertising and promotional expenditures.

STAR*VAR

At COMDEX/Fall, RDS announced an innovative new sales program known as STAR*VAR. The program is designed to meet the unique development requirements of Value-Added Resellers. By acknowledging the joint sales effort that exists between RDS and its VARs, the program provides resellers with a comprehensive support package which includes consulting and technical and marketing support, as well as substantial discounts. By allowing VARs to develop their resources, RDS has attracted many fine resellers in the highly competitive VAR arena.

HOOKS

RDS has enjoyed success with the implementation of its HOOKS program. In its multi-year effort to spur support for industry standardization

and integration based on IBM's Structured Query Language (SQL), RDS provided qualified vendors with INFORMIX-ESQL/C (embedded SQL for C) and the source code for the SQL Interface Library. The purpose of the HOOKS program is to encourage developers to build applications on SQL. Because the RDS SQL architecture allows different packages to access the same data at the same time, true integration is possible. Many VARs and systems integrators are participating in the RDS HOOKS program.

Customer Service

Complete documentation is provided with every RDS software product. In addition, full maintenance is available for RDS' entire product family. Technical phone support, product updates, and new releases are important components of the program. Customer call reports are reviewed regularly by RDS management.

Education and Training

RDS maintains a vigorous commitment to its training and educational programs. These services are designed to enhance product acceptance and momentum in the marketplace. Professional training for RDS' products is conducted at RDS headquarters, at a customer site, and on a regional basis in cities such as Chicago, Detroit, Washington, D.C., and Dallas. Courses in UNIX, vi, and database design are also part of the curriculum.

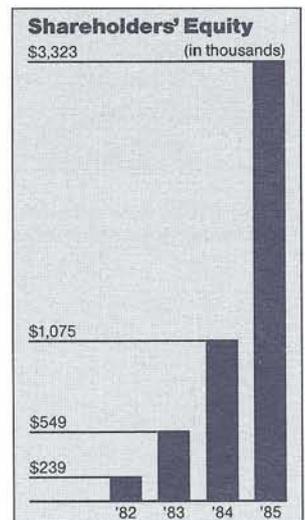
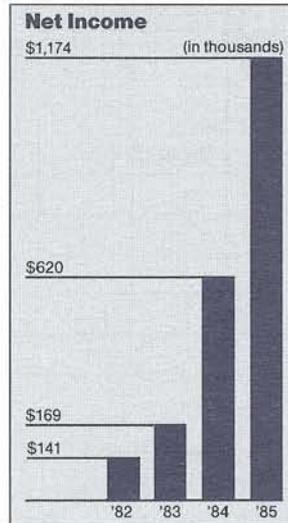
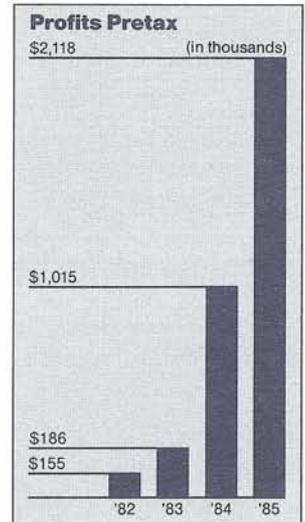
To the Board of Directors of Relational Database Systems, Inc.:

We have examined the balance sheets of Relational Database Systems, Inc. (a California corporation) as of December 31, 1985 and 1984 and the related statements of operations, shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Relational Database Systems, Inc., as of December 31, 1985 and 1984, and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Arthur Andersen & Co.

Arthur Andersen & Co.
San Jose, California
January 27, 1986



Balance Sheets

December 31, 1985 and 1984

Relational Database Systems, Inc.

ASSETS	1985	1984
Current Assets:		
Cash	\$2,808,336	\$ 225,132
Accounts receivable, less allowance of \$60,000 in 1985 and \$177,000 in 1984 for doubtful accounts	2,555,541	1,412,771
Prepaid expenses	250,014	65,281
Inventory	208,039	28,490
Total current assets	5,821,930	1,731,674
Property and Equipment, at cost:		
Computer equipment	947,995	679,277
Furniture and fixtures	576,270	220,286
	1,524,265	899,563
Less—Accumulated depreciation	(405,409)	(175,470)
	1,118,856	724,093
Other Assets	130,000	3,458
Total assets	\$7,070,786	\$2,459,225
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Current maturities of notes payable to bank	\$ 66,000	\$ 23,833
Current portion of lease payable	22,560	—
Accounts payable	379,339	280,446
Accrued expenses	1,003,160	593,156
Accrued and deferred income taxes	1,168,474	290,485
Deferred maintenance contract income	315,949	81,154
Total current liabilities	2,955,482	1,269,074
Notes Payable to Bank	197,833	64,000
Lease Payable	109,285	—
Guarantee of ESOP Liability	397,000	—
Deferred Taxes	88,467	50,839
Shareholders' Equity:		
Common stock, no par value		
Authorized—5,000,000 shares in 1985 and 1984		
Outstanding—2,756,936 shares in 1985 and 2,273,331 shares in 1984	1,943,929	449,155
Notes receivable from shareholder	(42,000)	(18,000)
Deferred compensation	(397,000)	—
Retained earnings	1,817,790	644,157
Total shareholders' equity	3,322,719	1,075,312
	\$7,070,786	\$2,459,225

The accompanying notes are an integral part of these statements.

Statements of Operations

For the Years Ended December 31, 1985, 1984 and 1983

Relational Database Systems, Inc.

	1985	1984	1983
Net Revenues	\$10,577,918	\$5,210,410	\$2,191,785
Cost of Revenues	897,128	406,778	213,663
Gross margin	9,680,790	4,803,632	1,978,122
Operating Expenses:			
Marketing	4,896,886	2,193,096	822,257
Research and development	1,470,544	712,720	672,066
General and administrative	1,275,554	902,676	323,108
	7,642,984	3,808,492	1,817,431
Income from operations	2,037,806	995,140	160,691
Interest Income (net)	80,509	20,120	25,767
Income before provision for income taxes	2,118,315	1,015,260	186,458
Provision for Income Taxes:			
Federal	744,980	298,107	—
State	199,702	97,433	17,900
Net Income	\$ 1,173,633	\$ 619,720	\$ 168,558
Net Income Per Share	\$.44	\$.28	\$.08
Weighted Average Number of Common and Common Equivalent Shares Outstanding	2,683,122	2,187,753	2,166,049

The accompanying notes are an integral part of these statements.

Statements of Shareholders' Equity

For the Years Ended December 31, 1985, 1984 and 1983

Relational Database Systems, Inc.

	Common Stock		Notes Receivable From Shareholders	Deferred Compensation	Retained Earnings	Total
	Shares	Amount				
Balance,						
December 31, 1982	1,878,770	\$ 175,017	\$ —	\$ —	\$ 63,879	\$ 238,896
Issuance of common stock at \$2.00 per share, to an employee in exchange for a non-interest bearing promissory note	10,000	20,000	(20,000)	—	—	—
Exercise of stock options at \$.22 per share	209,640	46,119	—	—	—	46,119
Tender of common stock as payment for stock options exercised at \$2.50 per share	(15,221)	(38,052)	—	—	—	(38,052)
Issuance of common stock for bonuses at \$2.50 per share	53,500	133,750	—	—	—	133,750
Net income	—	—	—	—	168,558	168,558
Balance,						
December 31, 1983	2,136,689	336,834	(20,000)	—	232,437	549,271
Payment on note	—	—	2,000	—	—	2,000
Exercise of stock options at \$.22 per share	214,270	47,143	—	—	—	47,143
Tender of common stock as payment for stock options exercised at \$2.50 per share	(15,628)	(39,072)	—	—	—	(39,072)
Issuance of common stock for bonuses at \$2.50 per share	50,500	126,250	—	—	—	126,250
Recision and return of common stock	(112,500)	(22,000)	—	—	(208,000)	(230,000)
Net income	—	—	—	—	619,720	619,720
Balance,						
December 31, 1984	2,273,331	449,155	(18,000)	—	644,157	1,075,312
Issuance of common stock at \$3.50 per share, to employees in exchange for promissory notes	8,000	28,000	(28,000)	—	—	—
Exercise of stock options	21,060	12,690	—	—	—	12,690
Sale of stock at \$3.30 per share, net of offering expenses of \$45,915	454,545	1,454,084	—	—	—	1,454,084
Payments received on notes receivable from shareholders	—	—	4,000	—	—	4,000
Guarantee of ESOP liability	—	—	—	(397,000)	—	(397,000)
Net income	—	—	—	—	1,173,633	1,173,633
Balance,						
December 31, 1985	2,756,936	\$1,943,929	\$(42,000)	\$(397,000)	\$1,817,790	\$3,322,719

The accompanying notes are an integral part of these statements.

Statements of Changes in Financial Position

For the Years Ended December 31, 1985, 1984 and 1983

Relational Database Systems, Inc.

	1985	1984	1983
Working capital was provided by:			
Net income	\$ 1,173,633	\$ 619,720	\$ 168,558
Add—Items not affecting working capital—			
Depreciation and amortization	229,939	117,504	48,071
Increase in deferred income taxes	37,628	47,758	2,781
Issuance of common stock for bonuses	—	126,250	133,750
Recision of common stock	—	(180,000)	—
Working capital provided by operations	1,441,200	731,232	353,160
Proceeds from notes payable to bank	198,000	—	110,000
Sale of common stock, net of notes receivable from shareholders	1,470,774	10,071	8,067
Increase in long-term lease payable	109,285	—	—
Total working capital provided	3,219,259	741,303	471,227
Working capital was used for:			
Additions to property and equipment	(624,702)	(504,373)	(324,010)
(Increase) decrease in other assets	(126,542)	9,992	(6,126)
Payments and current maturities of notes payable to bank	(64,167)	(22,000)	(24,000)
Recision of common stock	—	(50,000)	—
Total working capital used	(815,411)	(566,381)	(354,136)
Transactions not affecting working capital:			
Guarantee of ESOP liability	397,000	—	—
Increase in deferred compensation	(397,000)	—	—
Increase in working capital	\$ 2,403,848	\$ 174,922	\$ 117,091
Increase in working capital represented by:			
Increase (decrease) in current assets—			
Cash	\$ 2,583,204	\$(104,955)	\$ 272,955
Accounts receivable	1,142,769	963,627	314,024
Prepaid expenses	184,733	38,402	16,746
Inventory	179,550	28,490	—
	4,090,256	925,564	603,725
(Increase) in current liabilities—			
Current portion of notes payable to bank	(42,167)	(1,833)	(22,000)
Current portion of lease payable	(22,560)	—	—
Accounts payable	(98,893)	(118,384)	(146,619)
Accrued expenses	(410,004)	(314,631)	(278,525)
Accrued and deferred income taxes	(877,989)	(268,640)	(12,690)
Deferred maintenance contract income	(234,795)	(47,154)	(26,800)
	(1,686,408)	(750,642)	(486,634)
Increase in working capital	\$ 2,403,848	\$ 174,922	\$ 117,091

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

December 31, 1985

Relational Database Systems, Inc.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**Operations**

Relational Database Systems, Inc. (the "Company") designs, develops, manufactures and markets computer software systems to perform general purpose data management functions on various computer systems. The Company also licenses others to manufacture its software programs and user manuals. The Company is subject to a number of risks common to companies in the software industry, including competition from substitute products and large companies, dependence on certain key personnel, and the need to develop successful new products.

Revenues

The Company recognizes product revenue at the time of shipment and recognizes license revenue at the time the agreement is signed. Maintenance contract revenue is recognized over the term of the contract. In 1985, one customer accounted for 18% of the Company's total revenues. In 1984, no single customer accounted for 10% or more of net revenues. In 1983, one customer accounted for 10% of net revenues. Export sales accounted for less than 10% of net revenues in 1985 and 1984 and 20% of net revenues in 1983.

Property and Equipment

Depreciation of property and equipment is provided using the straight-line method over the estimated useful lives of the assets. The estimated

useful lives are as follows:

Computer equipment	3-5 years
Furniture, fixtures and leasehold improvements	3-5 years

Inventory

Inventory is recorded at the lower of (first-in, first-out) cost or market value and primarily consists of computer software manuals and related items.

Accrued Expenses

As of December 31, accrued expenses consisted of the following:

	1985	1984
Accrued payables	\$ 131,146	\$297,056
Profit sharing accrual	289,500	117,582
Amortized rent	190,127	—
Other accruals	392,387	178,518
	<u>\$1,003,160</u>	<u>\$593,156</u>

Research and Development Expenditures

Research and development expenditures are charged to operations as incurred. The Company expects to adopt the provision of SFAS No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed" in 1986, which could result in capitalization of certain software development expenditures in 1986 and subsequent years.

Reclassifications

Certain reclassifications were made to 1984 amounts as previously reported to make the presentation consistent with 1985 amounts. These reclassifications had no effect on previously reported net income or shareholders' equity.

2. NOTES PAYABLE TO BANK

Notes payable to bank as of December 31 are as follows:

	1985	1984
Note payable to bank secured by the Company's telephone equipment, bearing interest at prime plus 2% (11.5% at December 31, 1985) with principal and interest payable in equal monthly installments through August 1988	\$ 16,500	\$22,500
Note payable to bank secured by certain assets of the Company, bearing interest at prime plus 2% (11.5% at December 31, 1985) with principal and interest payable in equal monthly installments through December 1989	49,333	65,333
Note payable to bank secured by the Company's A.T.&T. 3B20 computer and other computer hardware, bearing interest at prime plus 2% (11.5% at December 31, 1985) with principal and interest payable in equal monthly installments through June 1990	198,000	—
	263,833	87,833
Less—Current portion	66,000	23,833
	<u>\$197,833</u>	<u>\$64,000</u>

The aggregate annual principal payments due for each of the next five years are:

1986	\$ 66,000
1987	66,000
1988	64,000
1989	44,000
1990	23,833
	<u>\$263,833</u>

3. COMMON STOCK

In August 1983, the Company increased the number of authorized common shares to 5,000,000 from 250,000 shares and approved a ten-for-one split of the outstanding shares. The financial statements, including all per share data, reflect this stock split.

Under the 1981 and 1985 Stock Option Plans, the Board of Directors may grant options at not less than the fair market value (as determined by the Board) of the shares at the date of grant. In December 1983, the Company's Board of Directors approved an acceleration of the vesting of Stock Options granted on or before December 31, 1982, such that shares not previously exercisable would become exercisable in 1983. Options are generally exercisable in cumulative annual installments over five years. The plans provide that payment for shares purchased upon exercise of options may be by cash or shares of the Company at fair market value (as determined by the Board) on the date of exercise. Under these plans, 158,450 shares are reserved for future grants. As of December 31, 1985, there are 373,000 options outstanding to purchase shares at prices ranging from \$2.00 to \$4.25, of which options for 76,500 shares are exercisable. Options for 21,060 shares of stock were exercised during 1985 at price ranges from \$.22 to \$2.75.

In addition, in 1983 the Company's Board of Directors approved stock bonuses of 104,000 shares of common stock valued at \$2.50 per share, entered into agreements with employees to cancel options for 104,000 shares and approved cash bonuses of \$271,950 to certain key employees. The effect of these actions was a net after-tax charge to earnings in 1983 of approximately

\$260,000. The Company issued 53,500 shares and 50,500 shares in 1983 and 1984, respectively, pursuant to these stock bonus arrangements.

On March 6, 1985, the Company settled its civil action against a former employee. The settlement agreement provides for, among other things, the return to the Company of 32,500 shares of the Company's common stock. Also, the Company received an additional 80,000 shares in connection with the rescission of common stock previously issued to the former employee. The Company has accounted for the return of stock as a reduction of operating expenses (\$180,000) for the year ended December 31, 1984.

On March 15, 1985, the Company entered into an agreement with a California computer manufacturing corporation, whereby 454,545 shares of its common stock were sold for \$1,499,998. In addition, certain Company officers and employees sold 151,515 additional shares to the manufacturer for \$500,000. This agreement allows the manufacturer to purchase additional shares to raise its ownership interest to 30% in the event of future common stock issuances unless such issuances are related to the Company's Employee Stock Option and Stock Ownership plans in which case the manufacturer could maintain an interest of approximately 22% of the Company's outstanding common stock; and at December 31, 1985, the Company was obligated to sell an additional 8,396 shares to the manufacturer at \$4.25, the fair market value as determined by the Company's Board of Directors at the time of the agreement.

4. EMPLOYEE STOCK OWNERSHIP PLAN

In May 1985, the Company's Shareholders and Board of Directors approved the adoption of the 1985 Employee Stock Ownership Plan and Trust (the "Plan"). The Plan purchased 75,143 shares from the Company's president for \$263,000 and 42,857 shares from a key officer of the Company for \$150,000.

In connection with the stock purchase referred to above, the Plan financed the entire \$413,000 at 9% interest, with the Company's president and a key officer for \$263,000 and \$150,000, respectively. Both notes and the related interest are payable in four equal annual installments

with the first annual installment due March 15, 1986. The Company has guaranteed these notes and, accordingly, recorded a \$397,000 ESOP liability which is included in the accompanying financial statements. The total ESOP debt, including \$19,000 of interest payable is offset by a \$35,000 contribution to the Plan.

Company contributions to the plan are made at the sole discretion of the Board of Directors. During 1985 the Company contributed \$35,000 to the Plan, to reduce the ESOP liability as described above.

5. COMMITMENTS

The Company has various operating leases for rental of office facilities and equipment. Rent expense recorded during fiscal years 1985, 1984 and 1983 approximated \$587,000, \$126,000 and \$51,000, respectively. As of December 31, 1985 future minimum lease payments under the leases are as follows:

1986	\$ 940,914
1987	972,894
1988	907,895
1989	738,640
1990	514,340
Total payments	4,074,683
Less: Sublease rental income	(203,708)
Net future minimum payments	<u>\$3,870,975</u>

6. CAPITALIZED LEASES

In 1985, the Company entered into a capitalized lease for its telephone system commencing October 1, 1985. Minimum future lease payments related to this lease are as follows:

1986	\$ 36,438
1987	36,438
1988	36,438
1989	36,438
1990	23,687
Total capitalized lease obligations	169,439
Less interest at 10.6%	(37,594)
Present value of future minimum lease payments	131,845
Less current portion	22,560
Long-term leases payable	<u>\$109,285</u>

7. TRANSACTIONS WITH RELATED PARTIES

In 1985, the Company paid approximately \$33,000 in consulting fees to a shareholder/director and paid approximately \$197,000 for legal services to the law firm of which one of the Company's shareholders and directors is a partner.

8. INCOME TAXES

Deferred income taxes result from timing differences in the determination of income for financial statement and income tax reporting purposes. Such timing differences arise principally from the use of installment sales reporting and accelerated depreciation methods for tax purposes.

As of December 31, the components of the provisions for income taxes are as follows:

	1985	1984	1983
Current deferred	\$ 26,045	\$255,541	\$ 2,151
Long-term deferred	38,707	47,758	(578)
Currently payable	879,930	92,241	16,327
Total provision for income taxes	\$944,682	\$395,540	\$17,900

Investment and research and development tax credits are accounted for under the flow-through method. The difference between the effective income tax rate and the statutory Federal income tax rate is summarized as follows:

	1985	1984	1983
Statutory Federal income tax rate	46.0%	46.0%	46.0%
State income taxes, net of Federal benefit	5.1	5.1	5.2
Investment and research and development credits	(8.1)	(12.2)	(31.0)
Surcharge deduction	—	(2.0)	(9.8)
Other	1.6	2.1	(.8)
Effective income tax rate	44.6%	39.0%	9.6%

The Company and its counsel believe that it should be taxed as an operating company, and it has filed tax returns as an operating company. The possibility exists that the Internal Revenue Service ("IRS") may attempt to characterize the Company's income as personal holding company income. If such a position were to prevail, the Company would be subject to an additional 50% penalty tax on undistributed personal holding company income and may be subject to a minimum tax on tax preferences based on the Company research and development expenditures. However, if the Company were treated as a personal holding company for tax purposes, any personal holding company tax liability may, if the Company elected to do so, be substantially minimized by a distribution, at the time of assessment of a penalty tax, of personal holding company income to shareholders of record at the time of distribution.

9. LINE OF CREDIT AGREEMENT

During 1985 the Company bank line of credit was lowered to \$200,000 from \$500,000. Borrowings under the credit agreement bear interest at the bank prime rate plus 1½%. The line of credit is available through June 30, 1986. There were no borrowings under this line of credit as of December 31, 1985.

10. EARNINGS PER SHARE

Earnings per share have been computed based upon the weighted average number of shares of common stock and common stock equivalents outstanding during the periods. Common stock equivalents consist of the dilutive effect of outstanding options to purchase common stock. Fully diluted earnings per share are the same as reported earnings per share.

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Independent Public Accountants

Arthur Andersen & Co.
San Jose, California

Bank

Bank of California
Palo Alto, California

Annual Meeting

The Annual Meeting of Stockholders will be held at 5:30 P.M. on Tuesday, April 29, 1986 at the Stanford Park Hotel, 100 El Camino Real, Menlo Park, California.

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