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

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended March 4, 2005

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file Number: 0-15175

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**ADOBE SYSTEMS INCORPORATED**

(Exact name of registrant as specified in its charter)

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**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**77-0019522**

(I.R.S. Employer  
Identification No.)

**345 Park Avenue, San Jose, California 95110-2704**

(Address of principal executive offices and zip code)

**(408) 536-6000**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

The number of shares outstanding of the registrant's common stock as of April 1, 2005 was 244,497,573.

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**FORM 10-Q**  
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**PART I—FINANCIAL INFORMATION**

**ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	March 4, 2005	December 3, 2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents . . . . .	\$ 217,360	\$ 259,061
Short-term investments . . . . .	1,249,743	1,054,160
Trade receivables, net . . . . .	138,352	141,945
Other receivables . . . . .	28,188	25,495
Deferred income taxes . . . . .	37,924	51,751
Prepaid expenses and other current assets . . . . .	28,372	18,617
Total current assets . . . . .	1,699,939	1,551,029
Property and equipment, net . . . . .	100,340	99,675
Goodwill . . . . .	119,082	110,287
Purchased and other intangibles, net . . . . .	17,814	15,513
Investment in lease receivable . . . . .	126,800	126,800
Other assets . . . . .	58,835	55,328
	<u>\$ 2,122,810</u>	<u>\$ 1,958,632</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade and other payables . . . . .	\$ 38,575	\$ 43,192
Accrued expenses . . . . .	196,567	202,762
Income taxes payable . . . . .	191,959	145,913
Deferred revenue . . . . .	57,087	59,541
Total current liabilities . . . . .	484,188	451,408
Other long-term liabilities . . . . .	5,058	4,838
Deferred income taxes . . . . .	8,999	78,909
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.0001 par value . . . . .	29,576	29,576
Additional paid-in-capital . . . . .	1,228,927	1,164,643
Retained earnings . . . . .	2,387,657	2,238,807
Accumulated other comprehensive loss . . . . .	(3,223)	(2,289)
Treasury stock, at cost (52,393* and 53,577* shares in 2005 and 2004, respectively), net of re-issuances . . . . .	(2,018,372)	(2,007,260)
Stockholders' equity . . . . .	1,624,565	1,423,477
	<u>\$ 2,122,810</u>	<u>\$ 1,958,632</u>

\* Does not reflect the two-for-one stock split in the form of a stock dividend that will become effective May 23, 2005.

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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

	<b>Three Months Ended</b>	
	<b>March 4, 2005</b>	<b>March 5, 2004</b>
Revenue:		
Products . . . . .	\$463,147	\$415,752
Services and support . . . . .	9,735	7,529
Total revenue . . . . .	<u>472,882</u>	<u>423,281</u>
Cost of revenue:		
Products . . . . .	21,855	20,444
Services and support . . . . .	5,114	3,738
Total cost of revenue . . . . .	<u>26,969</u>	<u>24,182</u>
Gross profit . . . . .	445,913	399,099
Operating expenses:		
Research and development . . . . .	86,686	75,071
Sales and marketing . . . . .	147,383	127,354
General and administrative . . . . .	41,132	33,412
Total operating expenses . . . . .	<u>275,201</u>	<u>235,837</u>
Operating income . . . . .	170,712	163,262
Non-operating income:		
Investment loss . . . . .	(1,554)	(1,031)
Interest and other income . . . . .	7,627	4,032
Total non-operating income . . . . .	<u>6,073</u>	<u>3,001</u>
Income before income taxes . . . . .	176,785	166,263
Provision for income taxes . . . . .	24,891	43,228
Net income . . . . .	<u>\$151,894</u>	<u>\$123,035</u>
Basic net income per share* . . . . .	<u>\$ 0.62</u>	<u>\$ 0.52</u>
Shares used in computing basic net income per share* . . . . .	<u>243,130</u>	<u>238,384</u>
Diluted net income per share* . . . . .	<u>\$ 0.60</u>	<u>\$ 0.50</u>
Shares used in computing diluted net income per share* . . . . .	<u>253,091</u>	<u>246,087</u>
Cash dividends declared per share* . . . . .	<u>0.0125</u>	<u>0.0125</u>

\* Does not reflect the two-for-one stock split in the form of a stock dividend that will become effective May 23, 2005.

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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

	<b>Three Months Ended</b>	
	<b>March 4, 2005</b>	<b>March 5, 2004</b>
Cash flows from operating activities:		
Net income . . . . .	\$ 151,894	\$ 123,035
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization . . . . .	14,954	13,438
Stock-based compensation expense . . . . .	76	184
Deferred income taxes . . . . .	(56,483)	23,110
Provision for (recovery of) losses on receivables . . . . .	137	(2,114)
Tax benefit from employee stock option plans . . . . .	27,197	5,124
Net losses on sales and impairments of investments . . . . .	1,554	1,031
Changes in operating assets and liabilities:		
Receivables . . . . .	1,674	21,166
Other current assets . . . . .	(9,353)	(4,281)
Trade and other payables . . . . .	(4,923)	(1,839)
Accrued expenses . . . . .	(6,222)	17,002
Income taxes payable . . . . .	46,046	(8,121)
Deferred revenue . . . . .	(2,454)	(2,274)
Net cash provided by operating activities . . . . .	<u>164,097</u>	<u>185,461</u>
Cash flows from investing activities:		
Purchases of short-term investments . . . . .	(569,644)	(537,407)
Maturities of short-term investments . . . . .	33,905	14,719
Sales of short-term investments . . . . .	339,223	390,168
Purchases of property and equipment . . . . .	(11,512)	(14,444)
Purchases of long-term investments and other assets . . . . .	(9,931)	(4,305)
Cash paid for acquisition, net . . . . .	(9,541)	—
Net cash used for investing activities . . . . .	<u>(227,500)</u>	<u>(151,269)</u>
Cash flows from financing activities:		
Purchases of treasury stock . . . . .	(100,022)	(55,607)
Proceeds from issuance of treasury stock . . . . .	125,921	40,356
Payment of dividends . . . . .	(3,032)	(2,986)
Net cash provided by (used for) financing activities . . . . .	<u>22,867</u>	<u>(18,237)</u>
Effect of foreign currency exchange rates on cash and cash equivalents . . . . .	<u>(1,165)</u>	<u>332</u>
Net increase (decrease) in cash and cash equivalents . . . . .	(41,701)	16,287
Cash and cash equivalents at beginning of period . . . . .	<u>259,061</u>	<u>126,522</u>
Cash and cash equivalents at end of period . . . . .	<u>\$ 217,360</u>	<u>\$ 142,809</u>
Supplemental disclosures:		
Cash paid during the period for income taxes . . . . .	<u>\$ 5,847</u>	<u>\$ 21,231</u>

*See accompanying Notes to Condensed Consolidated Financial Statements.*

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

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

*Basis of Presentation*

The accompanying condensed consolidated financial statements include those of Adobe and our subsidiaries, after elimination of all intercompany accounts and transactions. Adobe has prepared the accompanying interim condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, consistent in all material respects with those applied in our Annual Report on Form 10-K for the year ended December 3, 2004. The interim financial information is unaudited but reflects all adjustments which are, in the opinion of management, necessary to provide fair condensed consolidated balance sheets, condensed consolidated statements of income and cash flows for the interim periods presented. Such adjustments are normal and recurring except as otherwise noted. The Condensed Consolidated Balance Sheet as of December 3, 2004 is derived from the December 3, 2004 audited financial statements. You should read these interim condensed consolidated financial statements in conjunction with the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 3, 2004.

*Reclassification*

Certain amounts in fiscal 2004 as reported on the Condensed Consolidated Balance Sheet and Condensed Consolidated Statements of Cash Flows have been reclassified to conform to the current year presentation. We reclassified \$117.1 million in auction rate securities and variable rate demand obligations from cash and cash equivalents to short-term investments on the fiscal 2004 consolidated balance sheet. The reclassification to short-term investments is based on the latest interpretation of cash equivalents pursuant to Statement of Financial Accounting Standards No. 95 ("SFAS 95"), "Statement of Cash Flows."

*Stock Dividend*

On March 16, 2005 our Board of Directors approved a two-for-one stock split, in the form of a stock dividend, of our common stock payable on May 23, 2005 for stockholders of record as of May 2, 2005. Share and per share data have not been adjusted to give effect to this stock split.

*Revenue Recognition*

Our revenue is derived from the licensing of application and server-based software products, professional services, and maintenance and support. We recognize revenue when persuasive evidence of an arrangement exists, we have delivered the product or performed the service, the fee is fixed or determinable and collection is probable.

*Product revenue*

We recognize our product revenue upon shipment, provided collection is determined to be probable and no significant obligations remain on our part. Our desktop application products revenue from distributors is subject to agreements allowing limited rights of return, rebates, and price protection. Our direct sales and OEM sales are also subject to limited rights of return. Accordingly we reduce revenue recognized for estimated future returns, price protection and rebates at the time the related revenue is

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

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

recorded. The estimates for returns are adjusted periodically based upon historical rates of returns, inventory levels in the distribution channel and other related factors.

We record the estimated costs of providing free technical phone support to customers for our shrink-wrapped application products under warranty.

We record OEM licensing revenue, primarily royalties, when OEM partners ship products incorporating Adobe software, provided collection of such revenue is deemed probable.

Our product-related deferred revenue includes maintenance upgrade revenue and customer advances under OEM license agreements. Our maintenance upgrade revenue for our desktop application products is included in our product revenue line item as the maintenance primarily entitles customers to receive product upgrades. In cases where we provide a specified free upgrade to an existing product, we defer the fair value for the specified upgrade right until the future obligation is fulfilled or when the right to the specified free upgrade expires.

*Services and support revenue*

Our services and support revenue is composed of professional services (such as consulting services and training) and maintenance and support, primarily related to the licensing of our Intelligent Documents server solution products. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products.

Our professional services revenue is recognized using the percentage of completion method and is measured monthly based on input measures, such as on hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones when applicable. Our maintenance and support offerings, which entitle customers to receive product upgrades and enhancements or technical support, depending on the offering, are recognized ratably over the term of the arrangement.

*Multiple element arrangements*

We enter into revenue arrangements in which a customer may purchase a combination of software, upgrades, maintenance and support, and professional services (multiple-element arrangements). When vendor-specific objective evidence ("VSOE") of fair value exists for all elements, we allocate revenue to each element based on the relative fair value of each of the elements. VSOE of fair value is established by the price charged when that element is sold separately. For maintenance and support, VSOE of fair value is established by renewal rates. For arrangements where VSOE of fair value exists only for the undelivered elements, we defer the full fair value of the undelivered elements and recognize the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue, assuming all other criteria for revenue recognition have been met.

We perform ongoing credit evaluations of our customers' financial condition and in some cases we require various forms of security. We also maintain allowances for estimated losses on receivables.

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

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Stock-Based Incentive Compensation*

We account for our stock option plans and our employee stock purchase plan using the intrinsic value method under Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." The following table sets forth the pro forma amounts of net income and net income per share, for the three months ended March 4, 2005 and March 5, 2004, that would have resulted if we had accounted for our employee stock plans under the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation."

	<u>2005</u>	<u>2004</u>
Net income:		
As reported . . . . .	\$151,894	\$123,035
Add: Stock-based compensation expense for employees included in reported net income, net of related tax effects . . . . .	49	120
Less: Total stock-based compensation expense for employees determined under the fair value based method, net of related tax effects . . . . .	(23,135)	(27,894)
Pro forma . . . . .	<u>\$128,808</u>	<u>\$ 95,261</u>
Basic net income per share:		
As reported . . . . .	\$ 0.62	\$ 0.52
Pro forma . . . . .	\$ 0.53	\$ 0.40
Diluted net income per share:		
As reported . . . . .	\$ 0.60	\$ 0.50
Pro forma . . . . .	\$ 0.51	\$ 0.39

For purposes of computing pro forma net income, we estimate the fair value of option grants and employee stock purchase plan purchase rights using the Black-Scholes option pricing model. The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants and employee stock purchase plan shares. Additionally, option valuation models require the input of highly subjective assumptions, including the expected volatility of the stock price. Because our employee stock options and employee stock purchase plan shares have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimates, in management's opinion, the existing models do not provide a reliable single measure of the fair value of its stock-based awards.

For purposes of determining expected volatility, we considered implied volatility in market-traded options on our common stock as well as third party volatility quotes. In addition, we considered historical volatility. We will continue to monitor these and other relevant factors used to measure expected volatility for future option grants.



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

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The assumptions used to value option grants for the quarters ended March 4, 2005 and March 5, 2004 are as follows:

	2005	2004
Expected life (in years) . . . . .	3.0	2.5
Volatility . . . . .	30%	40%
Risk free interest rate . . . . .	3.38%	2.18% - 2.44%
Dividend yield . . . . .	—	0.125%

The assumptions used to value employee stock purchase rights for the quarters ended March 4, 2005 and March 5, 2004 are as follows:

	2005	2004
Expected life (in years) . . . . .	1.25	1.24
Volatility . . . . .	32%	40%
Risk free interest rate . . . . .	3.03%	1.24% - 1.76%
Dividend yield . . . . .	—	0.125%

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 amounts shown above may not be representative of the pro forma effect on reported net income in future years.

*Income Taxes*

We use the asset and liability method of accounting for income taxes. Under the asset and liability method, we recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities. We record a valuation allowance to reduce deferred tax assets to an amount for which realization is more likely than not. We also account for any income tax contingencies in accordance with Statement of Financial Accounting Standards No. 5 ("SFAS 5"), "Accounting for Contingencies."

*Recent Accounting Pronouncements*

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards 123—revised 2004 ("SFAS 123R"), "Share-Based Payment" which replaced Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." SFAS 123R requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. The accounting provisions of SFAS 123R are effective for reporting periods beginning after June 15, 2005. We are required to adopt SFAS 123R in the fourth quarter of fiscal 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See "Stock-Based Incentive Compensation" above for the pro forma net income and net income per share amounts, for the first quarters of fiscal 2005 and 2004, as if

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

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

we had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a significant adverse impact on our consolidated statements of income and net income per share.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-1 ("FAS 109-1"), "Application of FASB Statement No. 109, "Accounting for Income Taxes," to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 ("AJCA")." The AJCA introduces a special 9% tax deduction on qualified production activities. FAS 109-1 clarifies that this tax deduction should be accounted for as a special tax deduction in accordance with Statement 109. Pursuant to the AJCA, Adobe will not be able to claim this tax benefit until the first quarter of fiscal 2006. We do not expect the adoption of these new tax provisions to have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2 ("FAS 109-2"), "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004." The AJCA introduces a limited time 85% dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. Starting in the first quarter of fiscal 2005, Adobe has adopted the accounting and disclosure requirements as outlined in FAS 109-2. See Note 6 for further information regarding FAS 109-2.

**NOTE 2. GOODWILL AND PURCHASED AND OTHER INTANGIBLES**

Below is our goodwill reported by segment as of March 4, 2005 and December 3, 2004:

	<u>2005</u>	<u>2004</u>
Digital Imaging and Video . . . . .	\$ 14,112	\$ 14,112
Creative Professional . . . . .	4,650	4,650
Intelligent Documents . . . . .	100,320	91,525
Total goodwill . . . . .	<u>\$119,082</u>	<u>\$110,287</u>

During the first quarter of fiscal 2005, our goodwill increased due to the acquisition of OKYZ S.A. ("OKYZ"). OKYZ provides three dimensional technology and expertise to our Intelligent Documents platform.

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," we review our goodwill periodically for impairment.

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

**NOTE 2. GOODWILL AND PURCHASED AND OTHER INTANGIBLES (Continued)**

Purchased and other intangible assets, subject to amortization, were as follows as of March 4, 2005:

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Purchased technology . . . . .	\$27,775	\$(16,422)	\$11,353
Localization . . . . .	12,348	(6,349)	5,999
Trademarks . . . . .	300	(142)	158
Other intangibles . . . . .	1,101	(797)	304
Total other intangible assets . . . . .	13,749	(7,288)	6,461
Total purchased and other intangible assets . . . . .	<u>\$41,524</u>	<u>\$(23,710)</u>	<u>\$17,814</u>

Purchased and other intangible assets, subject to amortization, were as follows as of December 3, 2004:

	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Purchased technology . . . . .	\$41,009	\$(29,266)	\$11,743
Localization . . . . .	10,404	(7,109)	3,295
Trademarks . . . . .	300	(133)	167
Other intangibles . . . . .	1,105	(797)	308
Total other intangible assets . . . . .	11,809	(8,039)	3,770
Total purchased and other intangible assets . . . . .	<u>\$52,818</u>	<u>\$(37,305)</u>	<u>\$15,513</u>

Amortization expense related to purchased and other intangible assets was \$4.1 million and \$4.5 million in the first quarter of fiscal 2005 and 2004, respectively. As of March 4, 2005, we expect amortization expense in future periods to be as shown below:

<u>Fiscal year</u>	<u>Purchased Technology</u>	<u>Other Intangible Assets</u>
Remainder of 2005 . . . . .	\$ 4,751	\$5,620
2006 . . . . .	3,373	669
2007 . . . . .	1,921	43
2008 . . . . .	316	38
2009 . . . . .	316	18
2010 . . . . .	316	18
Thereafter . . . . .	360	55
Total expected amortization expense . . . . .	<u>\$11,353</u>	<u>\$6,461</u>

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

**NOTE 3. OTHER ASSETS**

Other assets consisted of the following as of March 4, 2005 and December 3, 2004:

	<u>2005</u>	<u>2004</u>
Investments . . . . .	\$45,882	\$41,382
Security deposits and other . . . . .	5,045	5,768
Prepaid land lease . . . . .	3,330	3,340
Prepaid rent . . . . .	4,578	4,838
Total other assets . . . . .	<u>\$58,835</u>	<u>\$55,328</u>

We own limited partnership interests in Adobe Ventures which are consolidated in accordance with FASB Interpretation No. 46R ("FIN 46R") a revision to FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities." The partnerships are controlled by Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures.

The following table summarizes the net realized gains and losses from our investments for the three months ended March 4, 2005 and March 5, 2004:

	<u>2005</u>	<u>2004</u>
Net losses related to our investments in Adobe Ventures and cost method investments . . . . .	\$(1,908)	\$(1,253)
Gains on stock warrants . . . . .	354	222
Total investment loss . . . . .	<u>\$(1,554)</u>	<u>\$(1,031)</u>

**NOTE 4. ACCRUED EXPENSES**

Accrued expenses consisted of the following as of March 4, 2005 and December 3, 2004:

	<u>2005</u>	<u>2004</u>
Compensation and benefits . . . . .	\$ 89,491	\$ 98,108
Sales and marketing allowances . . . . .	11,910	11,857
Other . . . . .	95,166	92,797
Total accrued expenses . . . . .	<u>\$196,567</u>	<u>\$202,762</u>

**NOTE 5. RESTRUCTURING AND OTHER CHARGES**

In connection with our acquisition of Accelio in the second quarter of fiscal 2002, we recognized \$14.5 million in liabilities associated with a worldwide reduction in force of Accelio employees, transaction costs, costs related to closing redundant facilities and terminating contracts and other exit costs associated with the acquisition. As of March 4, 2005, \$0.2 million remained in other accrued expenses on the consolidated balance sheet and comprised transaction and facilities costs. Transaction costs primarily relate to the liquidation of Accelio's subsidiaries and are expected to be paid through fiscal 2005. Facilities costs

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

**NOTE 5. RESTRUCTURING AND OTHER CHARGES (Continued)**

relate to leases we assumed upon acquisition of Accelio that terminate at various times through September 2006.

A summary of restructuring activities, related to our acquisition of Accelio, is as follows:

	Balance at December 3, 2004	Cash Payments	Balance at March 4, 2005
Transaction costs . . . . .	\$117	\$(10)	\$107
Cost of closing redundant facilities . . . . .	144	(3)	141
Total . . . . .	<u>\$261</u>	<u>\$(13)</u>	<u>\$248</u>

**NOTE 6. INCOME TAXES**

During the first quarter of fiscal 2005, we completed our evaluation of the repatriation provisions of the AJCA. The AJCA introduced a limited time 85% dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer, provided certain criteria are met. Although the AJCA contains a number of limitations related to the repatriation and some uncertainty remains on key elements of the provision, we have made a determination for a planned repatriation of \$555.0 million of certain foreign earnings, of which \$500.0 million qualifies for the 85% dividends received deduction.

For Adobe's first quarter, we have recorded an estimated tax provision of \$52.4 million for the planned repatriation of certain foreign earnings. Additionally, we recorded a reversal of \$71.7 million for income taxes on certain foreign earnings for which a deferred tax liability had been previously accrued. As a result, a net income tax benefit of \$19.3 million has been recognized for the difference between income taxes previously provided on certain foreign earnings at the federal statutory tax rate and income taxes at the lower rate under the repatriation provisions of the AJCA.

The estimated tax provision of \$52.4 million for the planned repatriation of certain foreign earnings includes an amount of additional taxes for a technical correction on key elements of the AJCA that we believe is forthcoming from Congress. Once the technical guidance is issued, an additional tax benefit may be recorded in the quarter the guidance is issued. In addition, at the time of repatriation, further adjustments could be required depending upon a number of factors, including required estimates of fiscal 2005 foreign earnings, 2005 foreign taxes, and statutory tax rates in effect at the time of the repatriation.

The planned repatriation of certain foreign earnings will occur during the remaining quarters of fiscal 2005. We will invest these earnings pursuant to an approved Domestic Reinvestment Plan that conforms to the AJCA guidelines.

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

**NOTE 7. STOCKHOLDERS' EQUITY**

*Stock Repurchase Program I—On-going Dilution Coverage*

To facilitate our stock repurchase program, designed to minimize dilution from stock issuance primarily from employee stock plans, we repurchase shares in the open market and from time to time enter into structured repurchase agreements with third parties. Authorization to repurchase shares to cover on-going dilution is not subject to expiration. However, this repurchase program is limited to covering net dilution from stock issuances and is subject to business conditions and cash flow requirements as determined by our Board of Directors from time to time.

During the quarter ended March 4, 2005, we entered into several stock purchase agreements with large financial institutions. Under these agreements, we provided the financial institutions with up-front payments totaling \$100.0 million. The financial institutions agreed to deliver to us, at certain intervals during the contract term, a certain number of our shares based on the volume weighted average price during such intervals less a specified discount. Upon payment, the \$100.0 million was classified as treasury stock on our balance sheet. As of March 4, 2005 and December 3, 2004, approximately \$47.2 million and 127.7 million, respectively, of the up-front payments remained under the agreements.

During the quarter ended March 4, 2005, we repurchased 3.1 million shares at an average price of \$58.77 through these structured repurchase agreements which included prepayments remaining from fiscal 2004. During the quarter ended March 5, 2004, we repurchased 1.4 million shares at an average price of \$38.78 through open market repurchases.

*Stock Repurchase Program II—Additional Authorization above Dilution Coverage*

On September 25, 2002, our Board of Directors authorized a program to purchase up to an additional 5.0 million shares of our common stock over a three-year period, subject to certain business and cash flow requirements. We have not made any purchases under this 5.0 million share repurchase program. The authorization for this program will expire in September 2005.

**NOTE 8. COMPREHENSIVE INCOME**

Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income," establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Items of other comprehensive income that we currently report are unrealized gains and losses on marketable securities categorized as available-for-sale and foreign currency translation adjustments. We also report gains and losses on derivative instruments qualifying as cash flow hedges such as (i) hedging a forecasted foreign currency transaction, (ii) the variability of cash flows to be received or paid related to a recognized asset or liability and (iii) interest rate hedges.

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

**NOTE 8. COMPREHENSIVE INCOME (Continued)**

The following table sets forth the components of comprehensive income, net of income tax expense, for the three months ended March 4, 2005 and March 5, 2004:

	<u>2005</u>	<u>2004</u>
Net income . . . . .	\$151,894	\$123,035
Other comprehensive income (loss), net of tax:		
Change in unrealized gain on available-for-sale securities, net of taxes	200	3,025
Currency translation adjustments . . . . .	(1,165)	332
Net gain in derivative instruments, net of taxes . . . . .	31	3,224
Other comprehensive income (loss) . . . . .	(934)	6,581
Total comprehensive income, net of taxes . . . . .	<u>\$150,960</u>	<u>\$129,616</u>

**NOTE 9. NET INCOME PER SHARE**

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 and stock options using the treasury stock method.

The following table sets forth the computation of basic and diluted net income per share for the three months ended March 4, 2005 and March 5, 2004:

	<u>2005</u>	<u>2004</u>
Net income . . . . .	<u>\$151,894</u>	<u>\$123,035</u>
Shares used to compute basic net income per share (weighted average shares outstanding during the period, excluding unvested restricted stock) . . . . .	243,130	238,384
Dilutive common equivalent shares:		
Unvested restricted stock . . . . .	16	17
Stock options . . . . .	9,945	7,686
Shares used to compute diluted net income per share . . . . .	<u>253,091</u>	<u>246,087</u>
Basic net income per share . . . . .	<u>\$ 0.62</u>	<u>\$ 0.52</u>
Diluted net income per share . . . . .	<u>\$ 0.60</u>	<u>\$ 0.50</u>

For the quarters ended March 4, 2005 and March 5, 2004, options to purchase approximately 3.5 million and 12.8 million shares, respectively, of common stock with exercise prices greater than the average fair market value of our stock of \$60.92 and \$38.55, respectively, were not included in the calculation because the effect would have been antidilutive.

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

**NOTE 10. COMMITMENTS AND CONTINGENCIES**

*Lease Commitments*

We lease certain of our facilities and some of our equipment under noncancelable operating lease arrangements that expire at various dates through 2025. We also have one land lease that expires in 2091.

We occupy three office buildings in San Jose, California where our corporate headquarters are located. We reference these office buildings as the “Almaden tower” and the “East and West towers.”

In December 2003, upon completion of construction, we began a five year lease agreement for the Almaden tower. Under the agreement, we have the option to purchase the building at any time during the lease term for the lease balance, which is approximately \$103.0 million. The maximum recourse amount (“residual value guarantee”) under this obligation is \$90.8 million.

In August 2004, we extended the lease agreement for our East and West towers for an additional five years with an option to extend for an additional five years solely at Adobe’s election. As part of the lease extension, we purchased a portion of the lease receivable of the lessor for \$126.8 million, which is recorded as an investment in lease receivable on our consolidated balance sheet. This purchase may be credited against the residual value guarantee if we purchase the properties or repaid from the sale proceeds if the properties are sold to third parties. Under the agreement for the East and West towers, we have the option to purchase the buildings at any time during the lease term for the lease balance, which is approximately \$143.2 million. The residual value guarantee under this obligation is \$126.8 million.

These two leases are both subject to standard covenants including liquidity, leverage and profitability ratios that are reported to the lessors quarterly. As of March 4, 2005, we were in compliance with all covenants. In the case of a default, the lessor may demand we purchase the buildings for an amount equal to the lease balance, or require that we remarket or relinquish the buildings. Both leases qualify for operating lease accounting treatment under Statement of Financial Accounting Standards No. 13, “Accounting for Leases,” and, as such, the buildings and the related obligations are not included on our consolidated balance sheet. We utilized this type of financing in order to access bank-provided funding at the most favorable rates and to provide the lowest total cost of occupancy for the headquarter buildings. At the end of the lease term, we can extend the lease for an additional five year term (for the East and West towers lease only), purchase the buildings for the lease balance, remarket or relinquish the buildings. If we choose to remarket or are required to do so upon relinquishing the buildings, we are bound to arrange the sale of the buildings to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the maximum recourse amount.

*Royalties*

We have 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.

*Guarantees*

The lease agreements for our corporate headquarters provide for residual value guarantees. Under FASB Interpretation No. 45 (“FIN 45”), “Guarantor’s Accounting and Disclosure Requirements for



**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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**NOTE 10. COMMITMENTS AND CONTINGENCIES (Continued)**

Guarantees, Including Indirect Guarantees of Indebtedness of Others,” the fair value of a residual value guarantee in lease agreements entered into after December 31, 2002, must be recognized as a liability on our consolidated balance sheet. As such, we have recognized a \$5.2 million liability related to the East and West towers lease that was extended in August 2004. This liability is recorded in other long-term liabilities with the offsetting entry recorded as prepaid rent in other assets. The balance will be amortized to the income statement over the life of the lease. As of March 4, 2005, the unamortized portion of the fair value of the residual value guarantee remaining in other long-term liabilities and prepaid rent was \$4.6 million.

In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

We have commitments to make certain milestone and/or retention payments typically entered into in conjunction with various acquisitions, for which we have made accruals in our consolidated financial statements. In connection with certain acquisitions and purchases of technology assets during fiscal 2003 and 2004, we entered into employee retention agreements and are required to make payments upon satisfaction of certain conditions in the agreements. These costs are being amortized over the retention period to compensation expense. As of March 4, 2005, we have \$1.2 million remaining to be paid under our retention agreements.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer’s or director’s lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

As part of our limited partnership interests in Adobe Ventures, we have provided a general indemnification to Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures, for certain events or occurrences while Granite Ventures is, or was serving, at our request in such capacity provided that Granite Ventures acts in good faith on behalf of the partnerships. We are unable to develop an estimate of the maximum potential amount of future payments that could potentially result from any hypothetical future claim, but believe the risk of having to make any payments under this general indemnification to be remote.

*Legal Proceedings*

On September 5, 2002, Agfa Monotype Corporation (“AMT”) and its subsidiary, International Typeface Corporation (“ITC”), filed suit against Adobe in the U.S. District Court, Eastern District of Illinois, asserting that Adobe’s distribution of the superseded 5.0 version of Adobe Acrobat violated the

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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**NOTE 10. COMMITMENTS AND CONTINGENCIES (Continued)**

Digital Millennium Copyright Act. In January 2005, the court granted Adobe's motion for summary judgment.

On November 13, 2002, ITC filed suit against Adobe in the United States District Court for the Eastern District of Illinois, asserting that Adobe breached its contract with ITC and that ITC, not Adobe, owns the copyrights in font software created by Adobe which generates ITC typefaces. In April 2005, the parties resolved this matter.

On September 6, 2002, Plaintiff Fred B. Dufresne filed suit against Adobe, Microsoft Corporation, Macromedia, Inc. and Trellix Corporation in the U.S. District Court, District of Massachusetts, alleging infringement of U.S. Patent No. 5,835,712, entitled "Client-Server System Using Embedded Hypertext Tags for Application and Database Development." The Plaintiff's complaint asserts that "Defendants have infringed, and continue to infringe, one or more claims of the '712 patent by making, using, selling and/or offering for sale, *inter alia*, products supporting Microsoft Active Server Pages technology." The plaintiff seeks unspecified compensatory damages, preliminary and permanent injunctive relief, trebling of damages for "willful infringement," and fees and costs. We believe the action has no merit and are vigorously defending against it. We cannot estimate any possible loss at this time.

In connection with our anti-piracy efforts, conducted both internally and through the Business Software Alliance ("BSA"), from time to time we undertake litigation against alleged copyright infringers. Such lawsuits may lead to counter-claims alleging improper use of litigation or violation of other local law and have recently increased in frequency, especially in Latin American countries. We believe we have valid defenses with respect to such counter-claims; however, it is possible that our consolidated financial position, cash flows or results of operations could be affected in any particular period by the resolution of one or more of these counter-claims.

From time to time, in addition to those identified above, Adobe is subject to legal proceedings, claims, investigations and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, Adobe makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against Adobe. It is possible, nevertheless, that our consolidated financial position, cash flows or results of operations could be affected by the resolution of one or more of such contingencies.

**NOTE 11. FINANCIAL INSTRUMENTS**

In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" we recognize derivative instruments and hedging activities as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting.

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

**NOTE 11. FINANCIAL INSTRUMENTS (Continued)**

*Economic Hedging—Hedges of Forecasted Transactions*

We use option and forward foreign exchange contracts to hedge certain operational (“cash flow”) exposures resulting from changes in foreign currency exchange rates. These foreign exchange contracts, carried at fair value, may have maturities between one and twelve months. Such cash flow exposures result from portions of our forecasted revenues denominated in currencies other than the U.S. dollar, primarily the Japanese yen and the euro. We enter into these foreign exchange contracts to hedge forecasted product licensing revenue in the normal course of business, and accordingly, they are not speculative in nature.

We record changes in the intrinsic value of these cash flow hedges in accumulated other comprehensive income (loss), until the forecasted transaction occurs. When the forecasted transaction occurs, we reclassify the related gain or loss on the cash flow hedge to revenue. In the event the underlying forecasted transaction does not occur, or it becomes probable that it will not occur, we reclassify the gain or loss on the related cash flow hedge from accumulated other comprehensive income (loss) to interest and other income (loss) on the consolidated statement of income at that time. For the quarter ended March 4, 2005, there were no such net gains or losses recognized in other income relating to hedges of forecasted transactions that did not occur.

The critical terms of the cash flow hedging instruments are the same as the underlying forecasted transactions. The changes in fair value of the derivatives are intended to offset changes in the expected cash flows from the forecasted transactions. We record any ineffective portion of the hedging instruments in other income (loss) on the consolidated statement of income. The time value of purchased derivative instruments, including premium costs on option contracts, is deemed to be ineffective and is recorded in other income (loss) over the life of the contract.

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

**NOTE 11. FINANCIAL INSTRUMENTS (Continued)**

**Gain (Loss) on Hedges of Forecasted Transactions:**

	<u>Other Accumulated Comprehensive Income</u>	
<u>Balance Sheet</u>	<u>March 4, 2005</u>	<u>December 3, 2004</u>
<b>Recognized but Unrealized—Open Transactions:</b>		
Net unrealized gain remaining in other accumulated comprehensive income . . . .	\$31	\$—

	<u>Three Months Ended</u>			
	<u>March 4, 2005</u>		<u>March 5, 2004</u>	
<u>Income Statement</u>	<u>Revenue</u>	<u>Other Income (Loss)</u>	<u>Revenue</u>	<u>Other Income (Loss)</u>
<b>Realized—Closed Transactions:</b>				
Net realized loss reclassified from other comprehensive income to revenue . . . . .	\$—	\$ —	\$(1,355)	\$ —
Net realized loss from the cost of purchased options and from any ineffective portion of hedges . . . . .	—	(2,363)	—	(1,703)
<b>Recognized but Unrealized—Open Transactions:</b>				
Net unrealized gain (loss) from time value degradation and any ineffective portion of hedges . . . . .	—	2,036	—	(307)
	<u>\$—</u>	<u>\$ (327)</u>	<u>\$(1,355)</u>	<u>\$(2,010)</u>

*Balance Sheet Hedging—Hedging of Foreign Currency Assets and Liabilities*

We hedge our net recognized foreign currency assets and liabilities with forward foreign exchange contracts to reduce the risk that our earnings and cash flows will be adversely affected by changes in foreign currency exchange rates. These derivative instruments hedge assets and liabilities that are denominated in foreign currencies and are carried at fair value with changes in the fair value recorded as other income (loss). These derivative instruments do not subject us to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being hedged. At March 4, 2005, the outstanding balance sheet hedging derivatives had maturities of 90 days or less.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except per share data)  
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**NOTE 11. FINANCIAL INSTRUMENTS (Continued)**

Net gains in other income relating to balance sheet hedging for the three months ended March 4, 2005 and March 5, 2004 were as follows:

	<u>2005</u>	<u>2004</u>
Gain (loss) on foreign currency assets and liabilities:		
Net realized gain (loss) recognized in other income . . . . .	\$ (831)	\$ 5,581
Net unrealized loss recognized in other income . . . . .	<u>(1,386)</u>	<u>(2,359)</u>
	<u>(2,217)</u>	<u>3,222</u>
Gain (loss) on hedges of foreign currency assets and liabilities:		
Net realized loss recognized in other income . . . . .	(448)	(11,695)
Net unrealized gain recognized in other income . . . . .	<u>3,313</u>	<u>8,699</u>
	<u>2,865</u>	<u>(2,996)</u>
Net gain recognized in other income . . . . .	<u>\$ 648</u>	<u>\$ 226</u>

**NOTE 12. INDUSTRY SEGMENTS**

We have four reportable segments: Digital Imaging and Video, Creative Professional, Intelligent Documents, and OEM PostScript and Other. The Digital Imaging and Video segment provides users with software for creating, editing, enhancing and sharing digital images and photographs, digital video, audio and animations. The Creative Professional segment provides software for professional page layout, professional Web page layout, graphic and illustration creation, technical document publishing and business publishing. Additionally, this segment provides Photoshop and Acrobat Professional as part of its Adobe Creative Suite products. The Intelligent Documents segment provides electronic document distribution software that allows users to create, enhance, annotate and securely send Adobe PDF files that can be shared, viewed, navigated and printed exactly as intended on a broad range of hardware and software platforms. In addition, this segment provides server-based solutions for enterprises, in the areas of document generation, document process management, document collaboration, and document control and security. The OEM PostScript and Other segment includes printing technology used to create and print simple or visually rich documents with precision.

**ADOBE SYSTEMS INCORPORATED**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
(In thousands, except per share data)  
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**NOTE 12. INDUSTRY SEGMENTS (Continued)**

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. With the exception of goodwill, we do not identify or allocate our assets by operating segments. See Note 2 for the allocation of goodwill to our reportable segments.

	Digital Imaging and Video	Creative Professional	Intelligent Documents	OEM PostScript and Other	Total
<b>Quarter ended March 4, 2005</b>					
Revenue . . . . .	\$106,625	\$160,692	\$184,883	\$20,682	\$472,882
Cost of revenue . . . . .	9,862	4,709	11,111	1,287	26,969
Gross profit . . . . .	<u>\$ 96,763</u>	<u>\$155,983</u>	<u>\$173,772</u>	<u>\$19,395</u>	<u>\$445,913</u>
Gross profit as a percentage of revenues .	91%	97%	94%	94%	94%
<b>Quarter ended March 5, 2004</b>					
Revenue . . . . .	\$113,517	\$158,110	\$130,291	\$21,363	\$423,281
Cost of revenue . . . . .	9,276	5,451	8,334	1,121	24,182
Gross profit . . . . .	<u>\$104,241</u>	<u>\$152,659</u>	<u>\$121,957</u>	<u>\$20,242</u>	<u>\$399,099</u>
Gross profit as a percentage of revenues .	92%	97%	94%	95%	94%

A reconciliation of the totals reported for the operating segments to the applicable line items in the condensed consolidated financial statements for the quarters ended March 4, 2005 and March 5, 2004 is as follows:

	2005	2004
Total gross profit from operating segments above . . . . .	\$445,913	\$399,099
Total operating expenses(*) . . . . .	<u>275,201</u>	<u>235,837</u>
Total operating income . . . . .	170,712	163,262
Non-operating income . . . . .	<u>6,073</u>	<u>3,001</u>
Income before income taxes . . . . .	<u>\$176,785</u>	<u>\$166,263</u>

(\*) Total operating expenses comprise research and development, sales and marketing and general and administrative.

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

*In addition to historical information, this Quarterly Report on Form 10-Q contains forward-looking statements, including statements regarding product plans and investing activities, 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 "Factors That May Affect Future Performance." You should carefully review the risks described herein and in other documents we file from time to time with the Securities and Exchange Commission, including the Annual Report on Form 10-K for fiscal 2004 and the other Quarterly Reports on Form 10-Q to be filed by us in fiscal 2005. When used in this report, the words "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "estimates," "looks for," "looks to," and similar expressions, as well as statements regarding Adobe's focus for the future, are generally intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.*

### **BUSINESS OVERVIEW**

Founded in 1982, Adobe Systems Incorporated offers a line of software and services for consumers, creative professionals and enterprises, in both public and private sectors. Our products are digital imaging, design, and document technology platforms which enable customers to create, manage and deliver visually rich, compelling and reliable content. We distribute our products through a network of distributors and dealers, value-added resellers ("VARs"), systems integrators, independent software vendors ("ISVs") and original equipment manufacturers ("OEMs"); direct to end users; and through our own Web site at [www.adobe.com](http://www.adobe.com). We also license our technology to major hardware manufacturers, software developers and service providers and we offer integrated software solutions to businesses of all sizes. We have operations in the Americas; Europe, Middle East and Africa ("EMEA"); and Asia. Our software runs on Microsoft Windows, Apple Macintosh, Linux, UNIX and various non-personal computer platforms, depending on the product.

We maintain executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Our telephone number is 408-536-6000. We maintain a Web site at [www.adobe.com](http://www.adobe.com). Investors can obtain copies of our SEC filings from this site free of charge, as well as from the SEC Web site at [www.sec.gov](http://www.sec.gov).

### **CRITICAL ACCOUNTING ESTIMATES**

In preparing our consolidated financial statements, we make assumptions, judgments and estimates that can have a significant impact on amounts reported in our consolidated financial statements. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis we evaluate our assumptions, judgments and estimates and make changes accordingly. We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition and income taxes have the greatest potential impact on our consolidated financial statements, so we consider these to be our critical accounting policies. We discuss below the critical accounting estimates associated with these policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results. For further information on our critical accounting policies, see the



discussion in the section titled “Recent Accounting Pronouncements” below and Note 1 of our Notes to Condensed Consolidated Financial Statements.

### **Revenue Recognition**

We recognize revenue in accordance with current generally accepted accounting principles that have been prescribed for the software industry. Revenue recognition requirements in the software industry are very complex and are subject to change. Our revenue recognition policy is one of our critical accounting policies because revenue is a key component of our results of operations and is based on complex rules which require us to make judgments and estimates. In applying our revenue recognition policy we must determine which portions of our revenue are recognized currently and which portions, if any, must be deferred. In order to determine current and deferred revenue, we make judgments and estimates with regard to future deliverable products and services and the appropriate pricing for those products and services. Our assumptions and judgments regarding future products and services could differ from actual events, thus materially impacting our financial position and results of operations.

We have to estimate provisions for returns which are recorded against our revenues. In determining our estimate for returns, and in accordance with our internal policy regarding global channel inventory which is used to determine the level of product held by our distributors on which we have recognized revenue, we rely upon historical data, the estimated amount of product inventory in our distribution channel, the rate at which our product sells through to the end user, product plans and other factors. Our estimated provisions for returns can vary from what actually occurs. More or less product may be returned from what was estimated. The amount of inventory in the channel could be different than what is estimated. Our estimate of the rate of sell through for product in the channel could be different than what actually occurs. There could be a delay in the release of our products. These factors and unanticipated changes in the economic and industry environment could make our return estimates differ from actual returns, thus materially impacting our financial position and results of operations.

### **Accounting for Income Taxes**

We use the asset and liability method of accounting for income taxes. Under this method, income tax expense is recognized for the amount of taxes payable or refundable for the current year and for deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity’s financial statements or tax returns. Management must make assumptions, judgments and estimates to determine our current provision for income taxes and also our deferred tax assets and liabilities and any valuation allowance to be recorded against a deferred tax asset. Our judgments, assumptions and estimates relative to the current provision for income tax take into account current tax laws, our interpretation of current tax laws and possible outcomes of current and future audits conducted by foreign and domestic tax authorities. Changes in tax law or our interpretation of tax laws and the resolution of current and future tax audits could significantly impact the amounts provided for income taxes in our consolidated financial statements. Our assumptions, judgments and estimates relative to the value of a deferred tax asset take into account predictions of the amount and category of future taxable income. Actual operating results and the underlying amount and category of income in future years could render our current assumptions, judgments and estimates of recoverable net deferred taxes inaccurate. Any of the assumptions, judgments and estimates mentioned above could cause our actual income tax obligations to differ from our estimates, thus materially impacting our financial position and results of operations.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

In December 2004, the FASB issued SFAS 123R which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. The accounting provisions of SFAS 123R are effective for reporting periods beginning after June 15, 2005. We are required



to adopt SFAS 123R in the fourth quarter of fiscal 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See Note 1 in our Notes to Condensed Consolidated Financial Statements for the pro forma net income and net income per share amounts as if we had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a significant adverse impact on our consolidated statements of income and net income per share.

In December 2004, the FASB issued FASB Staff Position No. FAS 109-2 (“FAS 109-2”), “Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004.” See “Provision for Income Taxes” under “Results of Operations” and Note 6 in our Notes to Condensed Consolidated Financial Statements for further information regarding FAS 109-2.

See Note 1 in our Notes to Condensed Consolidated Financial Statements for information regarding other recent accounting pronouncements.

## **RESULTS OF OPERATIONS**

### **Overview of the Quarter Ended March 4, 2005**

During the first quarter of fiscal 2005, we continued to focus on delivering comprehensive technology platforms to our customers to drive revenue and earnings growth. In our Creative Professional business, our strategy of providing a complete design platform continued to resonate with our customers, resulting in record quarterly revenue for our Adobe Creative Suite products. Momentum with our individual CS products, specifically Photoshop CS, InDesign CS, and Illustrator CS, also continued in the quarter. In our Intelligent Documents business, we shipped our new Acrobat 7.0 family of products in the first quarter, which helped drive record Acrobat and Intelligent Document business segment revenue. Acrobat 7.0 has numerous new features to help drive increased adoption by users in enterprises, governments, and specialized vertical markets such as architecture, engineering and construction. We also achieved year-over-year growth in our Intelligent Document server-based business.

We continue to focus on delivering innovative products and solutions for our customers. Our success could be limited by several factors, including the timely release of new products, continued market acceptance of our products, the introduction of new products by existing or new competitors and unfavorable exchange rate fluctuations. For a further discussion of these and other risk factors, see the section titled “Factors That May Affect Future Performance.”

The first quarter of fiscal 2005 was 13 weeks in length as compared to 14 weeks in the first quarter of fiscal 2004 due to our 52/53 week fiscal year. The difference in the number of weeks each quarter should be a consideration when performing any comparative analysis between the quarters.

## Revenue

	First Quarter		Percent Change
	2005	2004	
Product . . . . .	\$463.2	\$415.8	11%
Percentage of total revenues . . . . .	98%	98%	
Services and support . . . . .	9.7	7.5	29%
Percentage of total revenues . . . . .	2%	2%	
Total revenues . . . . .	<u>\$472.9</u>	<u>\$423.3</u>	12%

We have four reportable segments: Digital Imaging and Video, Creative Professional, Intelligent Documents, and OEM PostScript and Other. The Digital Imaging and Video segment provides users with software for creating, editing, enhancing and sharing digital images and photographs, digital video, audio and animations. The Creative Professional segment provides software for professional page layout, professional Web page layout, graphic and illustration creation, technical document publishing and business publishing. Additionally, this segment provides Photoshop and Acrobat Professional as part of its Adobe Creative Suite products. The Intelligent Documents segment provides electronic document distribution software that allows users to create, enhance, annotate and securely send Adobe PDF files that can be shared, viewed, navigated and printed exactly as intended on a broad range of hardware and software platforms. In addition, this segment provides server-based solutions for enterprises, in the areas of document generation, document process management, document collaboration, and document control and security. The OEM PostScript and Other segment includes printing technology used to create and print simple or visually rich documents with precision.

Our services and support revenue is composed of professional services (such as consulting services and training) and maintenance and support, primarily related to the licensing of our Intelligent Documents server solution products. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products. Our professional services revenue is recognized using the percentage of completion method and is measured monthly based on input measures, such as on hours incurred to date compared to total estimated hours to complete, with consideration given to output measures, such as contract milestones, when applicable. Our maintenance and support offerings, which entitle customers to receive product upgrades and enhancements or technical support, depending on the offering, is recognized ratably over the term of the arrangement.

## Segment Information

	First Quarter		Percent Change
	2005	2004	
Digital Imaging and Video . . . . .	\$106.6	\$113.5	(6)%
Percentage of total revenues . . . . .	23%	27%	
Creative Professional . . . . .	160.7	158.1	2%
Percentage of total revenues . . . . .	34%	37%	
Intelligent Documents . . . . .	184.9	130.3	42%
Percentage of total revenues . . . . .	39%	31%	
OEM PostScript and Other . . . . .	20.7	21.4	(3)%
Percentage of total revenues . . . . .	4%	5%	
Total revenues . . . . .	<u>\$472.9</u>	<u>\$423.3</u>	12%

Revenue from our Digital Imaging and Video segment decreased during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 primarily due to product lifecycle timing.

Overall revenue from our Creative Professional segment increased during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 primarily due to a 9% increase in revenues from our Adobe Creative Suite products. Revenue from our Adobe Creative Suite products increased due in part to the inclusion of the newly released Acrobat Professional product in our premium version of the Adobe Creative Suite. The increase in revenues from our Adobe Creative Suite products were partially offset by decreases in revenues in our illustration and business and technical page layout products due to product lifecycle timing.

Revenue from our Intelligent Documents segment increased during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 primarily due to a 47% increase in revenues from the new release of version 7.0 of our Acrobat desktop family of products in the first quarter of fiscal 2005. Additionally revenue from our Intelligent Documents server-based products increased 14% due to increased licensing and services and support revenue.

Revenue from our OEM PostScript and Other segment decreased during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 primarily due to a decline in pricing resulting from competition from clone PostScript technologies. Revenue from this segment has declined over the last few years and we expect this trend to continue, but if the decline significantly exceeds our expectations, it may harm our future results.

#### *Geographical Information*

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>	
Americas . . . . .	\$218.0	\$183.5	19%
Percentage of total revenues . . . . .	46%	43%	
EMEA . . . . .	150.5	144.1	4%
Percentage of total revenues . . . . .	32%	34%	
Asia . . . . .	104.4	95.7	9%
Percentage of total revenues . . . . .	22%	23%	
Total revenues . . . . .	<u>\$472.9</u>	<u>\$423.3</u>	12%

Revenues in each of the geographical segments increased during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 primarily due to the strength of our Intelligent Documents.

Additionally, revenues in EMEA and Asia increased approximately \$8.3 million and \$3.0 million during the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 due to the strength of the euro and the yen, respectively.

#### *Platform Information*

	<b>First Quarter</b>	
	<b>2005</b>	<b>2004</b>
Windows . . . . .	76%	71%
Macintosh . . . . .	24%	29%

We expect a growth trend towards the Windows platform over the long term due to our targeting of business users with our Intelligent Documents desktop products, where the majority of users run the Windows operating system.

### *Inventory Information*

At the end of the first quarter of fiscal 2005 our channel inventory position was within our global inventory policy which allows up to an estimated 4.5 weeks of anticipated product supply at our distributors.

With regard to our product backlog, our experience is that the actual amount of backlog at any particular time may not be a meaningful indicator of future business prospects. For example, prior to the finalization and release of new products, we may have significant levels of orders for new product releases. Our backlog of unfulfilled orders at the end of the first quarter of fiscal 2005, other than those associated with new product releases, those pending credit review and those due to the application of our global channel inventory policy, was approximately 4% of reported first quarter fiscal 2005 revenue. The comparable backlog at the end of fiscal 2004 was also approximately 4% of fourth quarter fiscal 2004 revenue.

### **Cost of Revenue**

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>	
Product . . . . .	\$21.9	\$20.4	7%
Percentage of total revenues . . . . .	5%	5%	
Services and support . . . . .	5.1	3.7	37%
Percentage of total revenues . . . . .	1%	1%	
Total cost of revenue . . . . .	<u>\$27.0</u>	<u>\$24.1</u>	12%

Cost of product revenue includes product packaging, third-party royalties, excess and obsolete inventory, amortization related to localization costs and acquired technologies and the costs associated with the manufacturing of our products.

Cost of product revenue increased in the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 due to an increase in excess and obsolete inventory expenses.

Cost of services and support revenue is composed primarily of employee-related costs and related costs incurred to provide consulting services, training and product support.

Cost of services and support revenue increased in the first quarter of fiscal 2005 as compared to the same period in the prior fiscal year due to costs associated with our Expert Support program that was implemented during the second quarter of fiscal 2004. Additionally, cost of services and support revenue increased due to compensation and related benefits and travel expenses as a result of higher headcount related to increases in services and support activities.

### **Operating Expenses**

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>	
Research and development . . . . .	\$86.7	\$75.1	16%
Percentage of total revenues . . . . .	18%	18%	

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

Research and development expenses increased 6% during the first quarter of fiscal 2005 as compared to the same period in fiscal 2004 due to compensation and related benefits associated with headcount

growth and higher incentive compensation. The remaining 10% increase in research and development expenses was due to various individually insignificant items.

We believe 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. We will continue to focus on long-term opportunities available in our end markets and make significant investments in the development of our desktop application and server-based software products.

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>	
Sales and marketing . . . . .	\$147.4	\$127.4	16%
Percentage of total revenues . . . . .	31%	30%	

Sales and marketing expenses include salary and benefit expenses, sales commissions, travel expenses and related facilities costs for our sales, marketing, customer support, order management and global supply chain management personnel. Sales and marketing expenses also include the costs of programs aimed at increasing revenue, such as advertising, trade shows, public relations and other market development programs.

Sales and marketing expenses increased 6% due to compensation and related benefits associated with headcount growth and higher incentive compensation. Sales and marketing expenses also increased 6% due to increased marketing spending related to overall marketing efforts to further increase revenues including the launch of Acrobat 7.0. The remaining 4% increase in sales and marketing expenses was due to various individually insignificant items.

	<b>First Quarter</b>		<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>	
General and administrative . . . . .	\$41.1	\$33.4	23%
Percentage of total revenues . . . . .	9%	8%	

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

General and administrative expenses increased 3% due to compensation and related benefits associated with headcount growth and higher incentive compensation and increased 6% due to higher professional fees. General and administrative expenses also increased 7% in the first quarter of fiscal 2005 as the comparative period in fiscal 2004 included a reduction in bad debt expense as a result of a settlement of an account. The remaining 7% increase in general and administrative expenses was due to various individually insignificant items.

## Non-operating Income

	First Quarter		Percent Change
	2005	2004	
Investment loss . . . . .	\$(1.5)	\$(1.0)	51%
Percentage of total revenues . . . . .	—%	—%	
Interest and other income . . . . .	7.6	4.0	89%
Percentage of total revenues . . . . .	2%	1%	
Total non-operating income . . . . .	<u>\$ 6.1</u>	<u>\$ 3.0</u>	102%

### *Investment Loss*

Investment loss consists principally of realized gains or losses from the sale of marketable equity investments, other-than-temporary declines in the value of marketable and non-marketable equity securities and gains and losses of Adobe Ventures.

The following table summarizes the net investment losses for the first quarters of fiscal 2005 and 2004:

	2005	2004
Net losses related to our investments in Adobe Ventures and cost method investments . . . . .	\$(1,908)	\$(1,253)
Gains on stock warrants . . . . .	354	222
Total investment loss . . . . .	<u>\$(1,554)</u>	<u>\$(1,031)</u>

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

### *Interest and Other Income*

The largest component of interest and other income is interest earned on cash, cash equivalents and short-term fixed income investments, but also includes gains and losses on the sale of fixed income investments, foreign exchange transaction gains and losses, and interest expense.

Interest and other income increased during the first quarter of fiscal 2005 as compared to fiscal 2004 due to higher interest income and lower foreign currency hedging expense.

## Provision for Income Taxes

	First Quarter		Percent Change
	2005	2004	
Provision for income taxes . . . . .	\$24.9	\$43.2	(42)%
Percentage of total revenues . . . . .	5%	10%	
Effective tax rate . . . . .	14%	26%	

Our effective tax rate decreased in the first quarter of fiscal 2005 as compared to the same period last year due to the planned repatriation of certain foreign earnings under the American Jobs Creation Act of 2004. The net tax benefit, which includes a reversal for taxes on foreign earnings for which a deferred tax liability had been previously accrued, was approximately 11%.

Absent the repatriation effect, Adobe's effective tax rate for the first quarter of fiscal 2005 would have been 25%. The decrease in the effective tax rate as compared to the same period last year is due to higher international profits which are taxed at a lower overall tax rate.

## FACTORS THAT MAY AFFECT FUTURE PERFORMANCE

As previously discussed, our actual results could differ materially from our forward looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed below. These and many other factors described in this report could adversely affect our operations, performance and financial condition.

*Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our operating results.*

If the economy worsens in any geographic areas where we do business, it would likely cause our future results to vary materially from our targets. A slower economy also may adversely affect our ability to grow. Political instability in any of the major countries in which we do business also may adversely affect our business.

*Delays in development or shipment of new products or major new versions of existing products could cause a decline in our revenue.*

Any delays or failures in developing and marketing our products, including upgrades of current products, may have a harmful impact on our results of operations. Our inability to extend our core technologies into new applications and new platforms and to anticipate or respond to technological changes could affect continued market acceptance of our products and our ability to develop new products. A portion of our future revenue will come from new applications. Delays in product or upgrade introductions could cause a decline in our revenue, earnings or stock price. We cannot determine the ultimate effect these delays or the introduction of new products or upgrades will have on our revenue or results of operations.

*Introduction of new products by existing and new competitors, particularly Microsoft, could harm our competitive position and results of operations.*

The end markets for our software products are intensely and increasingly competitive, and are significantly affected by product introductions and market activities of industry competitors. Microsoft has an electronic form tool called InfoPath included as part of its latest professional Office product that competes with certain aspects of our Intelligent Documents product line. Given Microsoft's market dominance, InfoPath, or any new competitive Microsoft product or technology that is bundled as part of its Office product or operating system, could harm our overall Intelligent Documents market opportunity. In addition, Microsoft is developing the next generation of its Windows operating system, codenamed Longhorn. It is anticipated that Microsoft will add new electronic document capabilities to Longhorn, providing additional competition to our Intelligent Documents products and solutions. Also, some enterprise vendors provide intelligent document capabilities that could directly or indirectly compete with our Intelligent Documents products. Additionally, content creation/management tools that use other formats for electronic document distribution provide alternate solutions to customers, and indirectly compete with Adobe's Intelligent Documents products and the use of Adobe PDF. We also are seeing an increase in competition from clone PDF products marketed by other companies. Other competitors, including Microsoft, Apple, Avid and Google, may increase their presence in the digital imaging and digital video markets. We also face competition from certain Open Source products. Additionally, many digital camera manufacturers are bundling their own or our competitors' digital imaging and video software products with their digital camera products. If these competing products achieve widespread acceptance, our operating results could suffer. In addition, consolidation has occurred among some of the competitors in our markets. Any further consolidations among our competitors may result in stronger competitors and may therefore harm our results of operations.



*If we fail to successfully manage transitions to new business models or markets our results of operations could be negatively impacted.*

We are devoting significant resources to the development of technologies and service offerings to address demands in the marketplace for document generation, document process management, document collaboration, and document control and security. As a result, we are transitioning to new business models and seeking to broaden our customer base in the enterprise and government markets, requiring a considerable investment of technical, financial and sales resources, and a scaleable organization. Many of our competitors may have advantages over us due to their larger presence, larger developer network, deeper experience in the enterprise and government markets, and greater sales and marketing resources. It is our intent to form strategic alliances with leading enterprise and government solutions and service providers to provide additional resources to further enable penetration of the enterprise and government markets. If we are unable to successfully enter into strategic alliances, or if they are not as productive as we anticipate, our market penetration may not proceed as rapidly as we anticipate and our results of operations could be negatively impacted.

Our limited operating history with Adobe Creative Suite products makes it difficult to predict the revenue effect of the Adobe Creative Suite product cycle and the individual products integrated within these products.

*If we fail to anticipate and develop new products in response to changes in demand for application software, computers and printers our business could be harmed.*

We offer our application-based products primarily on Windows and Macintosh platforms and on some UNIX platforms. We generally offer our server-based products, but not desktop application products, on the Linux platform as well as the Windows and UNIX platforms. To the extent that there is a slowdown of customer purchases of personal computers on either the Windows or Macintosh platform or in general, or to the extent that significant demand arises for our products or competitive products on the Linux desktop platform before we choose and are able to offer our products on this platform, our business could be harmed.

*We may incur substantial costs enforcing our intellectual property rights and defending against third-party claims as a result of litigation or other proceedings.*

In connection with the enforcement of our own intellectual property rights or in connection with disputes relating to the validity or alleged infringement of third-party rights, including but not limited to patent rights, we have been, are currently and may in the future be subject to claims, negotiations or complex, protracted litigation. Intellectual property disputes and litigation are typically very costly and can be disruptive to our business operations by diverting the attention and energies of management and key technical personnel. Although we have successfully defended or resolved past litigation and disputes, we may not prevail in any ongoing or future litigation and disputes. Adverse decisions in such litigation or disputes could have negative results, including subjecting us to significant liabilities, requiring us to seek licenses from others, preventing us from manufacturing or licensing certain of our products, or causing severe disruptions to our operations or the markets in which we compete, any one of which could seriously harm our business.

Additionally, although we actively pursue software pirates as part of our enforcement of our intellectual property rights, we do lose revenue due to illegal use of our software. If piracy activities increase, it may further harm our business.



*We rely on distributors to sell our products and any adverse change in our relationship with our distributors could result in a loss of revenue and harm our business.*

We distribute our application products primarily through distributors, resellers, retailers and increasingly systems integrators, ISVs and VARs (collectively referred to as “distributors”). A significant amount of our revenue for application products is from two distributors, Ingram Micro, Inc. and Tech Data Corporation. In addition, our channel program focuses our efforts on larger distributors, which has resulted in our dependence on a relatively small number of distributors licensing a large amount of our products. Our distributors also sell our competitors’ products, and if they favor our competitors’ products for any reason, they may fail to market our products as effectively or to devote resources necessary to provide effective sales, which would cause our results to suffer. In addition, the financial health of these distributors and our continuing relationships with them are important to our success. Some of these distributors may be unable to withstand adverse changes in business conditions. Our business could be seriously harmed if the financial condition of some of these distributors substantially weakens.

*If our internal computer network and applications suffer disruptions or fail to operate as designed our operations will be disrupted and our business may be harmed.*

We rely on our network infrastructure and enterprise applications, internal technology systems and our website for our development, marketing, operational, support and sales activities. The hardware and software systems related to such activities are subject to damage from earthquakes, floods, fires, power loss, telecommunication failures and other similar events. They are also subject to acts such as computer viruses, physical or electronic vandalism or other similar disruptions also could cause system interruptions, delays in our product development and loss of critical data and could prevent us from fulfilling our customers’ orders. We have developed disaster recovery plans and backup systems to reduce the potentially adverse effect of such events, as they could impact our sales and damage our reputation and the reputation of our products. Any event that causes failures or interruption in our hardware or software systems could result in disruption in our business operations, loss of revenues or damage to our reputation.

*We rely on turnkey assemblers and any adverse change in our relationship with our turnkey assemblers could result in a loss of revenue and harm our business.*

We currently rely on six turnkey assemblers of our products, with at least two turnkeys located in each major region we serve. If any significant turnkey assembler terminates its relationship with us, or if our supply from any significant turnkey assembler is interrupted or terminated for any other reason, we may not have enough time or be able to replace the supply of products replicated by that turnkey assembler to avoid serious harm to our business.

*Our future operating results are difficult to predict and are likely to fluctuate substantially from quarter to quarter and as a result the market price of our common stock may be volatile and our stock price could decline.*

As a result of a variety of factors discussed herein, our quarterly revenues and operating results for a particular period are difficult to predict. Our revenues may grow at a slower rate than experienced in previous periods and, in particular periods, may decline. Additionally, we periodically provide operating model targets for revenue, gross margin, operating expenses, operating margin, other income, tax rate, share count and earnings per share. These targets reflect a number of assumptions, including assumptions about product pricing and demand, economic and seasonal trends, manufacturing costs and volumes, the mix of shrink-wrap and licensing revenue, full and upgrade products, distribution channels and geographic markets. If one or more of these assumptions prove incorrect, our actual results may vary materially from those anticipated, estimated or projected.

Due to the factors noted above, our future earnings and stock price may be subject to volatility, particularly on a quarterly basis. Any shortfall in revenue or earnings or any delay in the release of any product or upgrade compared to analysts' or investors' expectations has caused and could cause in the future an immediate and significant decline in the trading price of our common stock. Additionally, we may not learn of such shortfalls or delays until late in the fiscal quarter, which could result in an even more immediate and greater decline in the trading price of our common stock. Finally, we participate in a highly dynamic industry. In addition to factors specific to us, changes in analysts' earnings estimates for us or our industry, and factors affecting the corporate environment, our industry, or the securities markets in general, will often result in volatility of our common stock price.

*We are subject to risks associated with international operations which may harm our business.*

We generate over 50% of our total revenue from sales to customers outside of the Americas. Sales to these customers subject us to a number of risks, including (i) foreign currency fluctuations, (ii) changes in government preferences for software procurement, (iii) international economic and political conditions, (iv) unexpected changes in, or impositions of, international legislative or regulatory requirements, (v) inadequate local infrastructure, (vi) delays resulting from difficulty in obtaining export licenses for certain technology, tariffs, quotas and other trade barriers and restrictions, (vii) transportation delays, (viii) the burdens of complying with a variety of foreign laws, and other factors beyond our control, including terrorism, war, natural disasters and diseases. If sales to any of our customers outside of the Americas are delayed or cancelled because of any of the above factors, our revenue may be negatively impacted.

*We may incur losses associated with currency fluctuations and may not be able to effectively hedge our exposure.*

Our operating results are subject to fluctuations in foreign currency exchange rates. We attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. We have established a hedging program to partially hedge our exposure to foreign currency exchange rate fluctuations, primarily the Japanese yen and the euro. We regularly review our hedging program and will make adjustments based on our judgment. Our hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates.

*Changes in, or interpretations of, accounting principles, such as expensing of stock options, could result in unfavorable accounting charges.*

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the Securities and Exchange Commission (the "SEC") and various bodies formed to interpret and create appropriate accounting principles. A change in these principles can have a significant effect on our reported results and may even retroactively affect previously reported transactions. Our accounting principles that recently have been or may be affected by changes in the accounting principles are as follows:

- software revenue recognition
- accounting for share-based payments
- accounting for income taxes
- accounting for business combinations and related goodwill

In particular, the FASB recently issued SFAS 123R which we believe will have a significant adverse effect on our reported financial results and may impact the way in which we conduct our business.

*Changes in, or interpretations of, tax rules and regulations may adversely affect our effective tax rates.*

Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in tax laws or the interpretation of tax laws, by unanticipated decreases in the amount of revenue or earnings in countries with low statutory tax rates, or by changes in the valuation of our deferred tax assets and liabilities.

In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other domestic and foreign tax authorities. We regularly assess the likelihood of outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. Any adverse outcome from these continuous examinations may have an adverse effect on our operating results and financial position.

*If we are unable to recruit and retain skilled personnel our business may be harmed.*

Much of our future success depends on the continued service and availability of skilled personnel. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense, especially in the Silicon Valley, where the majority of our employees are located. We have relied on our ability to grant equity compensation as one mechanism for recruiting and retaining such highly skilled personnel. Recently enacted accounting regulations requiring the expensing of equity compensation may impair our ability to provide these incentives without incurring significant compensation costs. If we are unable to continue to successfully attract and retain key personnel, our business may be harmed.

*We may suffer losses from our equity investments which could harm our business.*

We hold equity investments in public companies that have experienced significant declines in market value. We also have investments and may continue to make future investments in privately held companies, many of which are considered in the start-up or development stages. These investments are inherently risky, as the market for the technologies or products these companies have under development is typically in the early stages and may never materialize. Our investment activities can impact our net income. Future price fluctuations in these securities and any significant long-term declines in value of any of our investments could reduce our net income in future periods. We are uncertain about future investment gains and losses, as they are primarily dependent upon the operations of the underlying investee companies.

## **EMPLOYEE AND DIRECTOR STOCK OPTIONS**

### **Option Program Description**

Our stock option program is a long-term retention program that is intended to attract, retain and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. We consider our option programs critical to our operation and productivity; essentially all of our employees participate. Currently, we grant options from the 1) 2003 Equity Incentive Plan (“2003 Plan”), under which options could be granted to all employees, including executive officers, and outside consultants and 2) the 1996 Outside Directors Stock Option Plan, as amended, under which options are granted automatically under a pre-determined formula to non-employee directors. In addition, our stock option program includes the Adobe 1984 Stock Option Plan, as amended, and the Aldus 1984 Restated Stock Option Plan from which we currently do not grant options. The plans listed above are collectively referred to in the following discussion as “the Plans.” Option vesting periods are generally three years for all of the Plans.

All stock option grants to current executive officers are made after a review by and with the approval of the Executive Compensation Committee of the Board of Directors. All members of the Executive

Compensation Committee are independent directors, as defined in the current and proposed rules applicable to issuers traded on the Nasdaq Stock Market. See the “Report of the Executive Compensation Committee” appearing in the Company’s 2005 Proxy Statement for further information concerning the policies and procedures, of the Company and the Executive Compensation Committee, regarding the use of stock options.

On March 16, 2005 our Board of Directors approved a two-for-one stock split, in the form of a stock dividend, of our common stock payable on May 23, 2005 for stockholders of record as of May 2, 2005. The share and per share data below have not been adjusted to give effect to this stock split.

### Distribution and Dilutive Effect of Options

The table below provides information about stock options granted to our Chief Executive Officer and our four other most highly compensated executive officers, as identified in our 2005 Proxy Statement. This group is referred to as the Named Executive Officers. Please refer to the section headed “Stock Option Exercises and Option Holdings” below for the Named Executive Officers.

Options granted to employees, directors and Named Executive Officers for the first quarter of fiscal 2005 and for fiscal year 2004 are summarized as follows:

	2005	2004
Net grants <sup>(†)</sup> during the period as % of outstanding shares . . . . .	*%	4%
Net grants to Named Executive Officers during the period as % of total options granted . .	28%	9%
Net grants to Named Executive Officers during the period as % of outstanding shares . . . .	*%	*%
Cumulative options held by Named Executive Officers as % of total options outstanding . .	14%	16%

<sup>(†)</sup> “Net grants” equals the sum of the number of shares subject to options granted to all employees, directors and Named Executive Officers during the specified period reduced by the number of shares subject to options which were canceled or otherwise terminated during such period. Net grants during fiscal 2004 reflect the new options granted in exchange for options cancelled under our stock option exchange program in fiscal 2003. Net grants as a percentage of outstanding shares are based on 243.4 million shares and 242.2 million shares of our common stock outstanding as of March 4, 2005 and December 3, 2004, respectively.

<sup>(\*)</sup> Less than 1%.

### General Option Information

The following table sets forth the summary of option activity under our stock option program:

	Three Months Ended March 4, 2005			Year Ended December 3, 2004		
	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price	Options Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price
Beginning of period . . . . .	8,353,584	38,266,316	\$37.04	12,953,370	42,469,653	\$32.80
Granted . . . . .	(717,890)	717,890	60.23	(10,379,755)	10,379,755	42.13
Exercised . . . . .	—	(3,558,140)	30.60	—	(13,293,864)	27.10
Canceled . . . . .	365,946	(365,946)	38.04	1,289,228	(1,289,228)	40.91
Expired . . . . .	(112,500)	—	—	(9,259)	—	—
Increased authorization . . . . .	—	—	—	4,500,000	—	—
End of period . . . . .	<u>7,889,140</u>	<u>35,060,120</u>	<u>\$38.16</u>	<u>8,353,584</u>	<u>38,266,316</u>	<u>\$37.04</u>

The following table sets forth a comparison as of March 4, 2005, of the number of shares subject to outstanding options with exercise prices at or below the closing price of our common stock on March 4,

2005 (“In-the-Money” options) to the number of shares subject to outstanding options with exercise prices greater than the closing price of our common stock on such date (“Out-of-the-Money” options):

	<u>Exercisable</u>	<u>Unexercisable</u>	<u>Total</u>	<u>Percentage of Total Options Outstanding</u>
In-the-Money* . . . . .	18,234,054	13,774,927	32,008,981	91%
Out-of-the-Money . . . . .	3,051,139	—	3,051,139	9%
Total Options Outstanding . . . . .	<u>21,285,193</u>	<u>13,774,927</u>	<u>35,060,120</u>	<u>100%</u>

\* The closing price of our common stock was \$63.77 on March 4, 2005, as reported by the Nasdaq National Market.

### Named Executive Officer Option Grants

During the first quarter of fiscal 2005, we granted stock options to one of the Named Executive Officers. The following table sets forth information regarding stock options granted during the three months ended March 4, 2005. All options were granted with an exercise price equal to the closing price of our common stock on the date of grant. Potential realizable values are net of exercise price, but before taxes associated with exercise. These amounts represent hypothetical gains that could be achieved for the options if exercised at the end of the option term of seven years. The assumed 5% and 10% rates of stock price appreciation are provided for purposes of illustration only and do not represent our estimate or projection of the future price of our common stock.

(In actual dollars) Name	Number of Securities Underlying Options Granted	% of Total Options Granted to Employees(†) Year-to-Date	Exercise Price	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term	
					5%	10%
Shantanu Narayen . . . . .	200,000	28%	\$58.23	1/14/2012	\$4,741,092	\$11,048,759

(†) Based on approximately 0.7 million shares subject to options granted to employees under our option plans during fiscal 2005.

### Stock Option Exercises and Option Holdings

The following table shows stock options exercised by the Named Executive Officers in the first quarter of fiscal 2005, including the total value of gains on the date of exercise based on actual sale prices or on the closing price that day if the shares were not sold that day, in each case less the exercise price of the stock options. In addition, the number of shares covered by both exercisable and non-exercisable stock options, as of March 4, 2005, is shown. Also reported are the values for “In-the-Money” options. The dollar

amounts shown in the “In-the-Money” column represent the positive spread between the exercise price of any such existing stock options and closing price as of March 4, 2005 of our common stock.

(In actual dollars) Name	Number of Shares Acquired Upon Exercise	Value Realized Upon Exercise <sup>(1)</sup>	Number of Securities Underlying Unexercised Options at March 4, 2005		Value of Unexercised In-the-Money Options at March 4, 2005 <sup>(2)</sup>	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Bruce R. Chizen . .	300,000	\$10,556,398	1,590,739	768,752	\$18,597,585	\$20,988,450
Shantanu Narayen .	200,000	6,394,250	659,049	537,501	6,386,961	11,134,787
Murray J. Demo . .	104,544	2,809,328	616,667	312,502	3,176,919	9,521,325
Jim Stephens . . . .	215,300	1,682,462	150,000	212,502	932,500	6,218,325
James Heeger <sup>(3)</sup> . . .	150,000	3,998,615	187,500	—	5,183,250	—

(1) The “value realized” represents the total value of gains on the date of exercise based on actual sale prices or on the closing price that day if the shares were not sold that day, in each case less the exercise price of the stock options. See related Section 16 filings for detailed information on dispositions of shares.

(2) The closing price of our common stock was \$63.77 on March 4, 2005, as reported by the Nasdaq National Market.

(3) James Heeger resigned from Adobe during the first quarter of fiscal 2005.

#### Equity Compensation Plan Information

The following table gives information about our common stock that may be issued upon the exercise of options under our existing equity compensation plans as of March 4, 2005:

Plan Category	Equity Compensation Plan Information		
	Number of Securities to be Issued Upon Exercise of Outstanding Options (a)	Weighted Average Exercise Price of Outstanding Options (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders . . . . .	35,060,120	\$38.16	22,599,065*

\* Includes 2.7 million shares and 12.0 million shares which are reserved for issuance under the 1994 Performance and Restricted Stock Plan and the 1997 Employee Stock Purchase Plan as of March 4, 2005, respectively.

#### LIQUIDITY AND CAPITAL RESOURCES

	March 4, 2005	December 3, 2004	Percent Change
Cash, cash equivalents and short-term investments . . . . .	\$1,467.1	\$1,313.3	12%
Working capital . . . . .	\$1,215.8	\$1,099.6	11%
Stockholders' equity . . . . .	\$1,624.6	\$1,423.5	14%



Our primary source of cash is receipts from revenue. The primary uses of cash are payroll (salaries, bonuses, and benefits), general operating expenses (marketing, travel, office rent) and cost of product revenue. Another source of cash is proceeds from the exercise of employee options and another use of cash is our stock repurchase program, which is detailed below.

In 2005, we reclassified all auction rate securities and variable rate demand obligations to short-term investments pursuant to the recent interpretation of SFAS 95 relating to the definition of cash equivalents. This interpretation and subsequent reclassification has resulted in a presentation of our consolidated balance sheet that may not reflect the true liquidity of our bond portfolios. As of March 4, 2005, \$119.2 million of the bonds now classified as short-term investments have structural features that will allow us the opportunity to put back the bonds at par within 90 days and thus retain the same liquidity characteristics as cash equivalents.

Net cash provided by operating activities in the first quarter of fiscal 2005 of \$164.1 million, primarily comprised net income, net of non-cash related expenses. The primary working capital source of cash was an increase in income taxes payable due to an increase in tax liabilities related to the planned repatriation of certain foreign earnings. Working capital uses of cash included an increase in other assets and a decrease in accrued expenses. Other assets increased primarily due to an increase in prepaid expenses and accrued expenses decreased primarily due to compensation costs.

Net cash used for investing activities in the first quarter of fiscal 2005 of \$227.5 million increased from \$151.3 million net cash used in the first quarter of fiscal 2004, primarily due to higher net purchases of short-term investments in fiscal 2005. Additionally, during the first quarter of fiscal 2005 we paid cash for the acquisition of OKYZ. We expect to continue to invest in short-term investments and purchase additional property and equipment to support our growth.

Net cash provided for financing activities in the first quarter of fiscal 2005 of \$22.9 million increased from the \$18.2 million cash used in the first quarter of fiscal 2004 due to a higher number of options being exercised as well as a higher option exercise price. Cash provided during the first quarter of fiscal 2005 was partially offset by repurchases of stock. Cash used for stock repurchases during fiscal 2005 increased from the prior year due to a higher average cost per share, a higher number of shares being repurchased, and remaining prepayments related to stock repurchase agreements.

We have paid cash dividends on our common stock each quarter since the second quarter of 1988. Adobe's Board of Directors declared a cash dividend on our common stock of \$0.0125 per common share for the first quarter of fiscal 2005. Under the terms of our lease agreements for our San Jose headquarters, we are not prohibited from paying cash dividends unless an event of default occurs. On March 16, 2005 our Board of Directors approved a two-for-one stock split, in the form of a stock dividend, of our common stock payable on May 23, 2005 for stockholders of record as of May 2, 2005. We will discontinue our quarterly dividend after the payment of the dividend for the first quarter of fiscal 2005. We intend to use the cash used to pay the quarterly dividend for our ongoing stock repurchase programs.

We expect to continue our investing activities, including investments in short-term and long-term investments and purchases of computer systems for research and development, sales and marketing, product support, and administrative staff. Furthermore, cash reserves may be used to repurchase stock under our stock repurchase programs and strategically acquire companies, products or technologies that are complementary to our business.

Adobe uses professional investment management firms to manage most of our invested cash. External investment firms actively managed 89% of Adobe's invested balances during the first quarter of 2005. The fixed income portfolio is primarily invested in municipal bonds within the U.S. and in highly rated corporate and sovereign obligations outside of the U.S. The balance of the fixed income portfolio is managed internally and invested primarily in money market funds for working capital purposes. All investments are made according to guidelines and within compliance of policies approved by the Board of Directors.

Our existing cash, cash equivalents, and investment balances may decline during fiscal 2005 in the event of weakening of the economy or changes in our planned cash outlay. However, based on our current business plan and revenue prospects, we believe that our existing balances together with our anticipated cash flows from operations will be sufficient to meet our working capital and operating resource expenditure requirements for the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to the risks detailed in the section “Factors That May Affect Future Performance.” Also, while we currently have no committed lines of credit, we believe that our banking relationships and good credit should afford us the opportunity to raise sufficient debt in the bank or public market, if required.

#### **Stock Repurchase Program I—On-going Dilution Coverage**

To facilitate our stock repurchase program designed to minimize dilution from stock issuance primarily from employee stock plans, we repurchase shares in the open market and from time to time enter into structured repurchase agreements with third parties.

Authorization to repurchase shares to cover on-going dilution is not subject to expiration. However, this repurchase program is limited to covering net dilution from stock issuances and is subject to business conditions and cash flow requirements as determined by our Board of Directors from time to time. Refer to Part II, Item 2(c) in this filing for share repurchases during the quarter ended March 4, 2005.

During the first quarter of fiscal 2005, we entered into several stock purchase agreements with large financial institutions. Under these agreements, we provided the financial institutions with up-front payments totaling \$100.0 million. The financial institutions agreed to deliver to us, at certain intervals during the contract term, a certain number of our shares based on the volume weighted average price during such intervals less a specified discount. Upon payment, the \$100.0 million was classified as treasury stock on our balance sheet. In fiscal 2004, we entered into \$350 million in structured stock agreements under similar terms & conditions. As of March 4, 2005, approximately \$47.2 million of the up-front payments remained under the agreements. All outstanding structured repurchase contracts will expire on or before June 21, 2005.

#### **Stock Repurchase Program II—Additional Authorization above Dilution Coverage**

On September 25, 2002, our Board of Directors authorized a program to purchase up to an additional 5.0 million shares of our common stock over a three-year period, subject to certain business and cash flow requirements. We have not made any purchases under this 5.0 million share repurchase program. The authorization for this program will expire in September 2005.

#### **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

Our principal commitments as of March 4, 2005 consist of obligations under operating leases, royalty agreements and various service agreements. See Note 10 of our Notes to Condensed Consolidated Financial Statements for more detailed information.

##### *Lease Commitments*

The two lease agreements discussed in Note 10 of our Notes to Condensed Consolidated Financial Statements are subject to standard financial covenants. As of March 4, 2005, we were in compliance with all of our financial covenants. We expect to remain within compliance in the next 12 months. We are comfortable with these limitations and believe they will not impact our cash or credit in the coming year or restrict our ability to execute our business plan. See Note 10 of our Notes to Condensed Consolidated Financial Statements for further information regarding our leases.

##### *Indemnifications*

In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products.



Historically, costs related to these indemnification provisions have not been significant and we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

We have commitments to make certain milestone and/or retention payments typically entered into in conjunction with various acquisitions, for which we have made accruals in our consolidated financial statements. In connection with certain acquisitions and purchases of technology assets during fiscal 2003 and 2004, we entered into employee retention agreements and are required to make payments upon satisfaction of certain conditions in the agreements. These costs are being amortized over the retention period to compensation expense. As of March 4, 2005, we have \$1.2 million remaining to be paid under our retention agreements.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

As part of our limited partnership interests in Adobe Ventures, we have provided a general indemnification to Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures, for certain events or occurrences while Granite Ventures is, or was serving, at our request in such capacity provided that Granite Ventures acts in good faith on behalf of the partnerships. We are unable to develop an estimate of the maximum potential amount of future payments that could potentially result from any hypothetical future claim, but believe the risk of having to make any payments under this general indemnification to be remote.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In comparison with what we disclosed in our Annual Report on Form 10-K for fiscal 2004, we believe that there have been no significant changes in our market risk exposures for the quarter ended March 4, 2005.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based on their evaluation as of March 4, 2005, our Chief Executive Officer and Chief Financial Officer, have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were sufficiently effective to ensure that the information required to be disclosed by us in this quarterly report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and Form 10-Q.

There were no changes in our internal controls over financial reporting during the quarter ended March 4, 2005 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Adobe have been detected.

## PART II—OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

On September 5, 2002, AMT and its subsidiary, ITC, filed suit against Adobe in the U.S. District Court, Eastern District of Illinois, asserting that Adobe's distribution of the superseded 5.0 version of Adobe Acrobat violated the Digital Millennium Copyright Act. In January 2005, the court granted Adobe's motion for summary judgment.

On November 13, 2002, ITC filed suit against Adobe in the United States District Court for the Eastern District of Illinois, asserting that Adobe breached its contract with ITC and that ITC, not Adobe, owns the copyrights in font software created by Adobe which generates ITC typefaces. In April 2005, the parties resolved this matter.

On September 6, 2002, Plaintiff Fred B. Dufresne filed suit against Adobe, Microsoft Corporation, Macromedia, Inc. and Trellox Corporation in the U.S. District Court, District of Massachusetts, alleging infringement of U.S. Patent No. 5,835,712, entitled "Client-Server System Using Embedded Hypertext Tags for Application and Database Development." The Plaintiff's complaint asserts that "Defendants have infringed, and continue to infringe, one or more claims of the '712 patent by making, using, selling and/or offering for sale, *inter alia*, products supporting Microsoft Active Server Pages technology." The plaintiff seeks unspecified compensatory damages, preliminary and permanent injunctive relief, trebling of damages for "willful infringement," and fees and costs. We believe the action has no merit and are vigorously defending against it.

In connection with our anti-piracy efforts, conducted both internally and through the BSA, from time to time we undertake litigation against alleged copyright infringers. Such lawsuits may lead to counter-claims alleging improper use of litigation or violation of other local law and have recently increased in frequency, especially in Latin American countries. We believe we have valid defenses with respect to such counter-claims; however, it is possible that our consolidated financial position, cash flows or results of operations could be affected in any particular period by the resolution of one or more of these counter-claims.

From time to time, in addition to those identified above, Adobe is subject to legal proceedings, claims, investigations and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, Adobe makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against Adobe. It is possible, nevertheless, that our consolidated financial position, cash flows or results of operations could be affected by the resolution of one or more of such contingencies.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) Below is a summary of stock repurchases for the quarter ended March 4, 2005. See Note 7 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plans.

<u>Plan/Period</u>	<u>Shares Repurchased<sup>(1)</sup></u>	<u>Average Price Per Share</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plan</u>
<b><i>Stock Repurchase Program I</i></b>			
Beginning shares available to be repurchased as of December 3, 2004 . . . . .			28,261,654
December 4 - December 31, 2004			
From employees <sup>(2)</sup> . . . . .	23	\$ 60.45	
Open market . . . . .	499,762	57.77	
January 1 - January 28, 2005			
From employees <sup>(2)</sup> . . . . .	141	57.35	
Open market . . . . .	1,822,476	59.57	
January 29 - March 4, 2005			
From employees <sup>(2)</sup> . . . . .	403	64.00	
Open market . . . . .	748,878	57.50	
Adjustments to repurchase authority for net dilution . . . . .	—		3,776,361 <sup>(3)</sup>
Total shares repurchased . . . . .	<u>3,071,683</u>		<u>(3,071,683)</u>
Ending shares available to be repurchased as of March 4, 2005 . . . . .			<u>28,966,332<sup>(4)</sup></u>

(1) All shares were purchased as part of publicly announced plans.

(2) The repurchases from employees represent shares canceled when surrendered in lieu of cash payments for the option exercise price or withholding taxes due.

(3) Adjustment of authority to reflect underwater options which are no longer dilutive as well as increased dilution from share issuance.

(4) The remaining authorization for the ongoing stock repurchase plan is determined by combining all stock issuances, net of any canceled, surrendered or exchanged shares less all stock repurchases under the ongoing plan, beginning in the first quarter of fiscal 1998.

## ITEM 5. OTHER INFORMATION

As disclosed in Part II, Item 6 titled “Selected Financial Data” of our Annual Report on Form 10-K for the year ended December 3, 2004, we had 3,848 worldwide employees as of December 3, 2004. We also disclosed in Part I, Item 1 titled “Business—Employees” of this Annual Report that as of January 25, 2005, we employed 3,142 people. This was a typographical error and as of January 25, 2005 we actually employed 3,944 people.

## ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
3.1	Amended and Restated Bylaws as currently in effect	10-K	2/26/03	3.2	
3.2	Restated Certificate of Incorporation, as filed with the Secretary of State of the State of Delaware on 5/22/01	10-Q	7/16/01	3.6	
4.1	Fourth Amended and Restated Rights Agreement between the Company and Computershare Investor Services, LLC	8-K	7/3/00	1	
10.1	1984 Stock Option Plan, as amended*	10-Q	7/02/93	10.1.6	
10.2	Amended 1994 Performance and Restricted Stock Plan*	10-Q	5/29/98	10.24.2	
10.3	Form of Restricted Stock Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*	10-Q	10/7/04	10.7	
10.4	1994 Stock Option Plan, as amended*	S-8	5/30/97	10.40	
10.5	1997 Employee Stock Purchase Plan, as amended*	10-K	12/1/00	10.70	
10.6	1996 Outside Directors' Stock Option Plan, as amended*	DEF 14A	3/14/05	Appendix B	
10.7	Forms of Stock Option Agreements used in connection with the 1996 Outside Directors' Stock Option Plan*	S-8	6/16/00	4.8	
10.8	1999 Nonstatutory Stock Option Plan, as amended*	S-8	10/29/01	4.6	
10.9	1999 Equity Incentive Plan, as amended*	10-K	2/26/03	10.37	
10.10	2003 Equity Incentive Plan, as amended*	DEF 14A	3/14/05	Appendix A	
10.11	Forms of Stock Option and Restricted Stock Agreement used in connection with the 2003 Equity Incentive Plan	10-Q	10/7/04	10.11	
10.12	Form of Indemnity Agreement*	10-Q	5/30/97	10.25.1	
10.13	Forms of Retention Agreement*	10-K	11/28/97	10.44	
10.14	Second Amended and Restated Master Lease of Land and Improvements by and between SMBC Leasing and Finance, Inc. and Adobe Systems Incorporated	10-Q	10/7/04	10.14	
10.15	Lease agreement between Adobe Systems and Selco Service Corporation	10-K	2/21/02	10.77	
10.16	Participation agreement among Adobe Systems, Selco Service Corporation, et al.	10-K	2/21/02	10.78	
10.17	Executive Severance Plan in the Event of a Change of Control*	10-K	2/21/02	10.80	
10.18	Amendment No.1 to Lease Agreement between Adobe and Selco Services Corporation	10-K	2/26/03	10.81	

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	
10.19	Adobe Systems Incorporated 2004 Annual Executive Incentive Plan*	8-K	1/13/05	10.1	
10.20	Adobe Systems Incorporated 2005 Annual Executive Incentive Plan*	8-K	1/13/05	10.2	
10.21	Description of Director Compensation*	10-K	2/2/05	10.21	
31.1	Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934				X
31.2	Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934				X
32.1	Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934 <sup>(†)</sup>				X
32.2	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934 <sup>(†)</sup>				X

\* Compensatory plan or arrangement

<sup>(†)</sup> The certifications attached as Exhibits 32.1 and 32.2 that accompany this Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Adobe Systems Incorporated under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADOBE SYSTEMS INCORPORATED

By /s/ MURRAY J. DEMO

Murray J. Demo,  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: April 12, 2005

### **SUMMARY OF TRADEMARKS**

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

Adobe  
Acrobat  
Photoshop  
PostScript

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