Adobe *Ahead.*

1998 ANNUAL REPORT

At Adobe, we consider the Internet age our greatest opportunity yet.

In this revolutionary time, we're building on our legacy of technological leadership in every market we serve. We're developing future standards for the World Wide Web. And we're opening new possibilities for our long-time customers, who are some of the most innovative and passionate people in the world.

We've already set challenging precedents. Many of our flagship solutions—such as Adobe® PostScript® software, Adobe Photoshop® software, and Adobe Portable Document Format (PDF)—have changed not only the marketplace but the way the world communicates. They have also served as catalysts for other new products, new markets, and new companies—business opportunities unimaginable 16 years ago when we first opened our doors.

Adobe

From magazines laid out with our professional design tools to television commercials enhanced by our visual effects software, Adobe technology touches what the world sees. While we are proud of that presence, we know it is merely the beginning. Our future extends far beyond visual communications to publishing houses, corporate offices, and government agencies where people are grappling with critical productivity issues that require sophisticated information-management solutions.

As you read on, you'll see that Adobe is not only providing world-class technology and software solutions, but is fundamentally changing the way people do business. When it comes to meeting the demands of the Internet age, as well as the challenges that lie ahead, **the best answers start with "A."**

Adobe ACHIEVEment

In 1998, Adobe continued to help both its longtime and new customers make their ideas stand out in print and on the Internet—in every field from the enterprise to the design studio to the home. With our award-winning products and industry-standard core technologies, an increasing number of people worldwide changed not only the way they create information, but also how they share and manage it. New versions of flagship products garnered rave reviews and record revenue, and the release of new Web design applications made our presence on the Internet stronger than ever. Still, we faced one of our most challenging years. Ongoing instability in the Asian marketplace had a direct and significant impact on our revenue and that of our OEM customers.

In spite of challenges, the year also brought new and existing opportunities into sharper focus—our development of a totally new page-layout architecture prepares us to offer a truly revolutionary solution to the professional publishing community. Having acquired the assets of GoLive Systems, Adobe is the only software company to offer an industrial-strength, end-to-end solution that addresses every phase of world-class Web site creation. And the growing acceptance of PDF as a preferred method of delivering documents over the Internet proves that we are providing the comprehensive document solutions that enterprises demand. By continuing to introduce innovative technologies, taking a leadership role in developing standards for the Internet, and cultivating the customer loyalty that has always set us apart from our competitors, Adobe is looking ahead to make fiscal 1999 our best year ever.

TO OUR STOCKHOLDERS

State of the Business

1998

In fiscal year 1998, revenue totaled $895 million, a 2% decrease compared with fiscal 1997, and reported net income reached $105 million, a 44% decrease compared with fiscal 1997. Included in net income are restructuring and other charges of $38.2 million and investment gains of $15.0 million in fiscal 1998. In fiscal 1997, net income included investment gains of $34.3 million. Revenue from application products reached a record $731 million, compared with $716 million in fiscal 1997, and licensing revenue from Adobe PostScript and other technologies was $164 million, compared with $196 million in fiscal 1997.

The overall revenue decline from the previous fiscal year was due in large part to the instability of the Asian market and decreased licensing revenue. In particular, revenue from Japan declined 28% from $204 million in 1997 to $148 million in 1998. The decision by Hewlett-Packard to remove Adobe PostScript software from its monochrome printing devices has had continuing repercussions. Licensing revenue is likely to decline in fiscal 1999. We see growth opportunities for licensing revenue in the long term as both color printing and digital copiers become more pervasive. Product development and marketing efforts with strategic customers such as Xerox, EFI, and Tektronix promise to help us capitalize on these trends. New challenges in the first part of the year helped us learn some important lessons about leadership. In August 1998, we implemented a restructuring plan that streamlined our organization and made possible far more effective decision making. The resulting lowered cost structure formed the foundation for a leaner, more efficient organization, and we realized immediate benefits with a favorable fourth quarter.

During 1998, Adobe declared cash dividends on its common stock totaling $0.20 per share and repurchased more than 10.5 million shares of common stock, enhancing stockholder value, offsetting dilution from issuances under our employee stock option and stock purchase plans, and reducing the actual number of shares outstanding. Adobe's overall financial position is strong, with cash, cash equivalents, and short-term investment balances of $272.5 million and no long-term debt, as of our fiscal year-end on November 27, 1998.

Building the Future of Professional Publishing

In 1998, the runaway success of major new updates of our flagship products confirmed our status as an industry leader in the realm of professional publishing. Adobe Photoshop 5.0 software, released in May, shipped a record number of units and earned several best-of-class industry awards. Adobe Illustrator® 8.0 software, released in September, was received with similar acclaim and record revenue. In addition to these successful product launches, Adobe PDF gained further acceptance as the best file format for enabling a digital publishing workflow. And Adobe PostScript Extreme™ delivered ultra-fast performance for production printing environments.

Going forward, our strategy for the professional publishing market involves the integration of these products and other applications with a new page-layout architecture that will offer remarkable possibilities for graphic designers and production professionals alike. Establishing the Adobe professional publishing platform as the publishing solution of choice is one of our highest priorities for the coming fiscal year.

Setting New Standards for the Internet

Today, our presence on the Internet is pervasive—a vast majority of Web sites have been touched in some way by Adobe software such as Adobe Photoshop and Adobe Illustrator. Adobe Acrobat® software has become a preferred method for online document distribution when absolute document fidelity and efficient manageability are required. Our new Web design tools, Adobe ImageReady™ and Adobe ImageStyler,™ have generated excellent reviews. And the addition of a professional Web site creation tool, Adobe GoLive,™ brings even more power to the suite of award-winning Adobe applications that Web designers worldwide use every day.

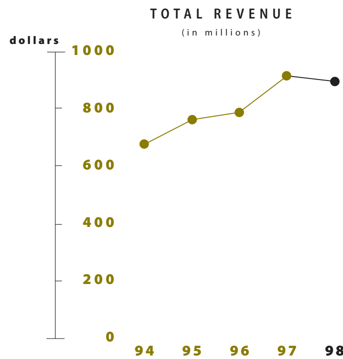
But offering first-class software is only part of our Internet strategy. We're taking an active role in helping to define the standards that will set the stage for tomorrow's online innovations. Adobe is a member of several development committees working on new Internet languages and protocols, including eXtensible Markup Language (XML) and Scalable Vector Graphics (SVG). SVG is an emerging XML-based vector graphics language that promises new levels of graphics precision and interactivity. Adobe is committed to supporting SVG with powerful authoring tools and viewing technologies. By advocating the new standards that will provide a more robust Internet experience, we're doing more than just following trends—we're helping to shape the future.

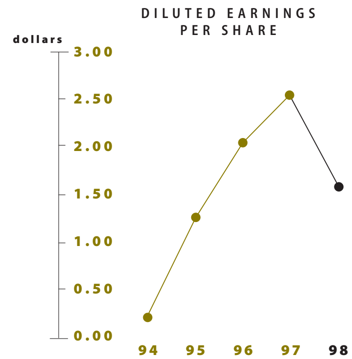
Delivering Sophisticated Document Solutions

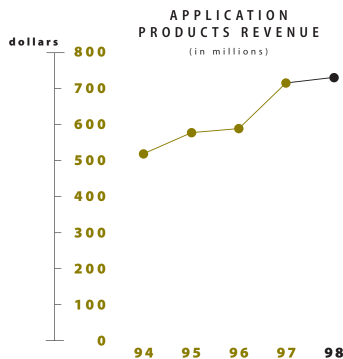
This past year, more and more enterprises employed Adobe Acrobat 3.0 software to electronically exchange and manage mission-critical documents by converting them to Adobe PDF. This trend was fueled not only by the instantaneous transmission of electronic documents offered by the Internet, but also by the proliferation of new complementary technologies, such as digital copiers. Adobe PDF, combined with standard-setting printing technologies such as Adobe PostScript 3,™ provides a solid foundation for effective solutions to broad-based document communication and management problems. And when it comes to creating documents in the first place, Adobe PageMaker® 6.5 software and Adobe FrameMaker® 5.5 software continue to provide the best tools available for everyone from office professionals to technical authors.

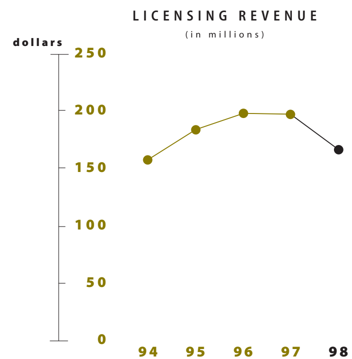
Among the many market segments realizing higher productivity and cost-effectiveness with Adobe document solutions are the government, financial management, health care, insurance, manufacturing, and legal sectors. Already, more than 120 government entities—including the U.S. Food and Drug Administration—are using Adobe PDF. Together, these customers represent our fastest growing business with the largest potential market, and we intend to aggressively address their evolving needs in 1999 by working closely with value-added resellers and systems integrators who intimately understand the complexities of today's enterprise.

Financial Highlights









Executive Team

BACK ROW

Chuck Geschke
Chairman of the Board and President

Bruce Chizen
Executive Vice President, Worldwide Products and Marketing

John Warnock
Chairman of the Board and Chief Executive Officer

Hal Covert
Senior Vice President and Chief Financial Officer

Fred Snow
Executive Vice President, Worldwide Field Operations

FRONT ROW

Jim Stephens
Vice President, Corporate Development

Colleen Pouliot
Senior Vice President, General Counsel, and Secretary

Rebecca Guerra
Vice President, Human Resources

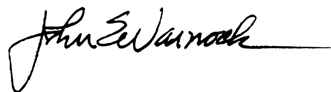
Charting a Course of Confidence

As the new millennium approaches, our course is clear. We will confidently execute on our strategies for professional publishing, document solutions, and the Internet. We will continue to pursue our cross-platform development strategy, creating robust applications for multiple leading platforms. In fiscal 1998, the Windows® and Macintosh platforms accounted for 58% and 42%, respectively, of application products revenue, excluding platform-independent and UNIX® products. We will also bolster strategic marketing efforts—such as introducing our consumer digital imaging products to as many homes as possible—to make Adobe one of the best-recognized software brands in the world. Perhaps most importantly, we will lead the way in a trend that promises to be as revolutionary as Adobe PostScript technology, desktop publishing, and Adobe PDF: "cross-media publishing." As the boundaries between print and online communications dissolve, the need arises for ways in which information can be rapidly deployed across several types of traditional and electronic media.

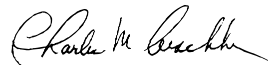
The software tools, technical infrastructure, and talent that enable this sea change are what cross-media publishing is all about. By leveraging Adobe's core technologies, we plan to bring the best of the online and print worlds together to create a platform upon which our customers can communicate in the most appropriate fashion. For example, the Adobe imaging model richly describes text, images, and graphics for the highest quality output, whether on screen or on the printed page.

Still, we know that cutting-edge technology and a confident outlook are not enough to thrive in a world of intense competition and rapid change. Innovation that stands the test of time can only come from the kind of visionary people who work for Adobe. We're proud to have some of the brightest and most creative minds in the industry working to turn ideas into powerful solutions for our customers.

Together, we're looking ahead to an exciting 1999.



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



Charles M. Geschke
Chairman of the Board
and President

Adobe Anywhere

CROSSING ALL MEDIA

For graphics professionals, looking good on paper is no longer enough. Just as they have relied on Adobe to deliver outstanding visual quality to the printed page, they are now looking to Adobe to deliver the same high fidelity across all media, from video to CD-ROM to the Web. And that's precisely what they're getting.

Adobe Photoshop and Adobe Illustrator software have long set the standard for rich print graphics. These tools, along with Adobe After Effects® and Adobe Premiere® software for video production, have also become top-choice applications for dynamic media. And now, all of these products combine with Adobe GoLive to provide leading tools for building World Wide Web content. Because files created with Adobe software can export directly to a variety of formats, including HTML and Adobe PDF, designers can easily move content from print to screen and back again.

Adobe also offers a growing suite of products exclusively for the Web. New Adobe ImageReady software, a professional image-processing tool, leads in its market after only a few months. Adobe GoLive software uniquely delivers a complete, high-end Web publishing system. Meanwhile, programs such as Adobe ImageStyler and Adobe PageMill® make it simple for anyone to build a compelling Web site.

Ultimately, Adobe products will enable users to publish what they create in any media. Further helping to make content truly interchangeable across media, Adobe has made a long-term commitment to developing Web standards. PDF, for example, has become a standard file format for distributing documents online. Adobe is also a member of the World Wide Web Consortium (W3C) and is currently an active participant of the Scalable Vector Graphics (SVG) working group. SVG is a new graphics language for the Web that promises to deliver unprecedented fidelity and interactivity to online images.

Is Adobe redefining the Web experience? **Absolutely.**

ADOBE ALLIANCE:

Hallmark Cards, Inc.

Three years ago, Hallmark—America's leader in personal expressions—decided to take its business online. Today, in addition to more than 1,000 free electronic greetings, the company sells more than 100 animated greetings on its Web site, adding 10 to 20 new designs each month. To build this high-quality Internet presence, Hallmark artists work with Adobe Photoshop, Adobe Illustrator, Adobe Premiere, Adobe After Effects, and other Adobe tools for Macintosh and Windows. Hallmark also uses Adobe software to create the interface and training videos for its new interactive computer kiosks that enable in-store shoppers to personalize blank greeting cards, invitations, and other items.

Adobe Archetype

SETTING THE STANDARD

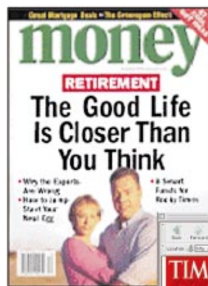
In the digital age, publishing and printing houses are doing business at Internet speed. Publishers must be able to create content once and move it throughout the organization for use in periodicals, Web pages, video, and other dynamic media. Production printers must no longer merely outperform their competitors, but keep pace with the light-speed distribution offered by the World Wide Web. The competitive advantage goes to those who master workflow and maximize productivity. It's an enterprise-wide challenge—and Adobe has the answer.

The Adobe print publishing platform combines leading content-creation tools, such as Adobe Photoshop and Adobe Illustrator, with the newly announced Adobe InDesign™ professional page-layout program and a new workflow application. All of these tools share not only a common user interface, but also optimized support for standard Adobe technologies, including Adobe PDF for print production and Adobe PostScript for printing. For high-end production, Adobe will offer PressReady,™ a new application for desktop color proofing, and PostScript Extreme technology for unsurpassed printing speed and accuracy.

ADOBE ALLIANCE:

Time, Inc.

Publishing powerhouse Time, Inc. has long relied on Adobe Photoshop, Adobe Illustrator, Adobe Acrobat, and other Adobe software to help create popular magazines such as *Time*, *People*, *Sports Illustrated*, *Money*, *Fortune*, *Life*, and *Entertainment Weekly*. Now the company is partnering with Adobe to explore the possibilities for enhancing and streamlining its publishing processes, linking its editorial workflow to the full range of communications, production, and business systems worldwide. The first step: testing the new Adobe InDesign professional page-layout program, which offers an open, adaptable environment that no other solution provides. Ultimately, Time expects to create and repurpose content faster while delivering publications more cost-effectively.



This set of tools and technologies will integrate the process of content creation and delivery for the first time. Moreover, it will give Adobe's network of plug-in developers, systems integrators, and value-added resellers the opportunity to devise solutions for specific markets and for publishing enterprises of any size and scope—solutions that can reshape and redefine ways of doing business.

Where is Adobe taking the publishing industry? **Above and beyond.**

Adobe Access

MAKING INFORMATION WORK

Around the world, corporations and government agencies have spent many millions of dollars to build repositories of essential data. Remarkably, those databases contain only about 15% of the mission-critical information that resides within a business. The remaining 85% exists in the form of electronic or paper documents, most of which are stored on disorganized intranet sites or in overstuffed filing cabinets. Yet no business can afford to neglect these critical assets. Fortunately, Adobe offers an effective document solution—one unique in its ability to manage electronic and paper documents from any source.

The Adobe document platform leverages the widespread acceptance of Adobe PDF as a standard file format, surrounding it with a set of tools that enables organizations to move gracefully from a paper-based to an electronic workflow—and to save money in the process. With Adobe Acrobat software, it's easy to convert files created in virtually any software program, on almost any computer, to compact, searchable PDF files that preserve the look and feel of the original. With the Acrobat Capture® application, it's also easy to generate PDF files from scanned printed pages. Adobe Circulate™ technology transforms documents scanned from digital copiers, network scanners, and digital senders into PDF. A new feature in Acrobat even converts Web sites to PDF for archiving and simple navigation. Conversely, a new server-based technology will translate PDF files into HTML for unrestricted use on intranets and extranets while preserving document quality.

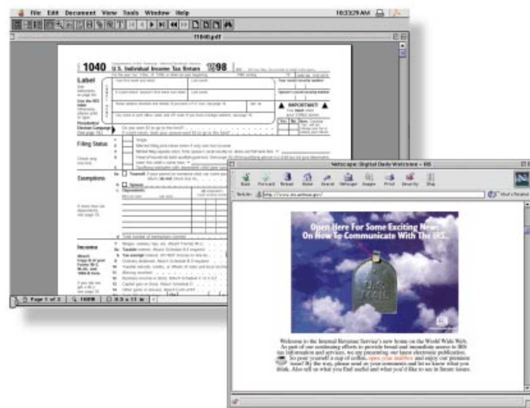
Through value-added resellers, hardware bundles, and other channels, Adobe offers its document-management solution to specific markets and to enterprises of all kinds—and is setting a new precedent for how information will move in the next century.

What do Adobe managed documents become? **Assets.**

ADOBE ALLIANCE:

U.S. Internal Revenue Service

Each year, the U.S. Internal Revenue Service (IRS) receives millions of requests for income-tax forms. In the past, taxpayers called a toll-free number and waited seven business days to receive paper documents by mail. Today, the IRS uses Adobe Acrobat software to convert its forms into PDF files for posting on its Web site, where taxpayers can view and print the documents anytime with Adobe's free Acrobat Reader. They downloaded 40 million forms in 1998 alone, reducing IRS expenses and saving taxpayers both time and money.



For generations, people have viewed and shared photographs by turning the pages of an album filled with prints, or by projecting slides on a wall or screen. Today, new technologies such as scanners and digital cameras are introducing exciting new ways for people to experience photographs.

ANYONE

EMPOWERING CREATIVE MINDS

Computer enthusiasts in homes and small businesses are eager to correct and enhance their images, to send them over e-mail, to post them on Web sites, and to incorporate them into a wide range of creative projects, from calendars to T-shirts to multimedia presentations. For those who want to explore the world of digital imaging, Adobe provides the inspiration to get started.

The first product in its category when it debuted in 1996, Adobe PhotoDeluxe® software is the world's best-selling consumer photo-editing package. Based on Adobe Photoshop, the professional image-editing standard, Adobe PhotoDeluxe delivers state-of-the-art technology. At the same time, the product includes templates, clip art, and Guided Activities that make it fun and easy for users to be successful. Adobe PhotoDeluxe software is available through retail channels in two affordable editions, one for home and one for business. A key to its market leadership is that Adobe PhotoDeluxe often comes bundled with scanners, digital cameras, personal portrait packages, and other third-party products.

While representing a small percentage of Adobe's revenue, consumer software builds brand familiarity and loyalty that solidifies the company's position as a leader in digital imaging—and that influences enterprise decisions.

How does it feel to bring photos to life with Adobe software? **Awesome!**

ADOBE ALLIANCE:

Eastman Kodak Company and Intel Corporation

Now Kodak customers have an additional film-processing choice. Along with their prints and processed film, they can receive the new Kodak Picture CD, produced and marketed in cooperation with Intel Corporation. The disk comes with Adobe software that makes it simple to store, enhance, share, and print pictures on a personal computer. Adobe's easy-to-use, magazine-style interface guides users through each step, including ordering prints online, sending pictures over e-mail, or posting them on a Web site. The Kodak, Intel, and Adobe collaboration combines each company's expertise—in imaging, desktop technology, and software—to bring the fun of digital photos to consumers everywhere.

Adobe *Analysis*

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Financial Highlights

(In thousands, except per share amounts and employee data)

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

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 1999. Readers are cautioned not to place undue reliance on the forward-looking statements, which speak only as of the date of this Annual Report. The Company undertakes no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

Results of Operations

OVERVIEW

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

REVENUE

	1998	CHANGE	1997	CHANGE	1996
Total revenue	$894.8	(2)%	$911.9	16%	$786.6

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

	1998	CHANGE	1997	CHANGE	1996
Product revenue:					
Licensing	$164.1	(16)%	$196.2	—	$196.7
Percentage of total revenue	18.3%		21.5%		25.0%

Licensing revenue is made up of royalties received from OEM customers who ship products containing Adobe PostScript technology, including Adobe PostScript, Adobe PostScript 3, Adobe PrintGear,® and PostScript Extreme. Adobe PostScript is a software language for describing to a printer the appearance of a page, including text, graphics, and images. Products containing Adobe PostScript technology that implement the language include: (1) black-and-white printers; (2) color printers; (3) slide recorders; (4) imagesetters; (5) screen displays; and (6) digital copiers. Adobe PostScript products serve the corporate enterprise, graphic arts, production printing, small office/ home office, and high-volume production printing markets. Licensing revenue is also derived from shipments of products containing the Configurable PostScript Interpreter ("CPSI") by OEM customers. CPSI is a fully functional Adobe PostScript interpreter that resides on the host computer system rather than in a dedicated controller integrated into an output device. The configuration flexibility of CPSI allows OEM customers and software developers to create and market a variety of Adobe PostScript products independently of controller hardware development.

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

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

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

	1998	CHANGE	1997	CHANGE	1996
Product revenue:					
Application products	$730.6	2%	$715.7	21%	$589.9
Percentage of total revenue	81.7%		78.5%		75.0%

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

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

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

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

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

DIRECT COSTS

	1998	CHANGE	1997	CHANGE	1996
Direct costs	$111.4	(12)%	$126.3	(11)%	$141.1
Percentage of total revenue	12.4%		13.8%		17.9%

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

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

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

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

OPERATING EXPENSES

	1998	CHANGE	1997	CHANGE	1996
Research and development	$207.3	21%	$170.9	10%	$155.4
Percentage of total revenue	23.2%		18.7%		19.8%

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

Research and development expenses increased in absolute dollars over the past three years due to the expansion of the Company's engineering staff and related costs required to support its continued emphasis on developing new products and enhancing existing products. The increase also reflects the Company's increased investments in new technologies, new product development, and the infrastructure to support such activities. The increase in research and development expenses in fiscal 1998 was partially offset by certain cost reduction initiatives related to the restructuring program that was implemented during the third quarter of fiscal 1998. The Company also experienced reduced outside labor costs and professional fees as certain research and development programs were discontinued (see Management's Discussion and Analysis of Restructuring and other charges).

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

	1998	CHANGE	1997	CHANGE	1996
Sales and marketing	$316.7	4%	$303.3	19%	$255.0
Percentage of total revenue	35.4%		33.3%		32.4%

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

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

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

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

	1998	CHANGE	1997	CHANGE	1996
General and administrative	$95.7	27%	$75.4	21%	$62.0
Percentage of total revenue	10.7%		8.3%		7.9%

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

General and administrative expenses increased $20.4 million, or 27%, in fiscal 1998 compared to fiscal 1997, due to increased expenses for outside legal and investment banking services associated with responding to an unsolicited acquisition proposal, as well as increased employee costs and related depreciation and building expenses associated with increased staff. Additionally, the provision for uncollectible accounts increased to reserve for accounts receivable from certain customers that were deemed potentially uncollectible. These increased expenses were partially offset by cost reduction initiatives related to the restructuring program implemented in the third quarter of fiscal 1998 that included a reduction in general office and other administrative expenses (see Management's Discussion and Analysis of Restructuring and other charges).

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

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

	1998	CHANGE	1997	CHANGE	1996
Write-off of acquired in-process research and development	—	(100)%	$6.0	(72)%	$21.3
Percentage of total revenue	—		0.7%		2.7%

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

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

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

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

RESTRUCTURING AND OTHER CHARGES

	1998	CHANGE	1997	CHANGE	1996
Restructuring and other charges	$38.2	NA	$(0.6)	(112)%	$5.0
Percentage of total revenue	4.3%		(0.1)%		0.6%

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

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

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

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

NONOPERATING INCOME

	1998	CHANGE	1997	CHANGE	1996
Investment gain	$15.0	(56)%	$34.3	(50)%	$68.9
Percentage of total revenue	1.7%		3.8%		8.8%

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

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

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

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

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

	1998	CHANGE	1997	CHANGE	1996
Interest and other income	$27.4	(12)%	$31.0	6%	$29.2
Percentage of total revenue	3.1%		3.4%		3.7%

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

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

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

INCOME TAX PROVISION

	1998	CHANGE	1997	CHANGE	1996
Income tax provision	$62.6	(43)%	$109.3	19%	$91.5
Percentage of total revenue	7.0%		12.0%		11.6%
Effective tax rate	37.3%		36.9%		37.4%

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

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

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

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

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

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

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

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

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

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

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

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

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

The Company derives a significant portion of its revenue and operating income from its subsidiaries in Europe, Japan, and Asia Pacific and Latin America. The Company generally experiences lower revenue from its European operations in the third quarter because many customers reduce their purchasing activities in the summer months. Additionally, the Company is uncertain whether the recent weakness experienced in the Japan and Asia Pacific and Latin America markets will continue in the foreseeable future due to possible currency devaluation and liquidity problems in these regions. While most of the revenue of the European subsidiaries is denominated in U.S. dollars, the majority of revenue derived from Japan is denominated in yen, and the majority of all subsidiaries' operating expenses are denominated in their local currencies. As a result, the Company's operating results are subject to fluctuations in foreign currency exchange rates. To date, the accounting impact of such fluctuations has been insignificant. The Company's hedging policy attempts to mitigate some of these risks, based on management's best judgment of the appropriate trade-offs among risk, opportunity, and expense. The Company has established a hedging program to hedge its exposure to foreign currency exchange rate fluctuations, primarily of the Japanese yen. The Company's hedging program is not comprehensive, and there can be no assurance that the program will offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates.

On January 1, 1999, eleven of the fifteen member countries of the European Union adopted the euro as their common legal currency and established fixed conversion rates between their existing sovereign currencies and the euro. The euro trades on currency exchanges and is available for non-cash transactions. Based on its preliminary assessment, the Company does not believe the conversion will have a material impact on the competitiveness of its products in Europe, where there already exists substantial price transparency, or increase the likelihood of contract cancellations. Further, the Company expects that modifications to comply with euro requirements have been and will continue to be made to its business operations and systems on a timely basis and does not believe that the cost of such modifications will have a material adverse impact on the Company's results of operations or financial condition.

There can be no assurance, however, that the Company will be able to continue to complete such modifications on a timely basis; any failure to do so could have a material adverse effect on the Company's results of operations or financial condition. In addition, the Company faces risks to the extent that suppliers, manufacturers, distributors, and other vendors upon whom the Company relies and their suppliers are unable to make appropriate modifications to support euro transactions. The inability of such third parties to support euro transactions could have a material adverse effect on the Company's results of operations or financial condition.

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

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

Due to the factors noted above, the Company's future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Any shortfall in revenue or earnings from levels expected by securities analysts could have, and has had in the past, an immediate and significant adverse effect on the trading price of the Company's common stock in any given period. Additionally, the Company may not learn of such shortfalls until late in the fiscal quarter, which could result in an even more immediate and adverse effect on the trading price of the Company's common stock. Finally, the Company participates in a highly dynamic industry. In addition to factors specific to the Company, changes in analysts' earnings estimates for the Company or its industry, and factors affecting the corporate environment, the Company's industry, or the securities markets in general will often result in significant volatility of the Company's common stock price.

"YEAR 2000" ISSUES

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

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

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

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

Third–party vendors, manufacturers, and suppliers The Company is also in the process of contacting its critical suppliers, manufacturers, distributors, and other vendors to determine that their operations and the products and services that they provide to the Company are Year 2000 compliant. Where practicable, the Company will attempt to mitigate its risks with respect to the failure of third parties to be Year 2000 ready, including developing contingency plans. However, such failures, including failures of any contingency plan, remain a possibility and could have a materially adverse impact on the Company's results of operations or financial condition.

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

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

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

RECENT ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

Liquidity and Capital Resources

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

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

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

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

In September 1997, the Company's Board of Directors authorized, subject to certain business and market conditions, the purchase of up to an additional 15 million shares of the Company's common stock over a two-year period. This new stock repurchase program was in addition to an existing program, whereby the Company has been authorized to repurchase

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

The Company has paid cash dividends on its common stock each quarter since the second quarter of 1988. The Board of Directors of the Company declared a cash dividend on the Company's common stock of $0.05 per common share for each quarter of fiscal 1998. Also, on December 1, 1997, the Company dividended one share of Siebel Systems, Incorporated ("Siebel") common stock for each 300 shares of Adobe common stock held by stockholders of record on October 31, 1997. An equivalent cash dividend was paid for holdings of less than 7,500 Adobe shares and for odd-lot and fractional Siebel shares. The declaration of future dividends, whether in cash or in-kind, is within the discretion of the Company's Board of Directors and will depend on business conditions, the Company's results of operations and financial condition, and other factors.

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

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

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

COMMITMENTS

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

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

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

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

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

DERIVATIVES AND FINANCIAL INSTRUMENTS

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

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

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

The Company's accounting policies for these instruments are based on the Company's designation of such instruments as hedging transactions. Gains and losses associated with the mark-to-market of outstanding foreign exchange forward contracts that are designated and effective as hedges of existing transactions, for which a firm commitment has been attained, are recognized in income in the current period. Corresponding gains and losses on the foreign currency denominated transactions being hedged are recognized in income in that same period. In this manner, the gains and losses on foreign currency denominated transactions will be offset by the gains and losses on the foreign currency contracts. The Company does not anticipate any material adverse effect on its consolidated financial position, results of operations, or cash flows as a result of these instruments. The Company uses yen options to hedge anticipated exposures.

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

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

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

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

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

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

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

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

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

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

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

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

	Common Stock and Additional Paid in Capital		Retained Earnings	Unrealized Gains on Investments, Net
	Shares	Amount		
BALANCES AS OF DECEMBER 1, 1995	72,834	$ 293,258	$ 390,793	$ 18,831
Stock issued under employee stock and stock option plans	2,032	39,870	—	—
Tax benefit from employee stock option plans	—	10,828	—	—
Stock compensation expense	—	2,772	—	—
Dividends declared	—	—	(14,524)	—
Repurchase of common stock	(3,390)	(126,778)	—	—
Put warrant obligations	—	(71,348)	—	—
Adjustment to unrealized gains on investments, net	—	—	—	14,683
Cumulative translation adjustment	—	—	—	—
Net income	—	—	153,277	—
BALANCES AS OF NOVEMBER 29, 1996	71,476	148,602	529,546	33,514
Stock issued under employee stock and stock option plans	3,631	70,995	—	—
Tax benefit from employee stock option plans	—	29,607	—	—
Stock compensation expense	—	1,329	—	—
Dividends declared	—	—	(52,522)	—
Repurchase of common stock	(1,166)	(36,956)	—	—
Proceeds from sale of put warrants	—	6,356	—	—
Reclassification of put warrant obligations	—	71,348	—	—
Adjustment to unrealized gains on investments, net	—	—	—	(29,924)
Cumulative translation adjustment	—	—	—	—
Net income	—	—	186,837	—
BALANCES AS OF NOVEMBER 28, 1997	73,941	291,281	663,861	3,590
Tax benefit from employee stock option plans	—	12,595	—	—
Stock compensation expense	—	215	—	—
Dividends declared	—	—	(12,962)	—
Purchase of treasury stock	—	—	—	—
Reissuance of treasury stock under employee stock and stock option plans	—	—	(23,313)	—
Proceeds from sale of put warrants	—	2,768	—	—
Adjustment to unrealized gains on investments, net	—	—	—	(2,767)
Cumulative translation adjustment	—	—	—	—
Net income	—	—	105,144	—
BALANCES AS OF NOVEMBER 27, 1998	**73,941**	**$306,859**	**$ 732,730**	**$ 823**

See accompanying Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (CONTINUED)

(In thousands)

	CUMULATIVE TRANSLATION ADJUSTMENT	TREASURY STOCK SHARES	TREASURY STOCK AMOUNT	TOTAL
BALANCES AS OF DECEMBER 1, 1995	$ (4,465)	—	$ —	$ 698,417
Stock issued under employee stock and stock option plans	—	—	—	39,870
Tax benefit from employee stock option plans	—	—	—	10,828
Stock compensation expense	—	—	—	2,772
Dividends declared	—	—	—	(14,524)
Repurchase of common stock	—	—	—	(126,778)
Put warrant obligations	—	—	—	(71,348)
Adjustment to unrealized gains on investments, net	—	—	—	14,683
Cumulative translation adjustment	(683)	—	—	(683)
Net income	—	—	—	153,277
BALANCES AS OF NOVEMBER 29, 1996	(5,148)	—	—	706,514
Stock issued under employee stock and stock option plans	—	—	—	70,995
Tax benefit from employee stock option plans	—	—	—	29,607
Stock compensation expense	—	—	—	1,329
Dividends declared	—	—	—	(52,522)
Repurchase of common stock	—	(5,176)	(238,688)	(275,644)
Proceeds from sale of put warrants	—	—	—	6,356
Reclassification of put warrant obligations	—	—	—	71,348
Adjustment to unrealized gains on investments, net	—	—	—	(29,924)
Cumulative translation adjustment	528	—	—	528
Net income	—	—	—	186,837
BALANCES AS OF NOVEMBER 28, 1997	(4,620)	(5,176)	(238,688)	715,424
Tax benefit from employee stock option plans	—	—	—	12,595
Stock compensation expense	—	—	2,298	2,513
Dividends declared	—	—	—	(12,962)
Purchase of treasury stock	—	(10,513)	(379,203)	(379,203)
Reissuance of treasury stock under employee stock and stock option plans	—	2,639	94,248	70,935
Proceeds from sale of put warrants	—	—	—	2,768
Adjustment to unrealized gains on investments, net	—	—	—	(2,767)
Cumulative translation adjustment	1,918	—	—	1,918
Net income	—	—	—	105,144
BALANCES AS OF NOVEMBER 27, 1998	**$ (2,702)**	**(13,050)**	**$(521,345)**	**$516,365**

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

YEARS ENDED	NOVEMBER 27 1998	NOVEMBER 28 1997	NOVEMBER 29 1996
Cash flows from operating activities:			
Net income	**$ 105,144**	$ 186,837	$ 153,277
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**56,264**	59,384	55,621
Deferred income taxes	**(6,774)**	(4,172)	(9,420)
Equity in net (income) loss of Adobe Ventures I and II	**(2,365)**	1,326	(19,001)
Gains on sales of equity securities	**(12,972)**	(35,616)	(53,216)
Tax benefit from employee stock option plans	**12,595**	29,607	10,828
Stock compensation expense	**2,513**	1,329	2,772
Write-off of acquired in-process research and development	**—**	5,969	21,251
Noncash restructuring and other charges	**9,077**	—	2,525
Changes in operating assets and liabilities:			
Receivables	**(11,054)**	(15,151)	8,556
Other current assets	**6,886**	(2,351)	(1,173)
Trade and other payables	**(8,461)**	14,802	8,534
Accrued expenses	**32,947**	4,216	(7,198)
Accrued restructuring charges	**3,914**	(2,471)	(20,229)
Income taxes payable	**17,125**	(32,294)	48,768
Deferred revenue	**(1,370)**	(2,768)	(3,781)
Net cash provided by operating activities	**203,469**	208,647	198,114
Cash flows from investing activities:			
Purchases of short-term investments	**(1,278,178)**	(2,657,302)	(2,363,993)
Maturities and sales of short-term investments	**1,347,800**	2,875,294	2,363,793
Acquisitions of property and equipment	**(59,745)**	(33,882)	(45,869)
Additions to other assets	**(57,520)**	(42,122)	(65,399)
Acquisitions, net of cash acquired	**(3,544)**	(6,121)	(8,027)
Proceeds from sales of equity securities	**10,886**	30,993	72,630
Net cash provided by (used for) investing activities	**(40,301)**	166,860	(46,865)

(continued)

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(In thousands)

YEARS ENDED	NOVEMBER 27 1998	NOVEMBER 28 1997	NOVEMBER 29 1996
Cash flows from financing activities:			
Proceeds from issuance of common stock	**$ —**	$ 70,995	$ 39,870
Purchase of treasury stock	**(379,203)**	(275,644)	(126,778)
Proceeds from reissuance of treasury stock	**70,935**	—	—
Proceeds from sale of put warrants	**2,768**	6,356	—
Payment of dividends	**(16,291)**	(20,911)	(14,586)
Net cash used for financing activities	**(321,791)**	(219,204)	(101,494)
Effect of foreign currency exchange rates on cash and cash equivalents	**1,918**	528	2,497
Net increase (decrease) in cash and cash equivalents	**(156,705)**	156,831	52,252
Cash and cash equivalents at beginning of year	**267,576**	110,745	58,493
Cash and cash equivalents at end of year	**$110,871**	$ 267,576	$110,745
Supplemental disclosures:			
Cash paid during the year for income taxes	**$ 22,471**	$ 85,062	$ 30,463
Noncash investing and financing activities:			
Cash dividends declared but not paid	**$ 3,062**	$ 3,558	$ 3,582
Dividends in-kind declared but not distributed	**$ —**	$ 10,032	$ —
Dividends in-kind distributed	**$ 7,197**	$ 21,603	$ —
Issuance of notes for acquisition	**$ —**	$ —	$ 9,473

See accompanying Notes to Consolidated Financial Statements.

Notes To Consolidated Financial Statements

(In thousands, except share and per share data)

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

Cash equivalents and short-term investments Cash equivalents consist of instruments with maturities of three months or less at the time of purchase.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 2. ACQUISITIONS

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

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

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

NOTE 3. CASH EQUIVALENTS AND INVESTMENTS

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

AS OF NOVEMBER 27, 1998	COST	UNREALIZED GAINS	UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Classified as current assets:				
Money market mutual funds	$ 34,583	$ —	$ —	$ 34,583
State and municipal bonds and notes	201,877	1,435	(63)	203,249
United States government treasury notes	3,952	7	—	3,959
Total current	240,412	1,442	(63)	241,791
Classified as noncurrent assets:				
Money market mutual funds	66,000	—	—	66,000
Total securities	$ 306,412	$1,442	$ (63)	$ 307,791

AS OF NOVEMBER 28, 1997	COST	UNREALIZED GAINS	UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Classified as current assets:				
Money market mutual funds	$ 53,051	$ —	$ —	$ 53,051
State and municipal bonds and notes	394,295	757	(36)	395,016
Corporate and bank notes	6,400	—	—	6,400
Auction-rate securities	2,800	—	—	2,800
Equity securities	4,082	5,292	—	9,374
Total current	460,628	6,049	(36)	466,641
Classified as noncurrent assets:				
Money market mutual funds	46	—	—	46
United States government treasury notes	66,607	9	(9)	66,607
Total noncurrent	66,653	9	(9)	66,653
Total securities	$ 527,281	$6,058	$ (45)	$ 533,294

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

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

NOTE 4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

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

NOTE 5. OTHER ASSETS

Other assets consisted of the following:

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

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

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

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

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

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

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

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

NOTE 6. ACCRUED EXPENSES

Accrued expenses consisted of the following:

	NOVEMBER 27 1998	NOVEMBER 28 1997
Accrued compensation and benefits	**$ 41,592**	$37,833
Sales and marketing allowances	**13,439**	15,965
Other	**62,508**	43,497
	$117,539	$97,295

NOTE 7. RESTRUCTURING AND OTHER CHARGES

In the third quarter of fiscal 1998, the Company implemented a restructuring program aimed at streamlining its underlying cost structure to better position the Company for growth and profitability. As part of the restructuring program, the Company implemented a reduction in force of 364 positions, four of which were executive positions, affecting mostly its North American operations. In addition to severance and related charges associated with the reduction in force, the restructuring program included charges for divesting two business units, vacating leased facilities, and canceling certain contracts. These actions and other non-restructuring related items resulted in charges of $38.2 million, of which approximately $9.1 million were non-cash charges. Of the $28.6 million in total cash charges, $6.2 million remains accrued at November 27, 1998.

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

	ACCRUED BALANCE AT NOVEMBER 28 1997	TOTAL CHARGES (CREDITS)	CASH PAYMENTS	WRITE-DOWNS	ACCRUED BALANCE AT NOVEMBER 27 1998
Severance and related charges	$ —	$14,264	$(13,370)	$ —	**$ 894**
Lease termination costs	—	4,526	(464)	—	**4,062**
Impairment of leasehold improvements at vacated facilities	—	6,382	—	(6,382)	**—**
Divestiture of business units	—	5,958	—	(5,958)	**—**
Canceled contracts	—	6,178	(5,235)	—	**943**
Other charges	—	4,367	(127)	(3,964)	**276**
	—	41,675	(19,196)	(16,304)	**6,175**
Accrual related to previous restructuring	8,383	(3,430)	(2,261)	—	**2,692**
	$8,383	$38,245	$(21,457)	$(16,304)	**$8,867**

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

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

Charges related to the impairment of leasehold improvements at vacated facilities of $6.4 million included the write-down of the net book value of leasehold improvements, telecommunications equipment, and a minimal amount of furniture and equipment used in the vacated facilities. Based on an analysis performed by a commercial real estate brokerage firm retained by the Company to sublease the facilities, the leasehold improvements and other assets specifically identified under the restructuring program as assets to be disposed of would have no future benefit to the Company as these assets would not enhance the Company's ability to sublease the facilities. Leasehold improvements consisted principally of a product demonstration room, a computer room with a raised floor, and a single building reception area, all of which would not be used by smaller tenants. Therefore, in accordance with

SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," the leasehold improvements and telecommunications equipment were reported at the lower of the carrying amount or fair value less costs to sell, which was zero. As of September 30, 1998, both of these facilities were fully vacated.

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

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

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

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

NOTE 8. INCOME TAXES

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

The provision for income taxes consisted of the following:

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

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

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

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

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

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

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

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

NOTE 9. BENEFIT PLANS

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

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

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

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

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

NOTE 10. EMPLOYEE STOCK PLANS

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

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

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

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

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

	NOVEMBER 27, 1998		NOVEMBER 28, 1997		NOVEMBER 29, 1996	
YEARS ENDED	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER OF SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding, beginning of year	**8,146,235**	**$31.74**	9,297,188	$25.68	10,125,792	$26.30
Granted	**10,713,350**	**35.06**	2,452,117	40.85	2,670,673	33.53
Exercised	**(1,988,977)**	**26.17**	(3,063,778)	20.29	(1,470,762)	17.37
Canceled	**(6,429,788)**	**39.08**	(539,292)	33.75	(2,028,515)	45.15
Outstanding, end of year	**10,440,820**	**31.68**	8,146,235	31.74	9,297,188	25.68
Exercisable, end of year	**4,368,318**	**28.57**	4,562,954	26.50	6,057,500	21.63
Weighted-average fair value of options granted during the year		**$13.84**		$15.68		$12.91

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

	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
RANGE OF EXERCISE PRICES	SHARES OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	SHARES EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
$ 3.45	1,092	1.03 years	$ 3.45	—	$ 3.45
6.56 — 9.50	249,598	1.34 years	8.96	249,598	8.96
10.13 — 15.13	269,252	3.74 years	14.18	269,247	14.18
15.75 — 23.63	395,597	2.99 years	20.62	394,292	20.62
23.75 — 33.75	2,519,330	6.33 years	30.72	2,054,649	30.33
33.81	6,770,762	7.39 years	33.81	1,325,524	33.81
34.25 — 50.75	234,349	8.08 years	43.21	74,168	46.02
51.75 — 67.00	840	6.85 years	56.14	840	56.14
$ 3.45 — $67.00	10,440,820	6.75 years	$31.68	4,368,318	$28.57

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

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

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

Employee Stock Purchase Plan The Company's Employee Stock Purchase Plan allows eligible employee participants to purchase shares of the Company's common stock at a discount through payroll deductions. For current offerings, the plan consists of two-year offering periods with four six-month purchase periods in each offering period; in September 1998, the Board of Directors reduced the offering periods of future offering periods to one year with two six-month purchase periods in each offering period. Employees purchase shares at 85% of the market value at either the beginning of the offering period or the end of the purchase period, whichever price is lower. As of November 27, 1998, the Company had reserved 9,500,000 shares of its common stock for issuance under this plan;

and 5,253,030 shares remain available for future issuance, although 2,500,000 shares of such reserve were approved by the Board of Directors in September 1998, which are subject to the approval of the Company's stockholders at the next annual meeting.

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

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

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

For purposes of computing pro forma net income, the fair value of each option grant, restricted stock grant, and Employee Stock Purchase Plan purchase right is estimated on the date of grant using the Black-Scholes option pricing model. The assumptions used to value the option grants and purchase rights are stated as follows:

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

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

NOTE 11. STOCKHOLDERS' EQUITY

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

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

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

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

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

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

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

NOTE 12. NET INCOME PER SHARE

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

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

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

NOTE 13. COMMITMENTS AND CONTINGENCIES

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

Included in the future minimum lease payments are the following amounts for leased facilities vacated in connection with the restructuring plan implemented in the third quarter of fiscal 1998: 1999—$4.0 million; 2000 — $2.1 million; 2001 — $2.2 million; 2002 —$2.3 million; 2003 — $2.3 million; and $7.3 million thereafter. These amounts, net of anticipated sublease income, were included in accrued restructuring costs at November 27, 1998.

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

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

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

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

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

NOTE 14. TRANSACTIONS WITH AFFILIATE

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

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

NOTE 15. FINANCIAL INSTRUMENTS

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

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

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

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

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

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

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

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

NOTE 16. FOREIGN OPERATIONS

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

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

NOTE 17. SUBSEQUENT EVENTS

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

Quarterly Results of Operations

(In thousands, except per share amounts)

1998	Quarter Ended Feb. 27	May 29	Aug. 28	Nov. 27	Year Ended Nov. 27
Revenue	$197,813	$227,310	$222,932	$246,736	$894,791
Gross profit	167,827	200,018	196,151	219,358	783,354
Income before income taxes	42,635	44,645	242	80,172	167,694
Net income	26,744	27,980	152	50,268	105,144
Basic net income per share	0.39	0.42	—	0.80	1.58
Shares used in computing basic net income per share	67,762	66,735	67,278	63,115	66,433
Diluted net income per share	0.38	0.41	—	0.78	1.55
Shares used in computing diluted net income per share	69,585	68,990	68,412	64,207	67,974
Common stock price per share					
High	$ 44.75	$ 51.88	$ 45.13	$ 48.00	$ 51.88
Low	33.50	39.94	24.06	23.63	23.63
Cash dividends per share	0.05	0.05	0.05	0.05	0.20

1997	Quarter Ended Feb. 28	May 30	Aug. 29	Nov. 28	Year Ended Nov. 28
Revenue	$226,459	$228,264	$230,039	$227,132	$911,894
Gross profit	192,170	195,606	197,350	200,497	785,623
Income before income taxes	73,167	63,204	85,528	74,191	296,090
Net income	46,484	40,106	53,428	46,819	186,837
Basic net income per share	0.65	0.56	0.73	0.66	2.60
Shares used in computing basic net income per share	71,493	72,085	72,766	71,345	71,962
Diluted net income per share	0.63	0.54	0.72	0.64	2.52
Shares used in computing diluted net income per share	73,939	74,416	74,528	73,651	74,160
Common stock price per share					
High	$ 44.13	$ 49.00	$ 45.25	$ 53.13	$ 53.13
Low	34.63	32.50	34.00	39.75	32.50
Cash dividends per share	0.05	0.05	0.05	0.05	0.20

The Company's common stock is traded on The Nasdaq National Market under the symbol "ADBE." On December 31, 1998, there were 1,694 holders of record of the Company's common stock. Because many of such shares are held by brokers and other institutions on behalf of stockholders, the Company is unable to estimate the total number of stockholders represented by these record holders.

Management's Report

Management is responsible for all the information and representations contained in the consolidated financial statements and other sections of this Form 10-K. 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 Form 10-K 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 LLP, the independent auditors, who have free access to the Audit Committee and the Board of Directors, without management present, to discuss internal accounting control, auditing, and financial reporting matters.

KPMG 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.

Harold L. Covert
Senior Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)
December 14, 1998

Independent Auditors' Report

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

We have audited the accompanying consolidated balance sheets of Adobe Systems Incorporated and subsidiaries as of November 27, 1998 and November 28, 1997, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended November 27, 1998. 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 conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Adobe Systems Incorporated and subsidiaries as of November 27, 1998 and November 28, 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended November 27, 1998, in conformity with generally accepted accounting principles.

KPMG LLP

KPMG LLP
Mountain View, California
December 14, 1998

Since 1982, Adobe has been building a customer base that is one of the most loyal in the world. Users of Adobe products have come to expect not only the highest quality software and service, but also real answers to the business challenges they face. Whether they're graphic designers who need to become Web savvy, publishers who need to maximize efficiency through digital workflow, or multinational corporations that need to streamline document management electronically, Adobe offers solutions tailored to meet their needs. We have worked hard to earn our customers' support. In return for their passionate loyalty to Adobe, we feel a tremendous responsibility to them. Our commitment to our customers is simple: to add value to their businesses and to their lives in a way that transcends products and technologies—to give them the creative and competitive advantage in a digital world that never stops changing.

Executive Officers

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

CHARLES M. GESCHKE
Chairman of the Board
and President

BRUCE R. CHIZEN
Executive Vice President,
Worldwide Products and Marketing

FREDERICK A. SNOW
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Senior Vice President
and Chief Financial Officer

DEREK J. GRAY
Senior Vice President
and General Manager,
Adobe Systems Europe

COLLEEN M. POULIOT
Senior Vice President,
General Counsel,
and Secretary

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Chairman of the Board and CEO
Adobe Systems Incorporated

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Adobe Systems Incorporated

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Acta Technology, Inc.

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Private Investor

WILLIAM HAMBRECHT
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W.R. Hambrecht & Co.

ROBERT SEDGEWICK
Professor of Computer Science
Princeton University

WILLIAM SPENCER
Chairman of the Board
SEMATECH

DELBERT YOCAM
Chairman of the Board and CEO
Inprise Corporation

Form 10-K

A copy of the Company's Annual Report filed with the Securities and Exchange Commission (Form 10-K) is available (without exhibits) free of charge by visiting our Web site, sending e-mail, or writing or calling:

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Annual Meeting

The Annual Meeting of Stockholders will be held April 15, 1999, at 4:30 P.M. at the Company's headquarters in San Jose, California.

Stock Exchange Listing

The Nasdaq Stock Market
Ticker Symbol "ADBE"

Transfer Agent/Registrar

Harris Trust Company
Chicago, Illinois, USA

Independent Auditors

KPMG LLP
Mountain View, California, USA

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 Stockholders 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.

Colophon

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