UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 3, 2004

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

ADOBE SYSTEMS INCORPORATED

(Exact name of registrant as specified in its charter)

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)

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 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 Securities Exchange Act of 1934). Yes ☒ No ☐

The number of shares outstanding of the registrant's common stock as of October 1, 2004 was 238,627,028.

ADOBE SYSTEMS INCORPORATED
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)

	September 3, 2004	November 28, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 198,700	$ 189,917
Short-term investments	941,072	906,616
Trade receivables, net	110,573	146,311
Other receivables	26,518	27,731
Deferred income taxes	30,113	35,875
Other current assets	26,595	22,578
Total current assets	1,333,571	1,329,028
Property and equipment, net	89,029	77,007
Goodwill	110,260	95,971
Purchased and other intangibles, net	14,200	15,318
Investment in lease receivable	126,800	—
Other assets	46,948	37,721
Total assets	$ 1,720,808	$ 1,555,045
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade and other payables	$ 36,661	$ 37,437
Accrued expenses	169,724	160,009
Income taxes payable	176,691	193,484
Deferred revenue	47,148	45,600
Total current liabilities	430,224	436,530
Other long-term liabilities	5,097	—
Deferred income taxes	59,731	17,715
Commitments and contingencies		
Stockholders' equity:		
Common stock, $0.0001 par value	29,576	29,576
Additional paid-in-capital	1,006,431	874,126
Retained earnings	2,128,353	1,800,398
Accumulated other comprehensive loss	(558)	(999)
Treasury stock, at cost, (58,860 and 57,464 shares in 2004 and 2003, respectively), net of re-issuances	(1,938,046)	(1,602,301)
Stockholders' equity	1,225,756	1,100,800
Total liabilities and stockholders' equity	$ 1,720,808	$ 1,555,045

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	September 3, 2004	August 29, 2003	September 3, 2004	August 29, 2003
Revenue:				
Products	$ 395,450	$ 312,633	$ 1,213,755	$ 917,538
Services and support	8,263	6,489	23,324	18,625
Total revenue	403,713	319,122	1,237,079	936,163
Cost of revenue:				
Products	19,035	18,854	62,685	58,426
Services and support	4,534	3,223	12,321	9,369
Total cost of revenue	23,569	22,077	75,006	67,795
Gross profit	380,144	297,045	1,162,073	868,368
Operating expenses:				
Research and development	80,072	68,814	231,196	203,892
Sales and marketing	122,939	106,134	380,854	309,874
General and administrative	36,819	30,321	104,608	90,857
Restructuring and other charges	—	(439)	—	(439)
Total operating expenses	239,830	204,830	716,658	604,184
Operating income	140,314	92,215	445,415	264,184
Non-operating income (loss):				
Investment loss, net	(1,494)	(2,996)	(1,652)	(13,254)
Interest and other income	2,343	2,958	11,502	10,492
Total non-operating income (loss)	849	(38)	9,850	(2,762)
Income before income taxes	141,163	92,177	455,265	261,422
Provision for income taxes	36,702	27,653	118,368	78,427
Net income	$ 104,461	$ 64,524	$ 336,897	$ 182,995
Basic net income per share	$ 0.44	$ 0.28	$ 1.41	$ 0.79
Shares used in computing basic net income per share	238,471	233,364	238,491	232,288
Diluted net income per share	$ 0.42	$ 0.27	$ 1.37	$ 0.77
Shares used in computing diluted net income per share	247,113	240,495	246,749	238,592
Cash dividends declared per share	$ 0.0125	$ 0.0125	$ 0.0375	$ 0.0375

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Nine Months Ended	
	September 3, 2004	August 29, 2003
Cash flows from operating activities:		
Net income	$ 336,897	$ 182,995
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	43,007	36,239
Stock compensation expense	294	2,459
Deferred income taxes	48,442	17,324
Provision for (recovery of) losses on receivables	(2,152)	1,300
Tax benefit from employee stock option plans	29,972	12,349
Net gains on sales and impairments of investments	1,645	13,254
Non-cash restructuring and other charges	—	(439)
Changes in operating assets and liabilities:		
Receivables	39,518	4,577
Other current assets	(1,509)	(12,246)
Trade and other payables	(776)	(5,695)
Accrued expenses	13,591	22,692
Accrued restructuring charges	(777)	(8,426)
Income taxes payable	(16,793)	27,714
Deferred revenue	1,548	10,424
Net cash provided by operating activities	492,907	304,521
Cash flows from investing activities:		
Purchases of short-term investments	(955,732)	(483,268)
Maturities and sales of short-term investments	914,016	206,366
Acquisitions of property and equipment	(41,352)	(26,864)
Purchases of long-term investments and other assets	(19,024)	(15,859)
Cash paid for acquisitions	(15,545)	(16,500)
Investment in lease receivable	(126,800)	—
Proceeds from sale of equity securities	3,145	2,321
Net cash used for investing activities	(241,292)	(333,804)
Cash flows from financing activities:		
Purchase of treasury stock	(408,666)	(84,537)
Proceeds from issuance of treasury stock	174,960	81,100
Payment of dividends	(8,960)	(8,701)
Net cash used for financing activities	(242,666)	(12,138)
Effect of foreign currency exchange rates on cash and cash equivalents	(166)	2,198
Net increase (decrease) in cash and cash equivalents	8,783	(39,223)
Cash and cash equivalents at beginning of period	189,917	183,684
Cash and cash equivalents at end of period	$ 198,700	$ 144,461
Supplemental disclosures:		
Cash paid during the period for income taxes	$ 59,426	$ 11,997
Non-cash investing and financing activities:		
Cash dividends declared but not paid	$ 2,961	$ 2,917
Unrealized losses on available-for-sale securities, net of taxes	$ (4,002)	$ (502)

See accompanying Notes to Condensed Consolidated Financial Statements.

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and 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 its 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 November 28, 2003. 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. You should read these interim condensed consolidated financial statements in conjunction with the audited financial statements in our Annual Report on Form 10-K for the year ended November 28, 2003.

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. Accordingly we reduce revenue recognized for estimated future returns, price protection and rebates at the time the related revenue is 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 provide free technical phone support to customers for our shrink-wrapped application products under warranty. We record the estimated cost of free technical phone support upon shipment of software.

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 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.

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. The following table sets forth the pro forma amounts of net income and net income per share, for the three and nine months ended September 3, 2004 and August 29, 2003, that would have resulted if we accounted for our employee stock plans under the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation."

	Three Months Ended		Nine Months Ended	
	2004	2003	2004	2003
Net income:				
As reported	$ 104,461	$ 64,524	$ 336,897	$ 182,995
Add: Stock-based compensation expense for employees included in reported net income, net of related tax effects	31	429	191	1,599
Less: Total stock-based compensation expense for employees determined under the fair value based method, net of related tax effects	(22,186)	(36,453)	(84,445)	(153,101)
Pro forma	$ 82,306	$ 28,500	$ 252,643	$ 31,493
Basic net income per share:				
As reported	$ 0.44	$ 0.28	$ 1.41	$ 0.79
Pro forma	$ 0.35	$ 0.12	$ 1.06	$ 0.14
Diluted net income per share:				
As reported	$ 0.42	$ 0.27	$ 1.37	$ 0.77
Pro forma	$ 0.33	$ 0.12	$ 1.02	$ 0.13

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 restriction 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 our 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.

The assumptions used to value the option grants and purchase rights, for the three and nine months ended September 3, 2004 and August 29, 2003, are as follows:

	Three Months Ended		Nine Months Ended	
	2004	2003	2004	2003
Expected life of options (in years)	2.5	2.5	2.5	2.5 - 3
Expected life of purchase rights (in years)	1.24	1.24	1.24	1.24
Volatility	37%	40%	37 - 40%	40 - 66%
Risk free interest rate—options	2.68 - 2.85%	1.37%	2.18 - 3.11%	1.36 - 1.74%
Risk free interest rate—purchase rights	1.24 - 1.76%	1.12 - 1.47%	1.24 - 1.76%	1.12 - 1.74%
Dividend yield	0.11%	0.13%	0.11 - 0.13%	0.13%

Option 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 June 2004, the Financial Accounting Standards Board ("FASB") issued Emerging Issues Task Force Issue No. 02-14 ("EITF 02-14"), "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock." EITF 02-14 addresses whether the equity method of accounting applies when an investor does not have an investment in voting common stock of an investee but exercises significant influence through other means. EITF 02-14 states that an investor should only apply the equity method of accounting when it has investments in either common stock or in-substance common stock of a corporation, provided that the investor has the ability to exercise significant influence over the operating and financial policies of the investee. The accounting provisions of EITF 02-14 are effective for reporting periods beginning after September 15, 2004. We do not expect the adoption of EITF 02-14 to have a material impact on our consolidated financial position, results of operations or cash flows.

In March 2004, the FASB issued EITF Issue No. 03-1 ("EITF 03-1"), "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" which provides new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however the disclosure requirements remain effective for annual periods ending after June 15, 2004. We will evaluate the impact of EITF 03-1 once final guidance is issued.

In December 2003, the FASB issued Interpretation No. 46R ("FIN 46R"), a revision to FIN 46. FIN 46R clarifies some of the provisions of FIN 46 and exempts certain entities from its requirements. FIN 46R is effective at the end of the first interim period ending after December 15, 2003. We have considered the provisions of FIN 46R and believe it will not be necessary to include in our consolidated financial statements any assets, liabilities, or activities of the third-party entities holding our corporate headquarters leases. We have provided certain disclosures related to these leases in other areas of this Quarterly Report on Form 10-Q (see Note 8 of our Notes to Condensed Consolidated Financial Statements). Under the provisions of FIN 46R, we began consolidating our Adobe Ventures partnerships in the first quarter of fiscal 2004. This consolidation did not have a material impact on our consolidated financial position, results of operations or cash flows.

In December 2003, the SEC issued Staff Accounting Bulletin No. 104 ("SAB 104"), "Revenue Recognition," which supercedes Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." The primary purpose of SAB 104 is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, which was superceded as a result of the issuance of Emerging Issues Task Force 00-21 ("EITF 00-21"), "Accounting for Revenue Arrangements with Multiple Deliverables." SAB 104 also incorporated certain sections of the SEC's "Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers" document. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not have a material impact on our consolidated financial position, results of operations or cash flows.

NOTE 2. ACQUISITION

On May 3, 2004, we acquired Q-Link Technologies, Inc ("Q-Link"), a privately held company, for $15.9 million in cash. Q-Link provides Java-based workflow technology that will be integrated with our Intelligent Documents platform to enable customers to integrate document process management with core applications. Goodwill has been allocated to our Intelligent Documents segment. Purchased technology is being amortized over its estimated useful life of three years. The consolidated financial statements include the operating results of Q-Link from the date of purchase. Pro forma results of operations have not been presented because the effect of this acquisition was not material. The following table summarizes the purchase price allocation:

Cash and cash equivalents	$	312
Accounts receivable, net		415
Other current assets		18
Purchased technology		1,380
Goodwill		14,289
Other intangible assets		290
Total assets acquired		16,704
Current liabilities		(99)
Liabilities recognized in connection with the business combination		(748)
Total liabilities assumed		(847)
Net assets acquired	$	15,857

NOTE 3. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Below is a breakdown of our goodwill reported by segment as of September 3, 2004 and November 28, 2003:

		2004		2003
Digital Imaging and Video	$	14,112	$	14,112
Creative Professional		4,650		4,650
Intelligent Documents		91,498		77,209
Total goodwill	$	110,260	$	95,971

In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," we review our goodwill periodically for impairment. We completed our annual goodwill impairment test during the second quarter of fiscal 2004 and determined that the carrying amount of goodwill was not impaired.

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

	Cost	Accumulated Amortization	Net
Purchased technology	$ 34,509	$ (24,432)	$ 10,077
Localization	9,673	(6,050)	3,623
Trademarks	300	(124)	176
Other intangibles	1,002	(678)	324
Total other intangible assets	10,975	(6,852)	4,123
Total purchased and other intangible assets	$ 45,484	$ (31,284)	$ 14,200

Purchased and other intangible assets, subject to amortization, were as follows as of November 28, 2003:

	Cost	Accumulated Amortization	Net
Purchased technology	$ 28,509	$ (18,875)	$ 9,634
Localization	$ 10,540	$ (5,348)	$ 5,192
Trademarks	300	(97)	203
Other intangibles	716	(427)	289
Total other intangible assets	$ 11,556	$ (5,872)	$ 5,684
Total purchased and other intangible assets	$ 40,065	$ (24,747)	$ 15,318

Amortization expense related to purchased and other intangible assets was $4.7 million and $13.7 million for the three and nine months ended September 3, 2004. Amortization expense related to purchased and other intangible assets was $3.7 million and $11.0 million for the three and nine months ended August 29, 2003. As of September 3, 2004, we expect amortization expense in future periods to be as shown below:

Fiscal year	Purchased Technology	Other Intangible Assets
Remainder of 2004	$ 1,729	$ 3,179
2005	4,833	800
2006	1,701	18
2007	507	18
2008	316	18
2009	316	18
Thereafter	675	72
Total expected amortization expense	$ 10,077	$ 4,123

NOTE 4. OTHER ASSETS

Other assets consisted of the following as of September 3, 2004 and November 28, 2003:

	2004	2003
Investments	$ 34,212	$ 30,840
Security deposits and other	4,289	3,503
Land deposit	3,350	3,378
Prepaid rent	5,097	—
Total other assets	$ 46,948	$ 37,721

We own limited partnership interests in Adobe Ventures which are consolidated in accordance with FIN 46R. The partnerships are controlled by Granite Ventures, an independent venture capital firm and sole general partner of Adobe Ventures. As of September 3, 2004 and November 28, 2003, the estimated fair value of our partnership interests in Adobe Ventures were $34.6 million and $30.6 million, respectively.

We recognize realized gains and losses upon the sale of investments using the specific identification method. During the three and nine months ended September 3, 2004, investment losses included losses related to our Adobe Ventures and our cost method investments totaling $1.6 million and $2.4 million, respectively. These losses were partially offset by gains on our short-term investments of $0.1 million and $0.2 million, respectively. For the nine months ended September 3, 2004, investment losses were also partially offset by gains of $0.5 million from the sale of our marketable equity securities.

During the three and nine months ended August 29, 2003, investment losses included losses related to our Adobe Ventures and our cost method investments totaling $2.8 million and $10.0 million, respectively. During the three months ended August 29, 2003, we recorded losses from the sale of our marketable equity securities of $0.1 million. During the three months ended August 29, 2003, investment losses also included write-downs due to other-than-temporary declines in value of $0.1 million related to our short-term investments. For the nine months ended August 29, 2003, the investment losses of $10.0 million were partially offset by gains of $0.7 million from the sale of our marketable equity securities. During the nine months ended August 29, 2003, investment losses also included write-downs due to other-than-temporary declines in value of $4.0 million related to our short-term investments.

During the third quarter of fiscal 2004, we restructured the lease for two of our headquarter office buildings. See Note 8 of our Notes to Condensed and Consolidated Financial Statements for additional information. The lease agreement provides for a residual value guarantee. In accordance with FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," we have recognized the fair value of the residual value guarantee of $5.2 million as a long-term liability on our balance sheet with the offsetting entry to prepaid rent in other assets. The balance will be amortized to the income statement over five years, the life of the lease. As of September 3, 2004, the unamortized portion of the fair value of the residual value guarantee remaining in prepaid rent was $5.1 million.

NOTE 5. ACCRUED EXPENSES

Accrued expenses consisted of the following as of September 3, 2004 and November 28, 2003:

	2004	2003
Accrued compensation and benefits	$ 82,032	$ 65,870
Sales and marketing allowances	11,265	14,169
Accrued restructuring	355	1,132
Other	76,072	78,838
Total accrued expenses	$ 169,724	$ 160,009

NOTE 6. 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 September 3, 2004, $0.4 million remained accrued 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 2004. Facility costs 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 November 28, 2003	Cash Payments	Adjustments	Balance at September 3, 2004
Transaction costs	$ 255	$ (112)	$ (19)	$ 124
Cost of closing redundant facilities	829	(598)	—	231
Other exit costs	48	(5)	(43)	—
Total	$ 1,132	$ (715)	$ (62)	$ 355

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 three and nine months ended September 3, 2004, we repurchased 4.5 million shares at an average price of $43.32 and 8.5 million shares at an average price of $42.00, respectively, through open market repurchases and structured repurchase agreements. During the three and nine months ended August 29, 2003, we repurchased 1.2 million shares at an average price of $32.96 and 2.8 million shares at an average price of $30.39, respectively, through open market repurchases and the exercise of put and call options.

During the second and third quarters of fiscal 2004, we entered into several stock purchase agreements with a large financial institution. Under these agreements, we provided the financial institution with up-front payments totaling $150.0 million. The financial institution 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 $150.0 million was classified as treasury stock on our balance sheet. As of September 3, 2004, approximately $53.1 million of the up-front payment remained under an agreement that expired October 1, 2004. At the expiration of this agreement, we received the remaining shares.

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. 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 maximum recourse amount ("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 lessor quarterly. As of September 3, 2004, 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 term for an additional five year term, 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 FIN 45, 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 tower 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 September 3, 2004, the unamortized portion of the fair value of the residual value guarantee remaining in other long-term liabilities was $5.1 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 September 3, 2004, we have $1.6 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 reduces 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.

We accrue for costs associated with future obligations which include costs for undetected bugs that are discovered only after the product is installed and used by customers. The accrual remaining as of September 3, 2004 primarily relates to our digital video software products. The table below summarizes the activity related to the accrual for the nine months ended September 3, 2004:

Balance at November 28, 2003	Accruals	Payments	Balance at September 3, 2004
$ 3,185	$ 114	$ (3,285)	$ 14

Legal Actions

In early 2002, International Typeface Corporation ("ITC") and Agfa Monotype Corporation ("AMT"), companies which have common ownership and management, each charged, by way of informal letters to Adobe, that Adobe's distribution of font software, which generates ITC and AMT typefaces, breaches its contracts with ITC and AMT, respectively, pursuant to which Adobe licensed certain rights with respect to ITC and AMT typefaces. AMT and ITC further charged that Adobe violated the Digital

Millennium Copyright Act ("DMCA") with respect to, or induced or contributed to, the infringement of copyrights in, ITC's and AMT's TrueType font software.

On September 4, 2002, Adobe initiated arbitration proceedings in London, England ("the London Arbitration") against AMT, seeking a declaration that Adobe's distribution of font software that generates AMT typefaces did not breach its contract pursuant to which it licensed certain rights with respect to AMT typefaces and, therefore, that AMT did not have the right to terminate the agreement. AMT made certain breach of contract claims in response to Adobe's arbitration demand. On June 28, 2004, the arbitrators held that the contract remains in full force and that AMT does not have the right to terminate it. The arbitrators found in favor of AMT on only one of its three claims, but have not yet ruled on whether AMT is entitled to recover any damages from Adobe on that claim. We believe that a damage award, if any, will not have a material adverse effect on Adobe.

On September 5, 2002, AMT and ITC filed suit against Adobe in the U.S. District Court, Eastern District of Illinois ("the Illinois Action"), asserting only that Adobe's distribution of the superseded 5.0 version of Adobe Acrobat violated the DMCA.

On November 13, 2002, ITC filed another 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.

If ITC prevails on its breach of contract claims in the second Illinois action, ITC may have the right to terminate Adobe's right to distribute any of its products that then still contain font software that generates ITC typefaces. The results of any litigation are inherently uncertain and we cannot assure that we will be able to successfully defend ourselves against the actions described above. AMT and ITC seek an unspecified aggregate dollar amount of damages in the Illinois actions. A favorable outcome for AMT or ITC in these actions could have a material adverse effect on Adobe's consolidated financial position, cash flows or results of operations. We believe that all of AMT's and ITC's remaining claims are without merit and we are vigorously defending against them. We cannot estimate any possible loss at this time.

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.

On November 18, 2002, Plaintiffs Shell & Slate Software Corporation and Ben Weiss filed a civil action in the U.S. District Court in Los Angeles against Adobe alleging false designation of origin, trade secret misappropriation, breach of contract and other causes of action. The claim derives from the Plaintiffs' belief that the "healing brush" technique of Adobe Photoshop software incorporates the Plaintiffs' trade secrets. The Plaintiffs seek preliminary and permanent injunctive relief, compensatory, treble and punitive damages and fees and costs. We believe the action has no merit and are vigorously defending against it. On September 9, 2003, Adobe filed a counter-claim against Ben Weiss for breach of contract and misappropriation of trade secrets. Adobe seeks injunctive relief against any use of Adobe's trade secrets. Adobe seeks compensatory, statutory and punitive damages. We cannot estimate any possible loss at this time.

On June 2, 2004, Plaintiff Information Technology Innovation, LLC filed suit against Adobe in the U.S. District Court, District of Colorado, alleging infringement of U.S. Patent No. 5,892,908, entitled "Method of Extracting Network Information." The Plaintiff's complaint asserted that Adobe infringes the '908 patent by making, using and selling "Acrobat Standard and Professional products." The plaintiff sought unspecified compensatory damages, injunctive relief, and fees and costs. In September 2004, the Plaintiff dismissed this case with prejudice.

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 these contingencies.

NOTE 9. FINANCIAL INSTRUMENTS

In accordance with Statement of Financial Accounting Standards No. 133 ("SFAS 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.

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 other income (loss) on the consolidated statement of income at that time. For the three and nine months ended September 3, 2004, 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 is deemed to be ineffective and is recorded in other income (loss) over the life of the contract.

Gain (Loss) on Hedges of Forecasted Transactions:

	Other Comprehensive Income (Loss)	
Balance Sheet	**September 3, 2004**	**November 28, 2003**
Recognized but Unrealized—Open Transactions:		
Unrealized net gain (loss) remaining in other comprehensive income (loss)	$ 2,120	$ (867)

Income Statement	Three Months Ended September 3, 2004 Revenue	Three Months Ended September 3, 2004 Other Income (Loss)	Three Months Ended August 29, 2003 Revenue	Three Months Ended August 29, 2003 Other Income (Loss)
Realized—Closed Transactions:				
Realized net gain (loss) reclassified from other comprehensive income (loss) to revenue	$ 1,055	$ —	$ (935)	$ —
Realized net loss from the cost of purchased options and gains or losses from any ineffective portion of hedges	—	(1,718)	—	(1,478)
Recognized but Unrealized—Open Transactions:				
Unrealized net gain (loss) from time value degradation and any ineffective portion of hedges	—	(555)	—	490
	$ 1,055	$ (2,273)	$ (935)	$ (988)

	Nine Months Ended September 3, 2004 Revenue	Nine Months Ended September 3, 2004 Other Income (Loss)	Nine Months Ended August 29, 2003 Revenue	Nine Months Ended August 29, 2003 Other Income (Loss)
Realized—Closed Transactions:				
Realized net loss reclassified from other comprehensive income (loss) to revenue	$ (514)	$ —	$ (3,382)	$ —
Realized net loss from the cost of purchased options and gains or losses from any ineffective portion of hedges	—	(4,793)	—	(3,023)
Recognized but Unrealized—Open Transactions:				
Unrealized net loss from time value degradation and any ineffective portion of hedges	—	(648)	—	(1,172)
	$ (514)	$ (5,441)	$ (3,382)	$ (4,195)

Interest Rate Hedging—Hedging of Interest Rate Sensitive Obligations

We have entered into interest rate swap agreements to manage our exposure to operating lease obligations that are tied to short-term interest rates. The swaps allow us to exchange variable interest rate payments for fixed interest rate payments, thereby securing a fixed payment amount for a portion of the total obligation. As of September 3, 2004, there were no swaps outstanding.

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 offset gains and losses on the assets and liabilities being hedged. At September 3, 2004, the outstanding balance sheet hedging derivatives had maturities of 90 days or less.

Net gains recognized in other income (loss) relating to balance sheet hedging for the three and nine months ended September 3, 2004 and August 29, 2003 were as follows:

	Three Months		Nine Months	
	2004	2003	2004	2003
Gain (loss) on foreign currency assets and liabilities:				
Net realized gain (loss) recognized in other income (loss)	$ (1,222)	$ (3,470)	$ (2,050)	$ 6,485
Net unrealized gain (loss) recognized in other income (loss)	(640)	(2,511)	1,533	(1,174)
	(1,862)	(5,981)	(517)	5,311
Gain (loss) on hedges of foreign currency assets and liabilities:				
Net realized gain (loss) recognized in other income (loss)	(1,110)	1,270	(7,062)	(5,058)
Net unrealized gain recognized in other income (loss)	2,276	3,796	7,405	1,205
	1,166	5,066	343	(3,853)
Net gain (loss) recognized in other income (loss)	$ (696)	$ (915)	$ (174)	$ 1,458

Fair Value Hedges—Hedging of Foreign Currency Denominated Available for Sale Securities

During the second and third quarter of fiscal 2004, a portion of our investment portfolio was invested in euro denominated securities. In order to mitigate the currency risk of those euro denominated securities, we entered into forward contracts. We designated these forward contracts as fair value hedges. As of September 3, 2004, there were no euro denominated securities in the investment portfolio and no remaining fair value hedges.

Net gains recognized in other income (loss) relating to fair value hedges for the three and nine months ended September 3, 2004 and August 29, 2003 were as follows:

	Three Months		Nine Months	
	2004	2003	2004	2003
Gain (loss) on foreign currency assets and liabilities:				
Net realized gain recognized in other income (loss)	$ 297	$ —	$ 2,234	$ —
Net unrealized loss recognized in other income (loss)	(1,755)	—	(1,935)	—
	(1,458)	—	299	—
Gain (loss) on hedges of foreign currency assets and liabilities:				
Net realized gain (loss) recognized in other income (loss)	(317)	—	3,026	—
Net unrealized gain (loss) recognized in other income (loss)	1,663	—	(3,482)	—
	1,346	—	(456)	—
Net loss recognized in other income (loss)	$ (112)	$ —	$ (157)	$ —

NOTE 10. COMPREHENSIVE INCOME

Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income," establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Items of 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.

The following table sets forth the components of comprehensive income, net of income tax expense, for the three and nine months ended September 3, 2004 and August 29, 2003:

	Three Months Ended		Nine Months Ended	
	2004	2003	2004	2003
Net income as reported	$ 104,461	$ 64,524	$ 336,897	$ 182,995
Other comprehensive income (loss), net of tax:				
Unrealized gain (loss) on available-for-sale securities, net of tax	3,024	3,891	(4,002)	6,711
Currency translation adjustments	(11)	(684)	(165)	2,198
Net gain (loss) in derivative instruments, net of taxes	850	(2,828)	4,609	(5,086)
Other comprehensive income	3,863	379	442	3,823
Total comprehensive income, net of taxes	$ 108,324	$ 64,903	$ 337,339	$ 186,818

NOTE 11. 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 and nine months ended September 3, 2004 and August 29, 2003:

	Three Months Ended		Nine Months Ended	
	2004	2003	2004	2003
Net income	$ 104,461	$ 64,524	$ 336,897	$ 182,995
Shares used to compute basic net income per share (weighted average shares outstanding during the period, excluding unvested restricted stock)	238,471	233,364	238,491	232,288
Dilutive common equivalent shares:				
Unvested restricted stock	11	45	11	45
Stock options	8,631	7,086	8,247	6,259
Shares used to compute diluted net income per share	247,113	240,495	246,749	238,592
Basic net income per share	$ 0.44	$ 0.28	$ 1.41	$ 0.79
Diluted net income per share	$ 0.42	$ 0.27	$ 1.37	$ 0.77

NOTE 12. INDUSTRY SEGMENTS

We have four reportable segments that offer different product lines: 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 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 with 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 private and public sector 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.

The accounting policies of the operating segments are the same as those described in summary of significant accounting policies. With the exception of goodwill, we do not identify or allocate our assets by operating segment. See Note 3 for the allocation of goodwill to our reportable segments. The following tables set forth our revenues, cost of revenues, gross profit and gross profit as a percentage of revenue for the three and nine months ended September 3, 2004 and August 29, 2003.

Three Months	Digital Imaging and Video	Creative Professional	Intelligent Documents	OEM PostScript and Other	Total
2004					
Revenue	$ 98,449	$ 150,395	$ 135,548	$ 19,321	$ 403,713
Cost of revenue	7,984	5,847	8,323	1,415	23,569
Gross profit	$ 90,465	$ 144,548	$ 127,225	$ 17,906	$ 380,144
Gross profit as a percentage of revenues	92%	96%	94%	93%	94%
2003					
Revenue	$ 88,334	$ 82,058	$ 126,954	$ 21,776	$ 319,122
Cost of revenue	6,973	4,293	9,354	1,457	22,077
Gross profit	$ 81,361	$ 77,765	$ 117,600	$ 20,319	$ 297,045
Gross profit as a percentage of revenues	92%	95%	93%	93%	93%

Nine Months	Digital Imaging and Video	Creative Professional	Intelligent Documents	OEM PostScript and Other	Total
2004					
Revenue	$ 312,228	$ 461,924	$ 401,923	$ 61,004	$ 1,237,079
Cost of revenue	27,072	16,140	27,974	3,820	75,006
Gross profit	$ 285,156	$ 445,784	$ 373,949	$ 57,184	$ 1,162,073
Gross profit as a percentage of revenues	91%	97%	93%	94%	94%
2003					
Revenue	$ 279,878	$ 261,618	$ 325,936	$ 68,731	$ 936,163
Cost of revenue	24,217	15,674	23,438	4,466	67,795
Gross profit	$ 255,661	$ 245,944	$ 302,498	$ 64,265	$ 868,368
Gross profit as a percentage of revenues	91%	94%	93%	94%	93%

A reconciliation of the totals reported for the operating segments to the applicable line items in the condensed consolidated financial statements for the three and nine months ended September 3, 2004 and August 29, 2003 is as follows:

	Three Months		Nine Months	
	2004	2003	2004	2003
Total gross profit from operating segments above	$ 380,144	$ 297,045	$ 1,162,073	$ 868,368
Total operating expenses*	239,830	204,830	716,658	604,184
Total operating income	140,314	92,215	445,415	264,184
Other income (loss), net	849	(38)	9,850	(2,762)
Income before income taxes	$ 141,163	$ 92,177	$ 455,265	$ 261,422

* Total operating expenses include research and development, sales and marketing, general and administrative and for fiscal 2003, restructuring and other charges.

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 2003 and the other Quarterly Reports on Form 10-Q filed by us in fiscal 2004. 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 offers a line of software for consumers, creative professionals, and enterprises, in both private and public sectors. Our products enable customers to create, manage and deliver visually rich, compelling and reliable content. We distribute our products through a network of distributors and dealers, VARs, systems integrators, independent software vendors ("ISVs") and OEMs; direct to end users; and through our own Web site at 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, 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. 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.

CRITICAL ACCOUNTING ESTIMATES

In preparing our consolidated financial statements, we make assumptions, judgments and estimates that can have a significant impact on our net revenue, operating income and net income, as well as on the value of certain assets and liabilities on our consolidated balance sheet. 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 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 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 channel inventory, we rely upon historical data, the estimated amount of product 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. 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.

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 our net 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 financial position and results of operations. Our assumptions, judgments and estimates relative to the value of our net 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, thus materially impacting our financial position and results of operations.

RESULTS OF OPERATIONS

Overview of the Three and Nine Months Ended September 3, 2004

During the third quarter of fiscal 2004, we continued to focus on delivering comprehensive technology platforms for enterprises and creative professionals to drive revenue and earnings growth. Our latest Acrobat desktop products, released during fiscal 2003, continued to perform well which indicates we are making progress against our Intelligent Documents segment strategy to increase the adoption of Acrobat. Our Intelligent Documents initiatives to deliver a comprehensive server-based platform to help governments and enterprises improve their business processes also have achieved both strong sequential and year-over-year revenue growth. Additionally, we believe our strategy of providing creative professionals a complete design platform is resonating with our customers. The success we achieved in fiscal 2003 and the first half of fiscal 2004 in our Creative Professional business segment continued in the third quarter of fiscal 2004 due to strong licensing of our Adobe Creative Suite and CS products.

We continue to focus on delivering innovative products and solutions for our customers. However, 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."

Revenue for the Three and Nine Months Ended September 3, 2004 and August 29, 2003

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Product	$ 395.4	$ 312.6	27%	$ 1,213.8	$ 917.5	32%
Percentage of total revenues	98%	98%		98%	98%	
Services and support	8.3	6.5	27%	23.3	18.6	25%
Percentage of total revenues	2%	2%		2%	2%	
Total revenues	$ 403.7	$ 319.1	27%	$ 1,237.1	$ 936.1	32%

We have four reportable segments that offer different product lines: 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 with 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 private and public sector 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.

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Digital Imaging and Video	$ 98.4	$ 88.3	12%	$ 312.2	$ 279.9	12%
Percentage of total revenues	24%	27%		25%	30%	
Creative Professional	150.4	82.0	83%	461.9	261.5	77%
Percentage of total revenues	37%	26%		37%	28%	
Intelligent Documents	135.5	127.0	7%	401.9	325.9	23%
Percentage of total revenues	34%	40%		33%	35%	
OEM PostScript and Other	19.4	21.8	(11)%	61.1	68.8	(11)%
Percentage of total revenues	5%	7%		6%	7%	
Total revenues	$ 403.7	$ 319.1	27%	$ 1,237.1	$ 936.1	32%

Revenue from our Digital Imaging and Video segment increased during the three and nine months ended September 3, 2004 due to increases in revenues from both our digital video and digital imaging software products. Overall, revenue from our digital video software products increased 28% and 22% during the three and nine months ended September 3, 2004, respectively, which was attributable to new releases during the second quarter of fiscal 2004. Revenue from our digital imaging software products increased 8% and 9% during the three and nine months ended September 3, 2004, respectively, primarily due to continued success with Adobe Photoshop CS which was released at the end of fiscal 2003. The increase in revenues from Adobe Photoshop CS was partially offset by decreases in revenues from our non-professional digital imaging software products.

Revenue from our Creative Professional segment increased during the three and nine months ended September 3, 2004 primarily due to the continued strength of our Adobe Creative Suite products which were initially released in the fourth quarter of fiscal 2003. The increase in revenues from our Adobe Creative Suite products were partially offset by decreases in revenues from certain of our layout software products due to product lifecycle timing.

Revenue from our Intelligent Documents segment increased during the three months ended September 3, 2004 primarily due to a 69% increase in revenues from our Intelligent Documents server-based products as we continue to focus on both the government sector and financial services markets. Revenue during the three months ended September 3, 2004 increased due to continued growth in license revenue, increased server support revenue and a large license payment from a software partner. Revenue growth for server based products in the third quarter of fiscal 2004 over the prior year quarter would have exceeded overall company revenue growth excluding the payment from the software partner. The increase in server-based products revenue was slightly offset by a 3% decrease in revenue from our Acrobat desktop products due to product lifecycle timing as compared to the same quarter last year. Revenue for the three months ended August 29, 2003 included higher revenue from our new Acrobat desktop launches in the second and third quarters of fiscal 2003. Revenue from our Intelligent Documents segment increased during the nine months ended September 3, 2004 primarily due to an 18% increase in revenues from our Acrobat desktop products due to continued adoption of Acrobat desktop products launched in the second and third quarters of fiscal 2003. Additionally, revenue from our Intelligent Documents server-based products increased 50% due to increased licensing and server support revenue.

Revenue from our OEM PostScript and Other segment decreased during the three and nine months ended September 3, 2004 due to a decline in pricing resulting from competition from clone PostScript technologies and lower prices of output devices.

	Three Months			Nine Months		
	2004	2003	Percent Change	2004	2003	Percent Change
Americas	$ 195.9	$ 156.8	25%	$ 561.9	$ 460.7	22%
Percentage of total revenues	48%	49%		45%	49%	
EMEA	123.5	84.3	47%	401.9	260.2	54%
Percentage of total revenues	31%	26%		33%	28%	
Asia	84.3	78.0	8%	273.3	215.2	27%
Percentage of total revenues	21%	24%		22%	23%	
Total revenues	$ 403.7	$ 319.1	27%	$ 1,237.1	$ 936.1	32%

Revenue in the Americas increased during the three and nine months ended September 3, 2004 due to the strength of our Creative Professional and Intelligent Documents products.

Revenue in EMEA increased during the three months ended September 3, 2004 due to the strength of our Creative Professional and Digital Imaging and Video products. Revenue in EMEA increased during the nine months ended September 3, 2004 due to the strength of our Creative Professional, Intelligent Documents and Digital Imaging and Video products.

Revenue in Asia increased during the three months ended September 3, 2004 due to the strength of our Creative Professional products, which was partially offset by a decrease in revenues from our Intelligent Documents products due to the launch of the Acrobat desktop products in third quarter of fiscal 2003. Revenue in Asia increased during the nine months ended September 3, 2004 due to the strength of our Creative Professional, Intelligent Documents and Digital Imaging and Video products.

Additionally, revenues in EMEA and Asia increased approximately $11.0 million and $55.8 million during the three and nine months ended September 3, 2004, respectively, over the same reporting periods last year due to the strength of the euro and the yen.

*Application platform mix**

	Three Months		Nine Months	
	2004	2003	2004	2003
Windows	73%	77%	72%	75%
Macintosh	27%	23%	28%	25%

* Total application platform mix excludes platform independent and UNIX revenue

Macintosh application revenue increased in recent quarters due to the successful launch of our Creative Professional applications, including Adobe Creative Suite and new CS versions of Illustrator, InDesign and Photoshop, which have large Macintosh customer bases. However, we expect the growth trend towards the Windows platform to continue over the long term due to our targeting of business users with our Intelligent Documents desktop products, where the significant majority of users run the Windows operating system.

In our experience, the actual amount of product backlog at any particular time is not a meaningful indicator of our future business prospects. Prior to major product releases, we tend to have significant levels of backlog, but at other times backlog has historically been low and we normally ship products within a few days of receiving an order, subject to credit verification and maintaining our targeted inventory position under our global channel inventory policy. In addition, backlog is subject to variability beyond this targeted inventory position. Historically, such variability usually has been less than 5% of reported revenue; however, for fiscal 2004 to date, such variability has been higher than historical levels. At the end of the third quarter of fiscal 2004, our backlog was comparable to second quarter levels.

Our channel inventory position was below our current global channel inventory policy at the end of the third quarter of fiscal 2004 and was comparable to second quarter levels.

During the third quarter of fiscal year 2004, we launched a revised licensing program, Adobe Open Options 4.0. The program changes included reporting some electronic orders on a daily basis rather than on a one month delayed basis. The program changes also resulted in some channel transition issues which have been substantially resolved. We estimate the net effect of the program changes led to a one-time benefit of approximately $10.0 million in revenue in the third quarter.

Cost of Revenues for the Three and Nine Months Ended September 3, 2004 and August 29, 2003

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Product	$ 19.0	$ 18.9	1%	$ 62.7	$ 58.4	7%
Percentage of total revenues	5%	6%		5%	6%	
Services and support	4.5	3.2	41%	12.3	9.4	32%
Percentage of total revenues	1%	1%		1%	1%	
Total cost of revenues	$ 23.5	$ 22.1	7%	$ 75.0	$ 67.8	11%

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 during the three months ended September 3, 2004 as compared to the three months ended August 29, 2003 primarily due to an increase in localization costs related to our foreign language product launches in the first part of fiscal 2004 and higher royalty fees. These increases were partially offset by lower material costs due to product mix. Cost of product revenue increased during the nine months ended September 3, 2004 as compared to the nine months ended August 29, 2003 due to a charge related to a litigation settlement that occurred during the second quarter of fiscal 2004 and an increase in localization costs related to our product launches. These increases were partially offset by a decrease in overall material costs.

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

Cost of services and support revenue increased during the three and nine months ended September 3, 2004 as compared to the three and nine months ended August 29, 2003 due to costs associated with our Expert Support program that was initiated during the second quarter of fiscal 2004. Additionally, cost of services and support revenue increased due to increases in compensation and related benefits as a result of higher headcount and incentive compensation to meet increases in support activities in fiscal 2004.

Operating Expenses for the Three and Nine Months Ended September 3, 2004 and August 29, 2003

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Research and development	$ 80.1	$ 68.8	16%	$ 231.2	$ 203.9	13%
Percentage of total revenues	20%	22%		19%	22%	

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 13% and 10% during the three and nine months ended September 3, 2004 as compared to the three and nine months ended August 29, 2003 due to compensation and related benefits associated with headcount growth and higher incentive compensation. The remaining increase in research and development expenses for the three and nine months ended September 3, 2004 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.

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Sales and marketing	$ 122.9	$ 106.1	16%	$ 380.9	$ 309.9	23%
Percentage of total revenues	31%	33%		31%	33%	

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 order fulfillment 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 10% and 11% during the three and nine months ended September 3, 2004 as compared to the three and nine months ended August 29, 2003 due to compensation and related benefits associated with headcount growth and higher incentive compensation. Sales and marketing expenses also increased 3% and 9%, respectively, due to increased marketing spending related to overall marketing efforts to further increase revenues. The remaining increase in sales and marketing expenses for the three and nine months ended September 3, 2004 was due to various individually insignificant items.

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
General and administrative	$ 36.8	$ 30.3	21%	$ 104.6	$ 90.9	15%
Percentage of total revenues	9%	10%		9%	10%	

General and administrative expenses consist of salary and benefit expenses, travel expenses and related facilities costs for our finance, 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 9% and 11% during the three and nine months ended September 3, 2004 as compared to the three and nine months ended August 29, 2003 due to compensation and related benefits associated with headcount growth and higher incentive compensation. General and administrative expenses increased 4% and 1%, respectively, due to higher professional fees. During the three months ended September 3, 2004, general and administrative expenses also increased 3% due to higher legal costs. The remaining increase in general and administrative expenses for the three and nine months ended September 3, 2004 was due to various individually insignificant items.

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Restructuring and other charges	$ —	$ (0.4)	*	$ —	$ (0.4)	*
Percentage of total revenues	—	*		—	*	

* Percentage is not meaningful.

During the nine months ended August 29, 2003, we revised our estimates of certain costs associated with a restructuring program that was implemented in the fourth quarter of fiscal 2002. As a result, we revised the accrual related to severance and other charges and facilities during the three months ended August 29, 2003.

Non-Operating Income (Loss) for the Three and Nine Months Ended September 3, 2004 and August 29, 2003

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Investment loss	$ (1.5)	$ (3.0)	(50)%	$ (1.7)	$ (13.3)	(88)%
Percentage of total revenues	*	(1)%		*	(1)%	
Interest and other income	2.3	3.0	(21)%	11.5	10.5	10%
Percentage of total revenues	1%	1%		1%	1%	
Total non-operating income (loss)	$ 0.8	$ —	*	$ 9.8	$ (2.8)	*

* Percentage is not meaningful.

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.

During the three and nine months ended September 3, 2004, investment losses included losses related to our Adobe Ventures and our cost method investments totaling $1.6 million and $2.4 million. These losses were partially offset by gains on our short-term investments of $0.1 million and $0.2 million, respectively. For the nine months ended September 3, 2004, investment losses were also partially offset by gains of $0.5 million from the sale of our marketable equity securities.

During the three and nine months ended August 29, 2003, investment losses included losses related to our Adobe Ventures and our cost method investments totaling $2.8 million and $10.0 million. During the three months ended August 29, 2003, we recorded losses from the sale of our marketable equity securities of $0.1 million. During the three months ended August 29, 2003, investment losses also included write-downs due to other-than-temporary declines in value of $0.1 million related to our short-term investments. For the nine months ended August 29, 2003, the investment losses of $10.0 million were partially offset by gains of $0.7 million from the sale of our marketable equity securities. During the nine months ended August 29, 2003, investment losses also included write-downs due to other-than-temporary declines in value of $4.0 million related to our short-term investments.

We are uncertain about future investment gains and losses, as they are primarily dependent upon market conditions and 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 decreased during the three months ended September 3, 2004 as compared to the three months ended August 29, 2003 due to higher costs related to our foreign currency hedging activity. Interest and other income increased during the nine months ended September 3, 2004 as compared to the nine months ended August 29, 2003 due to higher levels of cash during fiscal 2004.

Provision for Income Taxes for the Three and Nine Months Ended September 3, 2004 and August 29, 2003

	Three Months		Percent Change	Nine Months		Percent Change
	2004	2003		2004	2003	
Provision for income taxes	$ 36.7	$ 27.7	33%	$ 118.4	$ 78.4	51%
Percentage of total revenues	9%	9%		10%	8%	
Effective tax rate	26%	30%		26%	30%	

Our effective tax rate decreased in the three and nine months ended September 3, 2004 as compared to the three and nine months ended August 29, 2003 due to higher international profits which are taxed at a lower statutory 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

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 may also adversely affect our ability to grow. Political instability in any of the major countries in which we do business may also adversely affect our business.

Delays in development or shipment of our new products or major new versions of existing products

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

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, potentially providing additional competition to our Intelligent Document products and solutions. We are also seeing an increase in competition from clone PDF products marketed by other companies. Other competitors, including Microsoft and Apple, may increase their presence in the digital imaging markets Additionally, some 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.

Difficulties in transitions to new business models or markets

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. Many of our competitors may have advantages over us due to their larger presence, 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.

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

Changes in demand for application software, computers and printers

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.

Intellectual property disputes and litigation

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.

Changes to our distribution channel

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. 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 becoming more 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.

Malicious code such as worms and viruses could impact our computer network and applications

Malicious code, such as worms and viruses, are released into the public Internet using recently discovered vulnerabilities in popular software programs. The documents created by our applications, even those with security features, are also vulnerable to malicious acts such as hacking. Although we have a response team that is notified of high-risk malicious events from multiple sources and we take certain preventative measures, these procedures may not be sufficient to avoid harm to our business.

Interruptions or terminations in our relationships with our turnkey assemblers

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

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.

Fluctuations in foreign currency exchange rates

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 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.

Compliance with Sarbanes-Oxley Act of 2002

Under the Sarbanes-Oxley Act of 2002, we are required to assess the effectiveness of our internal controls for financial reporting and assert that such internal controls are effective. Our auditors must conduct an audit to evaluate management's assessment concerning the effectiveness of the internal controls over financial reporting and render an opinion on our assessment and the effectiveness of internal controls over financial reporting. To prepare for compliance with the Sarbanes-Oxley Act of 2002 we have undertaken certain actions including the adoption of an internal plan which includes a timeline and schedule of activities for the evaluation, test and remediation, if necessary, of internal controls. Although we believe that our efforts will enable us to provide the required report and our independent auditors to provide the required attestation as of our fiscal year end, we can give no assurance that such efforts will be completed in a timely manner and on a successful basis. If this were to occur, we may be unable to assert that the internal controls over financial reporting are effective, or our auditors may not be able to render the required attestation concerning our assessment and the effectiveness of the internal controls over financial reporting, which could adversely effect the market price of our common stock.

Changes in accounting rules

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 policies. A change in these policies can have a significant effect on our reported results and may even retroactively affect previously reported transactions. Our accounting policies that recently have been or may be affected by changes in the accounting rules are as follows:

- software revenue recognition
- accounting for stock-based compensation
- accounting for goodwill and other intangible assets
- accounting for guarantees and indemnities
- accounting for variable interest entities
- accounting for business combinations

In particular, FASB guidelines relating to accounting for goodwill could make our acquisition-related charges less predictable in any given reporting period. It is possible that in the future, we may incur less frequent, but larger, impairment charges related to previously recorded goodwill, as well as goodwill arising out of potential future acquisitions. Changes to these rules or current practices may have a significant adverse effect on our reported financial results or in the way in which we conduct our business.

Unanticipated changes in 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 adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our operating results and financial position.

Market risks associated with our equity investments (as discussed later under "Quantitative and Qualitative Disclosures about Market Risk")

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.

Our inability to attract and retain key personnel

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. Potential 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.

Future earnings and stock price may be subject to volatility

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.

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. 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 rules applicable to issuers listed on the Nasdaq National Market. See the "Report of the Executive Compensation Committee" appearing in our Proxy Statement for further information concerning the policies and procedures, of Adobe and the Executive Compensation Committee, regarding the use of stock options.

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 2004 Proxy Statement. This group is referred to as the Named Executive Officers. Please refer to the section headed "Named Executive Officer Option Grants" below for the Named Executive Officers.

Options granted to employees, directors and Named Executive Officers for the nine months ended September 3, 2004 and for fiscal year 2003 are summarized as follows:

	2004	2003
Net grants† during the period as % of outstanding shares	4%	(3)%
Net grants to Named Executive Officers during the period as % of total options granted	9%	0%
Net grants to Named Executive Officers during the period as % of outstanding shares	*%	0%
Cumulative options held by Named Executive Officers as % of total options outstanding	17%	16%

† "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 2003 reflect the cancellation of options under our stock option exchange program. Net grants as a percentage of outstanding shares are based on 236.9 million shares and 238.3 million shares of our common stock outstanding as of September 3, 2004 and November 28, 2003, respectively.

* Less than 1%.

General Option Information

The following table sets forth the summary of option activity under our stock option program for the nine months ended September 3, 2004 and for fiscal year 2003:

	2004			2003		
	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	12,953,370	42,469,653	$ 32.80	5,566,971	57,847,050	$ 35.64
Granted	(10,083,265)	10,083,265	41.74	(1,994,130)	1,994,130	33.12
Exercised	—	(5,499,301)	25.24	—	(7,978,054)	23.81
Canceled	1,089,505	(1,089,505)	40.32	9,388,535	(9,393,473)	58.00
Expired	(9,259)	—	—	(8,006)	—	—
Increased authorization	4,500,000	—	—	—	—	—
End of period	8,450,351	45,964,112	$ 35.49	12,953,370	42,469,653	$ 32.80

The following table sets forth a comparison, as of September 3, 2004, of the number of shares subject to outstanding options with exercise prices at or below the closing price of our common stock on September 3, 2004 ("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):

	Exercisable	Unexercisable	Total	Percentage of Total Options Outstanding
In-the-Money	22,202,267	17,185,540	39,387,807	86%
Out-of-the-Money	6,574,625	1,680	6,576,305	14%
Total Options Outstanding	28,776,892	17,187,220	45,964,112	100%

* The closing price of our common stock was $46.53 on September 3, 2004, as reported by the Nasdaq National Market.

Named Executive Officer Option Grants

The following table sets forth information regarding stock options granted during the nine months ended September 3, 2004, to our Named Executive Officers. 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 shares and dollars)

Name	Number of Securities Underlying Options Granted	% of Total Options Granted to Employees(1) Year-to-Date	Exercise Price	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term	
					5%	10%
Bruce R. Chizen	450,000	4%	$ 43.55	5/19/2011	$ 7,978,151	$ 18,592,483
Shantanu Narayen	150,000	1	43.55	5/19/2011	2,659,384	6,197,494
Murray J. Demo	125,000	1	43.55	5/19/2011	2,216,153	5,164,579
Jim Stephens	100,000	1	43.55	5/19/2011	1,772,922	4,131,663
James Heeger	100,000	1	43.55	5/19/2011	1,772,922	4,131,663

(1) Based on approximately 10.1 million shares subject to options granted to employees under our option plans to date during fiscal 2004.

Stock Option Exercises and Option Holdings

The following table shows stock options exercised by the Named Executive Officers in the nine months ended September 3, 2004, 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 September 3, 2004, 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 September 3, 2004 of our common stock.

(In actual shares and dollars)

Name	Number of Shares Acquired Upon	Value Realized Upon Exercise(1)	Number of Securities Underlying Unexercised Options at September 3, 2004		Value of Unexercised In-the-Money Options at September 3, 2004(2)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Bruce R. Chizen	—	$ —	2,289,697	969,794	$ 18,370,642	$ 11,748,067
Shantanu Narayen	—	—	1,194,465	452,085	10,888,672	6,496,825
Murray J. Demo	—	—	961,830	420,837	7,080,944	6,299,990
Jim Stephens	50,000	677,391	614,165	283,337	4,687,941	3,968,740
James Heeger	50,000	852,655	268,750	331,250	3,128,000	4,182,500

(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) Option values are based on $46.53, the closing price of our common stock on September 3, 2004, as reported by the Nasdaq National Market.

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 September 3, 2004:

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 stockholders	45,964,112	$ 35.49	23,863,631*

* Includes 12.7 million shares that are reserved for issuance under the 1997 Employee Stock Purchase Plan.

LIQUIDITY AND CAPITAL RESOURCES

	September 3, 2004	November 28, 2003	Percent Change
Cash, cash equivalents and short-term investments	$ 1,139.8	$ 1,096.5	4%
Working capital	$ 903.3	$ 892.5	1%
Stockholders' equity	$ 1,225.8	$ 1,100.8	11%

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.

Net cash provided by operating activities was $492.9 million for the nine months ended September 3, 2004, an increase of $188.4 million from the $304.5 million provided for the nine months ended August 29, 2003. Cash provided by operating activities, in the nine months ended September 3, 2004, primarily comprised net income, net of non-cash related expenses. Working capital sources of cash were a decrease in accounts receivable and an increase in accrued expenses. Our days sales outstanding in trade receivables ("DSO") decreased from 37 days at November 28, 2003 to 25 days at September 3, 2004. Our accounts receivable decreased due to increased levels of cash collections. Accrued expenses increased primarily due to compensation costs. Working capital uses of cash included a decrease in income taxes payable due to tax payments made for both agreed and disputed tax assessments.

Net cash used for investing activities was $241.3 million for the nine months ended September 3, 2004, a decrease of $92.5 million from the $333.8 million used in the nine months ended August 29, 2003. Net cash used for investing activities, in the nine months ended September 3, 2004, was primarily due to our investment of $126.8 million in a lease receivable associated with the restructuring of the lease agreement for the East and West towers. See below under "Lease Commitments" for further information. Additionally, we used $15.5 million, net of cash received of $0.3 million, in connection with our acquisition of Q-Link. See Note 2 of our Notes to Condensed Consolidated Financial Statements for further information regarding this acquisition. We expect to continue to invest in short-term investments and purchase additional property and equipment to support our growth.

Net cash used for financing activities was $242.7 million in the nine months ended September 3, 2004, an increase of $230.5 million from the $12.1 million used in the nine months ended August 29, 2003. During the nine months ended September 3, 2004, we repurchased 8.5 million shares as compared to 2.8 million shares during the nine months ended August 29, 2003. Cash used for stock repurchases during fiscal 2004 increased from the same period in fiscal 2003 due to a higher average cost per share, a higher number of shares being repurchased, and remaining prepayments of $53.1 million related to the stock purchase agreements (see Note 7 of our Notes to Condensed Consolidated Financial Statements for further information). The cost of the repurchases was partially offset by proceeds received from employees exercising their stock options. The increase in proceeds received is due to a higher number of options being exercised as well as higher option exercise prices.

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 third quarter of fiscal 2004. 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. The declaration of future dividends, whether in cash or in-kind, is within the discretion of Adobe's Board of Directors and will depend on business conditions, our results of operations and financial condition, and other factors.

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 highly regarded investment management firms to manage most of our invested cash. External investment firms actively managed 90% of Adobe's invested balances during the nine months ended September 3, 2004. 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 2004 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(e) in this filing for share repurchases during the quarter ended September 3, 2004.

During the second and third quarters of fiscal 2004, we entered into several stock purchase agreements with a large financial institution. Under these agreements, we provided the financial institution with up-front payments totaling $150.0 million. The financial institution 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 $150.0 million was classified as treasury stock on our balance sheet. At the expiration of the agreement on October 1, 2004, we received the remaining shares pursuant to the agreement.

During September 2004, we entered into several stock purchase agreements with large financial institutions. Under these agreements, we have provided the financial institutions with up-front payments of $180.0 million and the financial institutions have agreed to deliver to us, at certain intervals during the contract term, a number of our shares based on the volume weighted average price of Adobe stock during such intervals, less a specified discount. These contracts will expire on or before March 24, 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 September 3, 2004 consist of obligations under operating leases, royalty agreements and various service agreements. See Note 8 of our Notes to Condensed Consolidated Financial Statements for more detailed information.

Lease Commitments

The two lease agreements discussed in Note 8 of our Notes to Condensed Consolidated Financial Statements are subject to standard financial covenants. As of September 3, 2004 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 credit or cash in the coming year or restrict our ability to execute our business plan.

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 September 3, 2004, we have $1.6 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 reduces 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 2003, we believe that there have been no significant changes in our market risk exposures for the quarter ended September 3, 2004.

ITEM 4. CONTROLS AND PROCEDURES

Based on their evaluation as of September 3, 2004, 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 September 3, 2004 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

In early 2002, International Typeface Corporation ("ITC") and Agfa Monotype Corporation ("AMT"), companies which have common ownership and management, each charged, by way of informal letters to Adobe, that Adobe's distribution of font software, which generates ITC and AMT typefaces, breaches its contracts with ITC and AMT, respectively, pursuant to which Adobe licensed certain rights with respect to ITC and AMT typefaces. AMT and ITC further charged that Adobe violated the Digital Millennium Copyright Act ("DMCA") with respect to, or induced or contributed to, the infringement of copyrights in, ITC's and AMT's TrueType font software.

On September 4, 2002, Adobe initiated arbitration proceedings in London, England ("the London Arbitration") against AMT, seeking a declaration that Adobe's distribution of font software that generates AMT typefaces did not breach its contract pursuant to which it licensed certain rights with respect to AMT typefaces and, therefore, that AMT did not have the right to terminate the agreement. AMT made certain breach of contract claims in response to Adobe's arbitration demand. On June 28, 2004, the arbitrators held that the contract remains in full force and that AMT does not have the right to terminate it. The arbitrators found in favor of AMT on only one of its three claims, but have not yet ruled on whether AMT is entitled to recover any damages from Adobe on that claim. We believe that a damage award, if any, will not have a material adverse effect on Adobe.

On September 5, 2002, AMT and ITC filed suit against Adobe in the U.S. District Court, Eastern District of Illinois ("the Illinois Action"), asserting only that Adobe's distribution of the superseded 5.0 version of Adobe Acrobat violated the DMCA.

On November 13, 2002, ITC filed another 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.

If ITC prevails on its breach of contract claims in the second Illinois action, ITC may have the right to terminate Adobe's right to distribute any of its products that then still contain font software that generates ITC typefaces. The results of any litigation are inherently uncertain and we cannot assure that we will be able to successfully defend ourselves against the actions described above. AMT and ITC seek an unspecified aggregate dollar amount of damages in the Illinois actions. A favorable outcome for AMT or ITC in these actions could have a material adverse effect on Adobe's consolidated financial position, cash flows or results of operations. We believe that all of AMT's and ITC's remaining claims are without merit and we are vigorously defending against them.

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.

On November 18, 2002, Plaintiffs Shell & Slate Software Corporation and Ben Weiss filed a civil action in the U.S. District Court in Los Angeles against Adobe alleging false designation of origin, trade secret misappropriation, breach of contract and other causes of action. The claim derives from the Plaintiffs' belief that the "healing brush" technique of Adobe Photoshop software incorporates the Plaintiffs' trade secrets. The Plaintiffs seek preliminary and permanent injunctive relief, compensatory, treble and punitive damages and fees and costs. We believe the action has no merit and are vigorously defending against it. On September 9, 2003, Adobe filed a counter-claim against Ben Weiss for breach of contract and misappropriation of trade secrets. Adobe seeks injunctive relief against any use of Adobe's trade secrets. Adobe seeks compensatory, statutory and punitive damages.

On June 2, 2004, Plaintiff Information Technology Innovation, LLC filed suit against Adobe in the U.S. District Court, District of Colorado, alleging infringement of U.S. Patent No. 5,892,908, entitled "Method of Extracting Network Information." The Plaintiff's complaint asserted that Adobe infringes the '908 patent by making, using and selling "Acrobat Standard and Professional products." The plaintiff sought unspecified compensatory damages, injunctive relief, and fees and costs. In September 2004, the Plaintiff dismissed this case with prejudice.

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 these contingencies.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(e) Below is a summary of stock repurchases for the quarter ended September 3, 2004 (in thousands, except average price per share). See Note 7 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase plans.

Plan/Period	Shares Repurchased(1)	Average Price Per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plan
Stock Repurchase Program I			
Beginning shares available to be issued as of June 4, 2004			22,734,512
June 5, 2004 - July 2, 2004			
From employees(2)	137	$ 45.07	
Open market	225,029	43.51	
Structured repurchases	589,306	44.42	
July 3, 2004 - July 30, 2004			
From employees(2)	117	41.59	
Open market	983,948	43.44	
July 31, 2004 - September 3, 2004			
From employees(2)	202	44.06	
Open market	1,622,000	43.24	
Structured repurchases	1,097,445	42.71	
Adjustments to repurchase authority for net dilution	—		2,960,384(3)
Total shares repurchased	4,518,184		(4,518,184)
Ending shares available to be issued as of September 3, 2004			21,176,712(4)

(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 withholding taxes due.

(3) Adjustment of authority to reflect changes in the dilution from outstanding shares and options.

(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

Pursuant to Section 10A(i)(2) of the Securities Exchange Act of 1934, we are responsible for listing the non-audit services approved in the third quarter of 2004 by our Audit Committee to be performed by KPMG LLP, our external auditor. Each of the permitted non-audit services has been pre-approved by the Audit Committee or the Audit Committee's Chairman pursuant to delegated authority by the Audit Committee. During the third quarter of 2004, the Audit Committee pre-approved the following non-audit services anticipated to be performed by KPMG LLP: 1) foreign financial statement review and 2) tax audit and compliance services.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Date	Number	Filed Herewith
3.1	Amended and Restated Bylaws as currently in effect	10-K	02/26/03	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	07/02/93	10.1.6	
10.2	Amended 1994 Performance and Restricted Stock Plan*	10-Q	05/29/98	10.24.2	
10.3	Form of Restricted Stock Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*				X
10.4	1994 Stock Option Plan, as amended*	S-8	05/30/97	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*				X
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	02/26/03	10.37	
10.10	2003 Equity Incentive Plan*	DEF 14A	3/17/03	10.1	
10.11	Forms of Stock Option and Restricted Stock Agreement used in connection with the 2003 Equity Incentive Plan				X
10.12	Form of Indemnity Agreement*	10-Q	05/30/97	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				X
10.15	Credit Agreement among Adobe Systems Incorporated, Lenders named therein and ABN AMRO Bank N.V., as Administrative Agent, with certain related Credit Documents	10-Q	9/3/99	10.54	
10.16	Credit Agreement among Adobe Systems Incorporated, Lenders Named therein and ABN Amro Bank N.V., as Administrative Agent, with Certain Related Credit Documents	10-Q	9/1/00	10.66	

10.17	Lease agreement between Adobe Systems and Selco Service Corporation	10-K	2/21/02	10.77	
10.18	Participation agreement among Adobe Systems, Selco Service Corporation, et al.	10-K	2/21/02	10.78	
10.19	Executive Severance Plan in the Event of a Change of Control*	10-K	2/21/02	10.80	
10.20	Amendment No.1 to Lease Agreement between Adobe and Selco Services Corporation	10-K	02/26/03	10.81	
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†				X
32.2	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934†				X

* Compensatory plan or arrangement

† 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.

(b) Reports on Form 8-K

(i) On June 17, 2004, Adobe filed a report on Form 8-K under Item 12 announcing its financial results for the quarter ended June 4, 2004.

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: October 7, 2004

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.

QuickLinks