ADOBE SYSTEMS INC
Form 10-Q
September 23, 2015

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended August 28, 2015

or

o 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 check mark 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 x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller	Smaller reporting company o

reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No x

The number of shares outstanding of the registrant's common stock as of September 18, 2015 was 498,799,349.

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 par value)

	August 28, 2015 (Unaudited)	November 28, 2014 (*)
ASSETS		
Current assets:		
Cash and cash equivalents	$829,292	$1,117,400
Short-term investments	2,839,441	2,622,091
Trade receivables, net of allowances for doubtful accounts of $7,255 and $7,867, respectively	593,554	591,800
Deferred income taxes	82,438	95,279
Prepaid expenses and other current assets	181,163	175,758
Total current assets	4,525,888	4,602,328
Property and equipment, net	797,464	785,123
Goodwill	5,402,159	4,721,962
Purchased and other intangibles, net	556,810	469,662
Investment in lease receivable	80,439	80,439
Other assets	145,635	126,315
Total assets	$11,508,395	$10,785,829
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	$69,823	$68,377
Accrued expenses	658,342	683,866
Debt and capital lease obligations	—	603,229
Accrued restructuring	1,450	17,120
Income taxes payable	71,487	23,920
Deferred revenue	1,259,712	1,097,923
Total current liabilities	2,060,814	2,494,435
Long-term liabilities:		
Debt	1,906,094	911,086
Deferred revenue	46,317	57,401
Accrued restructuring	3,142	5,194
Income taxes payable	250,569	125,746
Deferred income taxes	316,142	342,315
Other liabilities	83,985	73,747
Total liabilities	4,667,063	4,009,924
Stockholders' equity:		
Preferred stock, $0.0001 par value; 2,000 shares authorized, none issued	—	—
Common stock, $0.0001 par value; 900,000 shares authorized; 600,834 shares issued; 498,705 and 497,484 shares outstanding, respectively	61	61
Additional paid-in-capital	4,094,133	3,778,495

Retained earnings	7,049,629	6,924,294
Accumulated other comprehensive income (loss)	(140,831)	(8,094)
Treasury stock, at cost (102,129 and 103,350 shares, respectively), net of reissuances	(4,161,660)	(3,918,851)
Total stockholders' equity	6,841,332	6,775,905
Total liabilities and stockholders' equity	$11,508,395	$10,785,829

(*) The Condensed Consolidated Balance Sheet as of November 28, 2014 has been derived from the audited Consolidated Financial Statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended		Nine Months Ended	
	August 28, 2015	August 29, 2014	August 28, 2015	August 29, 2014
Revenue:				
Subscription	$829,065	$547,373	$2,316,470	$1,447,630
Products	275,338	349,151	840,650	1,299,852
Services and support	113,365	108,885	331,987	326,255
Total revenue	1,217,768	1,005,409	3,489,107	3,073,737
Cost of revenue:				
Subscription	103,605	86,670	302,826	247,549
Products	24,545	23,172	65,715	75,169
Services and support	62,835	47,882	174,415	138,419
Total cost of revenue	190,985	157,724	542,956	461,137
Gross profit	1,026,783	847,685	2,946,151	2,612,600
Operating expenses:				
Research and development	218,660	212,049	642,216	630,666
Sales and marketing	422,031	406,475	1,241,770	1,243,446
General and administrative	122,578	141,676	397,867	409,798
Restructuring and other charges	(751)	201	1,038	498
Amortization of purchased intangibles	18,246	13,108	50,599	40,012
Total operating expenses	780,764	773,509	2,333,490	2,324,420
Operating income	246,019	74,176	612,661	288,180
Non-operating income (expense):				
Interest and other income (expense), net	4,433	1,454	11,510	7,162
Interest expense	(16,519)	(13,361)	(47,669)	(47,054)
Investment gains (losses), net	(1,314)	669	339	813
Total non-operating income (expense), net	(13,400)	(11,238)	(35,820)	(39,079)
Income before income taxes	232,619	62,938	576,841	249,101
Provision for income taxes	58,154	18,252	169,995	68,842
Net income	$174,465	$44,686	$406,846	$180,259
Basic net income per share	$0.35	$0.09	$0.82	$0.36
Shares used to compute basic net income per share	498,630	498,468	498,891	497,782
Diluted net income per share	$0.34	$0.09	$0.80	$0.35
Shares used to compute diluted net income per share	505,809	507,811	507,124	508,575

See accompanying Notes to Condensed Consolidated Financial Statements.

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ADOBE SYSTEMS INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	August 28, 2015	August 29, 2014	August 28, 2015	August 29, 2014
	Increase/(Decrease)		Increase/(Decrease)	
Net income	$174,465	$44,686	$406,846	$180,259
Other comprehensive income (loss), net of taxes:				
Available-for-sale securities:				
Unrealized gains / losses on available-for-sale securities	(8,334)	(1,822)	(8,275)	1,666
Reclassification adjustment for recognized gains / losses on available-for-sale securities	(570)	(1,592)	(2,130)	(3,480)
Net increase (decrease) from available-for-sale securities	(8,904)	(3,414)	(10,405)	(1,814)
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments	(1,874)	10,003	18,480	11,976
Reclassification adjustment for recognized gains / losses on derivative instruments	(8,899)	(1,075)	(54,478)	(6,490)
Net increase (decrease) from derivatives designated as hedging instruments	(10,773)	8,928	(35,998)	5,486
Foreign currency translation adjustments	8,318	(32,090)	(86,334)	(29,708)
Other comprehensive income (loss), net of taxes	(11,359)	(26,576)	(132,737)	(26,036)
Total comprehensive income, net of taxes	$163,106	$18,110	$274,109	$154,223

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Nine Months Ended	
	August 28, 2015	August 29, 2014
Cash flows from operating activities:		
Net income	$406,846	$180,259
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	253,114	235,443
Stock-based compensation	254,836	248,811
Deferred income taxes	(47,769)	(7,912)
Unrealized (gains) losses on investments	(8,548)	47
Tax benefit from stock-based compensation	58,326	31,883
Excess tax benefits from stock-based compensation	(58,345)	(31,953)
Other non-cash items	260	829
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Trade receivables, net	(104)	71,973
Prepaid expenses and other current assets	(24,453)	13,352
Trade payables	(614)	(8,305)
Accrued expenses	(26,581)	(13,749)
Accrued restructuring	(16,824)	(5,627)
Income taxes payable	83,307	4,952
Deferred revenue	141,536	167,726
Net cash provided by operating activities	1,014,987	887,729
Cash flows from investing activities:		
Purchases of short-term investments	(1,424,288)	(1,412,539)
Maturities of short-term investments	254,020	209,172
Proceeds from sales of short-term investments	931,267	913,308
Acquisitions, net of cash acquired	(826,004)	—
Purchases of property and equipment	(120,260)	(111,557)
Purchases of long-term investments and other assets	(20,853)	(12,496)
Proceeds from sale of long-term investments	3,747	1,364
Net cash used for investing activities	(1,202,371)	(412,748)
Cash flows from financing activities:		
Purchases of treasury stock	(500,000)	(475,000)
Proceeds from issuance of treasury stock	154,759	213,841
Cost of issuance of treasury stock	(176,904)	(163,293)
Excess tax benefits from stock-based compensation	58,345	31,953
Proceeds from debt issuance	989,280	—
Repayment of debt and capital lease obligations	(602,189)	(11,431)
Debt issuance costs	(8,828)	—
Net cash used for financing activities	(85,537)	(403,930)
Effect of foreign currency exchange rates on cash and cash equivalents	(15,187)	(2,278)
Net (decrease) increase in cash and cash equivalents	(288,108)	68,773
Cash and cash equivalents at beginning of period	1,117,400	834,556
Cash and cash equivalents at end of period	$829,292	$903,329

Supplemental disclosures:		
Cash paid for income taxes, net of refunds	$61,546	$7,114
Cash paid for interest	$48,920	$61,562
Non-cash investing activities:		
Issuance of common stock and stock awards assumed in business acquisitions	$677	$—
Investment in lease receivable applied to building purchase	$—	$126,800

See accompanying Notes to Condensed Consolidated Financial Statements.

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ADOBE SYSTEMS INCORPORATED
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

We have prepared the accompanying unaudited Condensed Consolidated Financial Statements pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Pursuant to these rules and regulations, we have condensed or omitted certain information and footnote disclosures we normally include in our annual Consolidated Financial Statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). In management's opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) necessary to fairly present our financial position, results of operations and cash flows. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the Consolidated Financial Statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended November 28, 2014 on file with the SEC (our "Annual Report").

There have been no material changes to our significant accounting policies as compared to the significant accounting policies described in our Annual Report.

Assets Held-For-Sale

Included in property and equipment, net in the Condensed Consolidated Balance sheets as of August 28, 2015 are certain land, with a carrying value of $35.5 million, and an unoccupied building with a net carrying value of $0.8 million, both located in San Jose, California and are classified as held-for-sale. During the second quarter of fiscal 2015, management approved a plan to sell these property assets largely based upon a general lack of operational needs for the building and land, and recent improvements in market conditions for commercial real estate in the area. We began to actively market the assets during the second quarter of fiscal 2015 and finalized the sale of these assets on September 23, 2015.

Recent Accounting Pronouncements Not Yet Effective

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date, which deferred the effective date of the new revenue standard for periods beginning after December 15, 2016 to December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of fiscal 2019. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new standard discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the nine months ended August 28, 2015, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 28, 2014, that are of significance or potential significance to us.

NOTE 2. ACQUISITIONS

On January 27, 2015, we completed our acquisition of privately held Fotolia, a leading marketplace for royalty-free photos, images, graphics and HD videos. During the first quarter of fiscal 2015, we began integrating Fotolia into our Digital Media reportable segment.

Under the acquisition method of accounting, the total preliminary purchase price was allocated to Fotolia's net tangible and intangible assets based upon their estimated fair values as of January 27, 2015. During the nine months ended August 28, 2015, we recorded immaterial purchase accounting adjustments based on changes to management's estimates and assumptions in regards to assumed intangible assets, liabilities and equity awards. The total adjusted preliminary purchase price for Fotolia was $807.5 million of which $747.9 million was allocated to goodwill that was non-deductible for tax purposes, $204.4 million to identifiable intangible assets and $144.8 million to net liabilities assumed. The fair values assigned to assets acquired and liabilities assumed are based on management's best estimates and assumptions as of the reporting date and are considered preliminary pending finalization of valuation analyses pertaining to tax liabilities assumed including calculation of deferred tax assets and liabilities. Pro forma information has not been presented as the impact to our Condensed Consolidated Financial Statements was not material.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3. CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS

Cash equivalents consist of instruments with remaining maturities of three months or less at the date of purchase. We classify all of our cash equivalents and short-term investments as “available-for-sale.” In general, these investments are free of trading restrictions. We carry these investments at fair value, based on quoted market prices or other readily available market information. Unrealized gains and losses, net of taxes, are included in accumulated other comprehensive income, which is reflected as a separate component of stockholders’ equity in our Condensed Consolidated Balance Sheets. Gains and losses are recognized when realized in our Condensed Consolidated Statements of Income. When we have determined that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to a credit loss is recognized in income. Gains and losses are determined using the specific identification method.

Cash, cash equivalents and short-term investments consisted of the following as of August 28, 2015 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$345,625	$—	$—	$345,625
Cash equivalents:				
Money market mutual funds	447,303	—	—	447,303
Time deposits	36,364	—	—	36,364
Total cash equivalents	483,667	—	—	483,667
Total cash and cash equivalents	829,292	—	—	829,292
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,732,496	1,596	(4,891)	1,729,201
Asset-backed securities	67,307	40	(32)	67,315
Municipal securities	164,449	221	(60)	164,610
U.S. agency securities	207,550	182	(3)	207,729
U.S. Treasury securities	670,367	363	(144)	670,586
Total short-term investments	2,842,169	2,402	(5,130)	2,839,441
Total cash, cash equivalents and short-term investments	$3,671,461	$2,402	$(5,130)	$3,668,733

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Cash, cash equivalents and short-term investments consisted of the following as of November 28, 2014 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$348,283	$—	$—	$348,283
Cash equivalents:				
Money market mutual funds	705,978	—	—	705,978
Time deposits	63,139	—	—	63,139
Total cash equivalents	769,117	—	—	769,117
Total cash and cash equivalents	1,117,400	—	—	1,117,400
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,514,632	5,253	(509)	1,519,376
Foreign government securities	4,499	12	—	4,511
Municipal securities	174,775	438	(12)	175,201
U.S. agency securities	497,154	1,295	(64)	498,385
U.S. Treasury securities	423,075	1,080	(28)	424,127
Subtotal	2,614,135	8,078	(613)	2,621,600
Marketable equity securities	153	338	—	491
Total short-term investments	2,614,288	8,416	(613)	2,622,091
Total cash, cash equivalents and short-term investments	$3,731,688	$8,416	$(613)	$3,739,491

See Note 4 for further information regarding the fair value of our financial instruments.

The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category, that have been in an unrealized loss position for less than twelve months, as of August 28, 2015 and November 28, 2014 (in thousands):

	2015		2014	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$1,213,183	$(4,871)	$291,890	$(443)
Asset-backed securities	35,502	(32)	—	—
Municipal securities	24,143	(60)	21,759	(12)
U.S. Treasury and agency securities	345,982	(144)	43,507	(64)
Total	$1,618,810	$(5,107)	$357,156	$(519)

There were 885 securities and 213 securities in an unrealized loss position for less than twelve months at August 28, 2015 and at November 28, 2014, respectively.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category, that were in a continuous unrealized loss position for more than twelve months, as of August 28, 2015 and November 28, 2014 (in thousands):

	2015		2014	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$1,416	$(20)	$8,636	$(66)
U.S. Treasury and agency securities	650	(3)	5,884	(28)
Total	$2,066	$(23)	$14,520	$(94)

There were two securities and eight securities in an unrealized loss position for more than twelve months at August 28, 2015 and at November 28, 2014, respectively.

The following table summarizes the cost and estimated fair value of short-term fixed income securities classified as short-term investments based on stated effective maturities as of August 28, 2015 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	$791,191	$791,528
Due between one and two years	1,036,774	1,036,349
Due between two and three years	761,569	759,576
Due after three years	252,635	251,988
Total	$2,842,169	$2,839,441

We review our debt and marketable equity securities classified as short-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. We consider factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer and our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment’s amortized cost basis. If we believe that an other-than-temporary decline exists in one of these securities, we write down these investments to fair value. For debt securities, the portion of the write-down related to credit loss would be recorded to interest and other income, net in our Condensed Consolidated Statements of Income. Any portion not related to credit loss would be recorded to accumulated other comprehensive income, which is reflected as a separate component of stockholders’ equity in our Condensed Consolidated Balance Sheets. For equity securities, the write-down would be recorded to investment gains (losses), net in our Condensed Consolidated Statements of Income. During the nine months ended August 28, 2015, we did not consider any of our investments to be other-than-temporarily impaired.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4. FAIR VALUE MEASUREMENTS

Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis

We measure certain financial assets and liabilities at fair value on a recurring basis. There have been no transfers between fair value measurement levels during the nine months ended August 28, 2015.

The fair value of our financial assets and liabilities at August 28, 2015 was determined using the following inputs (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	447,303	447,303	—	—
Time deposits	36,364	36,364	—	—
Short-term investments:				
Corporate bonds and commercial paper	1,729,201	—	1,729,201	—
Asset-backed securities	67,315	—	67,315	—
Municipal securities	164,610	—	164,610	—
U.S. agency securities	207,729	—	207,729	—
U.S. Treasury securities	670,586	—	670,586	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	8,162	—	8,162	—
Other assets:				
Deferred compensation plan assets	30,379	531	29,848	—
Interest rate swap derivatives	19,051	—	19,051	—
Total assets	$3,380,700	$484,198	$2,896,502	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$1,914	$—	$1,914	$—
Total liabilities	$1,914	$—	$1,914	$—

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair value of our financial assets and liabilities at November 28, 2014 was determined using the following inputs (in thousands):

		Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	$705,978	$705,978	$—	$—
Time deposits	63,139	63,139	—	—
Short-term investments:				
Corporate bonds and commercial paper	1,519,376	—	1,519,376	—
Foreign government securities	4,511	—	4,511	—
Marketable equity securities	491	491	—	—
Municipal securities	175,201	—	175,201	—
U.S. agency securities	498,385	—	498,385	—
U.S. Treasury securities	424,127	—	424,127	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	32,991	—	32,991	—
Other assets:				
Deferred compensation plan assets	25,745	549	25,196	—
Interest rate swap derivatives	14,268	—	14,268	—
Total assets	$3,464,212	$770,157	$2,694,055	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$663	$—	$663	$—
Total liabilities	$663	$—	$663	$—

See Note 3 for further information regarding the fair value of our financial instruments.
Our fixed income available-for-sale securities consist of high quality, investment grade securities from diverse issuers with a minimum credit rating of BBB and a weighted average credit rating of AA-. We value these securities based on pricing from pricing vendors who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, we classify all of our fixed income available-for-sale securities as having Level 2 inputs. The valuation techniques used to measure the fair value of our financial instruments and derivatives having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques. Our procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources.
Our deferred compensation plan assets consist of prime money market funds and mutual funds.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We also have direct investments in privately held companies accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. If we determine that an other-than-temporary impairment has occurred, we write down the investment to its fair value. We estimate fair value of our cost method investments considering available information such as pricing in recent rounds of financing, current cash positions, earnings and cash flow forecasts, recent operational performance and any other readily available market data. For the three and nine months ended August 28, 2015 and August 29, 2014, we determined there were no other-than-temporary impairments on our cost method investments.

As of August 28, 2015, the carrying value of our lease receivables approximated fair value, based on Level 2 valuation inputs which include Treasury rates, London Interbank Offered Rate ("LIBOR") interest rates and applicable credit spreads. See Note 12 for further details regarding our investment in lease receivable.

The fair value of our senior notes was $2 billion as of August 28, 2015, based on observable market prices in less active markets and categorized as Level 2. See Note 13 for further details regarding our debt.

NOTE 5. DERIVATIVES

Hedge Accounting and Hedging Programs

We recognize all derivative instruments as either assets or liabilities in our Condensed Consolidated Balance Sheets 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.

We evaluate hedge effectiveness on our hedges that are designated and qualify for hedge accounting at the inception of the hedge prospectively as well as retrospectively, and record any ineffective portion of the hedging instruments in interest and other income (expense), net on our Condensed Consolidated Statements of Income. The time value of purchased contracts is recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.

The bank counterparties to these contracts expose us to credit-related losses in the event of their nonperformance which are largely mitigated with collateral security agreements that provide for collateral to be received or posted when the net fair value of certain financial instruments fluctuates from contractually established thresholds. In addition, the Company enters into master netting arrangements which have the ability to further limit credit related losses with the same counterparty by permitting net settlement of transactions. Our hedging policy also establishes maximum limits for each counterparty to mitigate any concentration of risk.

Balance Sheet Hedging—Hedges of Foreign Currency Assets and Liabilities

We hedge our net recognized foreign currency denominated assets and liabilities with foreign exchange forward contracts to reduce the risk that the value of these assets and liabilities will be adversely affected by changes in exchange rates. These contracts hedge assets and liabilities that are denominated in foreign currencies and are carried at fair value as either assets or liabilities on the Condensed Consolidated Balance Sheet with changes in the fair value recorded to interest and other income (expense), net in our Condensed Consolidated Statements of Income. These contracts do not subject us to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being hedged.

Cash Flow Hedging—Hedges of Forecasted Foreign Currency Revenue and Interest Rate Risk

In countries outside the U.S., we transact business in U.S. Dollars and in various other currencies. We may use foreign exchange option contracts or forward contracts to hedge certain cash flow exposures resulting from changes in these foreign currency exchange rates. These foreign exchange contracts, carried at fair value, have maturities of up to twelve months. We enter into these foreign exchange contracts to hedge a portion of our forecasted foreign currency denominated revenue in the normal course of business and accordingly, they are not speculative in nature.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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To receive hedge accounting treatment, all hedging relationships are formally documented at the inception of the hedge, and the hedges must be highly effective in offsetting changes to future cash flows on hedged transactions. We record changes in the intrinsic value of these cash flow hedges in accumulated other comprehensive income in our Condensed Consolidated Balance Sheets, 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 to interest and other income (expense), net in our Condensed Consolidated Statements of Income at that time. If we do not elect hedge accounting, or the contract does not qualify for hedge accounting treatment, the changes in fair value from period to period are recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.
In December 2014, prior to issuing new long-term fixed rate debt, we entered into an interest rate lock agreement on a notional amount of $600 million to hedge against the variability of future interest payments due to changes in the benchmark interest rate. This instrument was designated as a cash flow hedge. Upon issuance of our $1 billion of 3.25% senior notes due February 1, 2025 (the “2025 Notes”) in January 2015, we terminated the instrument and incurred a loss of $16.2 million. This loss is recorded in the stockholders’ equity section in our Condensed Consolidated Balance Sheets in accumulated other comprehensive income and will be reclassified to interest expense over a ten-year term consistent with the impact of the hedged item. See Note 13 for further details regarding our debt.

Fair Value Hedging - Hedges of Interest Rate Risk

During the third quarter of fiscal 2014, we entered into interest rate swaps designated as fair value hedges related to our $900 million of 4.75% fixed interest rate senior notes due February 1, 2020 (the “2020 Notes”). The interest rate swaps effectively convert the fixed interest rate on our 2020 Notes to a floating interest rate based on LIBOR. Under the terms of the swaps, we will pay monthly interest at the one-month LIBOR interest rate plus a fixed number of basis points on the $900 million notional amount through February 1, 2020. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 13 for further details regarding our debt.

The interest rate swaps are accounted for as fair value hedges and substantially offset the changes in fair value of the hedged portion of the underlying debt that are attributable to the changes in market risk. Therefore, the gains and losses related to changes in the fair value of the interest rate swaps are included in interest and other income (expense), net in our Condensed Consolidated Statement of Income. The fair value of the interest rate swaps is reflected as either an asset or liability in our Condensed Consolidated Balance Sheets.

The fair value of derivative instruments on our Condensed Consolidated Balance Sheets as of August 28, 2015 and November 28, 2014 were as follows (in thousands):

	2015		2014	
	Fair Value Asset Derivatives	Fair Value Liability Derivatives	Fair Value Asset Derivatives	Fair Value Liability Derivatives
Derivatives designated as hedging instruments:				
Foreign exchange option contracts[(1) (3)]	$6,952	$—	$31,275	$—
Interest rate swap [(2)]	19,051	—	14,268	—
Derivatives not designated as hedging instruments:				

Foreign exchange forward contracts [1]	1,210	1,914	1,716	663
Total derivatives	$27,213	$1,914	$47,259	$663

(1) Included in prepaid expenses and other current assets and accrued expenses for asset derivatives and liability derivatives, respectively, on our Condensed Consolidated Balance Sheets.

(2) Included in other assets or other liabilities on our Condensed Consolidated Balance Sheets.

(3) Hedging effectiveness expected to be recognized into income within the next twelve months.

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(Unaudited)

The effect of foreign currency derivative instruments designated as cash flow hedges and of foreign currency derivative instruments not designated as hedges in our Condensed Consolidated Statements of Income for the three and nine months ended August 28, 2015 was as follows (in thousands):

	Three Months		Nine Months	
	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax[(1)]	$(1,874)	$—	$28,509	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[(2)]	9,146	—	55,068	—
Net gain (loss) recognized in income[(3)]	$(3,933)	$—	$(11,074)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[(4)]	$—	$628	$—	$4,703

The effect of foreign currency derivative instruments designated as cash flow hedges and of foreign currency derivative instruments not designated as hedges in our Condensed Consolidated Statements of Income for the three and nine months ended August 29, 2014 was as follows (in thousands):

	Three Months		Nine Months	
	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax[(1)]	$10,003	$—	$11,976	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[(2)]	$1,075	$—	$6,490	$—
Net gain (loss) recognized in income[(3)]	$(4,676)	$—	$(11,871)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[(4)]	$—	$(1,575)	$—	$(855)

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(1) Net change in the fair value of the effective portion classified in other comprehensive income ("OCI").
(2) Effective portion classified as revenue.
(3) Ineffective portion and amount excluded from effectiveness testing classified in interest and other income (expense), net.
(4) Classified in interest and other income (expense), net.

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of August 28, 2015 and November 28, 2014 was $5.40 billion and $4.72 billion, respectively. The increase was primarily due to our acquisition of Fotolia and was offset in part by foreign currency translation adjustments. During the second quarter of fiscal 2015, we completed our annual goodwill impairment test associated with our reporting units and determined there was no impairment of goodwill.

Purchased and other intangible assets subject to amortization as of August 28, 2015 and November 28, 2014 were as follows (in thousands):

	2015			2014		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	$393,820	$(282,737)	$111,083	$405,208	$(264,697)	$140,511
Customer contracts and relationships	$510,956	$(188,484)	$322,472	$376,994	$(143,330)	$233,664
Trademarks	87,050	(44,035)	43,015	67,268	(36,516)	30,752
Acquired rights to use technology	144,202	(95,147)	49,055	148,836	(86,258)	62,578
Localization	1,300	(684)	616	549	(382)	167
Other intangibles	36,535	(5,966)	30,569	3,163	(1,173)	1,990
Total other intangible assets	$780,043	$(334,316)	$445,727	$596,810	$(267,659)	$329,151
Purchased and other intangible assets, net	$1,173,863	$(617,053)	$556,810	$1,002,018	$(532,356)	$469,662

Amortization expense related to purchased and other intangible assets was $46.3 million and $131.6 million for the three and nine months ended August 28, 2015, respectively. Comparatively, amortization expense related to purchased and other intangible assets was $39.1 million and $115.1 million for the three and nine months ended August 29, 2014. Of these amounts $27.7 million and $80.0 million were included in cost of sales for the three and nine months ended August 28, 2015, respectively, and $26.0 million and $75.1 million for the three and nine months ended August 29, 2014.

As of August 28, 2015, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2015	$14,526	$28,425
2016	31,229	108,276
2017	23,868	98,147
2018	16,866	87,206
2019	10,096	60,636
Thereafter	14,498	63,037
Total expected amortization expense	$111,083	$445,727

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NOTE 7. ACCRUED EXPENSES

Accrued expenses as of August 28, 2015 and November 28, 2014 consisted of the following (in thousands):

	2015	2014
Accrued compensation and benefits	$287,310	$320,679
Sales and marketing allowances	59,194	75,627
Accrued corporate marketing	47,926	28,369
Taxes payable	19,825	24,658
Royalties payable	19,762	15,073
Accrued interest expense	7,761	22,621
Other	216,564	196,839
Accrued expenses	$658,342	$683,866

Other primarily includes general corporate accruals and local and regional expenses. Other is also comprised of deferred rent related to office locations with rent escalations and foreign currency liability derivatives.

NOTE 8. STOCK-BASED COMPENSATION

Summary of Restricted Stock Units

Restricted stock unit activity for the nine months ended August 28, 2015 and the fiscal year ended November 28, 2014 was as follows (in thousands):

	2015	2014
Beginning outstanding balance	13,564	17,948
Awarded	3,670	4,413
Released	(6,242)	(7,502)
Forfeited	(704)	(1,295)
Ending outstanding balance	10,288	13,564

Information regarding restricted stock units outstanding at August 28, 2015 and August 29, 2014 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2015			
Restricted stock units outstanding	10,288	1.10	$816.9
Restricted stock units vested and expected to vest	9,320	1.03	$730.3
2014			
Restricted stock units outstanding	13,845	1.12	$995.5
Restricted stock units vested and expected to vest	12,367	1.05	$882.4

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market values as of August 28, 2015 and August 29, 2014 were $79.40 and $71.90, respectively.

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Summary of Performance Shares

On January 26, 2015, our Executive Compensation Committee approved the 2015 Performance Share Program, including the award calculation methodology, under the terms of our 2003 Equity Incentive Plan. Under our 2015 Performance Share Program ("2015 Program"), shares may be earned based on the achievement of an objective relative total stockholder return measured over a three-year performance period. The purpose of the 2015 Program is to help focus key employees on building stockholder value, provide significant award potential for achieving outstanding Company performance and enhance the ability of the Company to attract and retain highly talented and competent individuals. Performance share awards will be awarded and fully vest upon the Executive Compensation Committee's certification of the level of achievement following the three-year anniversary of the grant date on January 24, 2018. Participants in the 2015 Program generally have the ability to receive up to 200% of the target number of shares originally granted.

On January 24, 2014, our Executive Compensation Committee approved the 2014 Performance Share Program, including the award calculation methodology, under the terms of our 2003 Equity Incentive Plan. Under our 2014 Performance Share Program ("2014 Program"), shares may be earned based on the achievement of an objective relative total stockholder return measured over a three-year performance period. The purpose of the 2014 Program is to help focus key employees on building stockholder value, provide significant award potential for achieving outstanding company performance and enhance the ability of the Company to attract and retain highly talented and competent individuals. Performance share awards will be awarded and fully vest upon the Executive Compensation Committee's certification of the level of achievement following the three-year anniversary of the grant date on January 24, 2017. Participants in the 2014 Program generally have the ability to receive up to 200% of the target number of shares originally granted.

Effective January 24, 2013, our Executive Compensation Committee modified our Performance Share Program by eliminating the use of qualitative performance objectives, with 100% of shares to be earned based on the achievement of an objective relative total stockholder return measured over a three-year performance period. Performance awards were granted under the 2013 Performance Share Program ("2013 Program") pursuant to the terms of our 2003 Equity Incentive Plan. The purpose of the 2013 Program is to align key management and senior leadership with stockholders' interests over the long term and to retain key employees. Performance share awards will be awarded and fully vest upon the Executive Compensation Committee's certification of the level of achievement following the three-year anniversary of the grant date on January 24, 2016. Participants in the 2013 Program generally have the ability to receive up to 200% of the target number of shares originally granted.

As of August 28, 2015, the shares awarded under our 2015, 2014, and 2013 Performance Share Programs are yet to be achieved. The following table sets forth the summary of performance share activity under our 2015, 2014, and 2013 Performance Share Programs for the nine months ended August 28, 2015 and the fiscal year ended November 28, 2014 (in thousands):

	2015		2014	
	Shares Granted	Maximum Shares Eligible to Receive	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	1,517	3,034	854	1,707
Awarded	671	1,342	709	1,417
Forfeited	(101)	(201)	(46)	(90)
Ending outstanding balance	2,087	4,175	1,517	3,034

The following table sets forth the summary of performance share activity under our performance share programs prior to fiscal 2013, based upon share awards actually achieved, for the nine months ended August 28, 2015 and the fiscal year ended November 28, 2014 (in thousands):

	2015	2014
Beginning outstanding balance	354	861
Released	(354)	(486)
Forfeited	—	(21)
Ending outstanding balance	—	354

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Information regarding performance shares outstanding at August 29, 2014 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2014			
Performance shares outstanding	354	0.41	$25.4
Performance shares vested and expected to vest	339	0.41	$24.2

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market value as of August 29, 2014 was $71.90.

Summary of Stock Options

There were no option grants during the nine months ended August 28, 2015 and the nine months ended August 29, 2014. Option activity for the nine months ended August 28, 2015 and the fiscal year ended November 28, 2014 was as follows (in thousands):

	2015	2014
Beginning outstanding balance	3,173	7,359
Exercised	(1,557)	(4,055)
Cancelled	(32)	(153)
Increase due to acquisition	88	22
Ending outstanding balance	1,672	3,173

Information regarding stock options outstanding at August 28, 2015 and August 29, 2014 is summarized below:

	Number of Shares (thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2015				
Options outstanding	1,672	$28.14	2.72	$85.7
Options vested and expected to vest	1,659	$28.26	2.70	$84.9
Options exercisable	1,539	$29.64	2.44	$76.6
2014				
Options outstanding	3,640	$28.98	3.33	$156.2
Options vested and expected to vest	3,610	$29.08	3.31	$154.5
Options exercisable	3,056	$30.26	2.99	$127.3

(*) The intrinsic value is calculated as the difference between the market value as of the end of the fiscal period and the exercise price of the shares. As reported by the NASDAQ Global Select Market, the market values as of

August 28, 2015 and August 29, 2014 were $79.40 and $71.90, respectively.

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Summary of Employee Stock Purchase Plan Shares

The expected life of the ESPP shares is the average of the remaining purchase periods under each offering period. The assumptions used to value employee stock purchase rights during the nine months ended August 28, 2015 and August 29, 2014 were as follows:

	Three Months		Nine Months	
	2015	2014	2015	2014
Expected life (in years)	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0
Volatility	26 - 27%	26 - 27%	26 - 30%	26 - 28%
Risk free interest rate	0.11 - 0.64%	0.06 - 0.47%	0.11 - 0.67%	0.06 - 0.47%

Employees purchased 2.1 million shares at an average price of $52.37 and 2.9 million shares at an average price of $34.76 for the nine months ended August 28, 2015 and August 29, 2014, respectively. The intrinsic value of shares purchased during the nine months ended August 28, 2015 and August 29, 2014 was $54.0 million and $93.4 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of purchase and the purchase price of the shares.

Compensation Costs

As of August 28, 2015, there was $464.3 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock-based awards which will be recognized over a weighted average period of 1.7 years. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Total stock-based compensation costs included in our Condensed Consolidated Statements of Income for the three months ended August 28, 2015 and August 29, 2014 were as follows (in thousands):

	2015		2014	
Income Statement Classifications	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$258	$1,637	$458	$1,451
Cost of revenue—services and support	1,277	1,425	1,064	1,666
Research and development	3,468	26,378	4,151	26,100
Sales and marketing	4,540	29,146	4,492	25,447
General and administrative	1,056	16,792	1,682	16,502
Total	$10,599	$75,378	$11,847	$71,166

Total stock-based compensation costs included in our Condensed Consolidated Statements of Income for the nine months ended August 28, 2015 and August 29, 2014 were as follows (in thousands):

	2015		2014	
Income Statement Classifications	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$1,070	$4,946	$1,424	$4,261

Cost of revenue—services and support	3,897	4,711	2,759	4,886
Research and development	11,162	78,375	12,397	78,567
Sales and marketing	13,768	84,686	13,571	76,541
General and administrative	3,652	50,744	4,962	49,443
Total	$33,549	$223,462	$35,113	$213,698

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NOTE 9. RESTRUCTURING CHARGES

Fiscal 2014 Restructuring Plan

In the fourth quarter of fiscal 2014, in order to better align our global resources for Digital Media and Digital Marketing, we initiated a restructuring plan to vacate our Research and Development facility in China and our Sales and Marketing facility in Russia. This plan consisted of reductions of approximately 350 full-time positions and we recorded restructuring charges of approximately $21.0 million through the third quarter of fiscal 2015 related to ongoing termination benefits for the positions eliminated. The amount accrued for the fair value of future contractual obligations under these operating leases was insignificant. During the first quarter of fiscal 2015 we vacated both of these facilities and as of August 28, 2015 we consider the Fiscal 2014 Restructuring Plan to be substantially complete.

Other Restructuring Plans

During the past several years, we have implemented Other Restructuring Plans consisting of reductions in workforce and the consolidation of facilities to better align our resources around our business strategies. As of August 28, 2015, we considered our Other Restructuring Plans to be substantially complete. We continue to make cash outlays to settle obligations under these plans, however the current impact to our Condensed Consolidated Financial Statements is not significant.

Summary of Restructuring Plans

The following table sets forth a summary of restructuring activities related to all of our restructuring plans during the nine months ended August 28, 2015 (in thousands):

	November 28, 2014	Costs Incurred	Cash Payments	Other Adjustments	August 28, 2015
Fiscal 2014 Restructuring Plan:					
Termination benefits	$14,461	$773	$(16,455)	$1,287	$66
Cost of closing redundant facilities	472	—	(417)	(55)	—
Other Restructuring Plans:					
Termination benefits	537	—	(120)	(303)	114
Cost of closing redundant facilities	6,844	—	(870)	(1,562)	4,412
Total restructuring plans	$22,314	$773	$(17,862)	$(633)	$4,592

Accrued restructuring charges of $4.6 million as of August 28, 2015 includes $1.5 million recorded in accrued restructuring, current and $3.1 million related to long-term facilities obligations recorded in accrued restructuring, non-current on our Condensed Consolidated Balance Sheets. We expect to pay accrued termination benefits through fiscal 2016 and facilities-related liabilities under contract through fiscal 2021 of which approximately 34% will be paid through fiscal 2016.

NOTE 10. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the nine months ended August 28, 2015 were as follows (in thousands):

Balance as of November 28, 2014	$6,924,294
Net income	406,846
Re-issuance of treasury stock	(281,511)
Balance as of August 28, 2015	$7,049,629

We account for treasury stock under the cost method. When treasury stock is re-issued at a price higher than its cost, the difference is recorded as a component of additional paid-in-capital in our Condensed Consolidated Balance Sheets.

When treasury stock is re-issued at a price lower than its cost, the difference is recorded as a component of additional paid-in-capital to the extent

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that there are treasury stock gains to offset the losses. If there are no treasury stock gains in additional paid-in-capital, the losses upon re-issuance of treasury stock are recorded as a reduction of retained earnings in our Condensed Consolidated Balance Sheets.

The components of accumulated other comprehensive income (loss) and activity, net of related taxes, as of August 28, 2015 were as follows (in thousands):

	November 28, 2014	Increase / Decrease	Reclassification Adjustments	August 28, 2015
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	$ 8,237	$(3,565)	$ (2,323)	$2,349
Unrealized losses on available-for-sale securities	(609)	(4,710)	193	(5,126)
Total net unrealized gains on available-for-sale securities	7,628	(8,275)	(2,130) (1)	(2,777)
Net unrealized gains / losses on derivative instruments designated as hedging instruments	28,655	18,480	(54,478) (2)	(7,343)
Cumulative foreign currency translation adjustments	(44,377)	(86,334)	—	(130,711)
Total accumulated other comprehensive income (loss), net of taxes	$ (8,094)	$(76,129)	$ (56,608)	$(140,831)

(1) Reclassification adjustments for gains / losses on available-for-sale securities are classified in interest and other income (expense), net.

(2) Reclassification adjustments for loss on the interest rate lock agreement and gains / losses on other derivative instruments are classified in interest and other income (expense), net and revenue, respectively.

The following table sets forth the taxes related to each component of other comprehensive income (loss) for the three and nine months ended August 28, 2015 and August 29, 2014 (in thousands):

	Three Months		Nine Months	
	2015	2014	2015	2014
Available-for-sale securities:				
Unrealized gains / losses	$30	$68	$(126)	$37
Reclassification adjustments	—	(3)	—	(6)
Subtotal available-for-sale securities	30	65	(126)	31
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments*	—	—	6,147	—
Reclassification adjustments*	(152)	—	(362)	—
Subtotal derivatives designated as hedging instruments	(152)	—	5,785	—
Foreign currency translation adjustments	(8)	(1,577)	(2,439)	(474)
Total taxes, other comprehensive income (loss)	$(130)	$(1,512)	$3,220	$(443)

(*) Taxes related to derivative instruments other than the interest rate lock agreement were zero based on the tax jurisdiction where these derivative instruments were executed.

Stock Repurchase Program

To facilitate our stock repurchase program, designed to return value to our stockholders and minimize dilution from stock issuances, we may repurchase shares in the open market or enter into structured repurchase agreements with third parties. In the first quarter of fiscal 2015, the Board of Directors approved a new stock repurchase program granting the Company authority to repurchase up to $2 billion in common stock through the end of fiscal 2017. During the nine months ended August 28, 2015 and August 29, 2014, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling $500 million and $475

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million, respectively. Of the $500 million prepayments during the nine months ended August 28, 2015, $300 million was under the new $2 billion stock repurchase program and the remaining $200 million was under the previous $2 billion authority. The prepayment of $475 million for the nine months ended August 29, 2014 was under the previous $2 billion authority. We enter into these agreements in order to take advantage of repurchasing shares at a guaranteed discount to the Volume Weighted Average Price (“VWAP”) of our common stock over a specified period of time. We only enter into such transactions when the discount that we receive is higher than the foregone return on our cash prepayments to the financial institutions. There were no explicit commissions or fees on these structured repurchases. Under the terms of the agreements, there is no requirement for the financial institutions to return any portion of the prepayment to us.

The financial institutions agree to deliver shares to us at monthly intervals during the contract term. The parameters used to calculate the number of shares deliverable are: the total notional amount of the contract, the number of trading days in the contract, the number of trading days in the interval and the average VWAP of our stock during the interval less the agreed upon discount. During the nine months ended August 28, 2015, we repurchased approximately 6.7 million shares at an average price of $75.93 through structured repurchase agreements entered into during fiscal 2014 and the nine months ended August 28, 2015. During the nine months ended August 29, 2014, we repurchased approximately 9.0 million shares at an average price of $62.42 through structured repurchase agreements entered into during fiscal 2013 and the nine months ended August 29, 2014.

For the nine months ended August 28, 2015, the prepayments were classified as treasury stock on our Condensed Consolidated Balance Sheets at the payment date, though only shares physically delivered to us by August 28, 2015 were excluded from the computation of earnings per share. As of August 28, 2015, $34.9 million of prepayment remained under this agreement.

Subsequent to August 28, 2015, as part of our $2 billion stock repurchase program, we entered into a structured stock repurchase agreement with a large financial institution whereupon we provided them with a prepayment of $125 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the $125 million stock repurchase agreement, $1.575 billion remains under our current authority.

NOTE 11. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three and nine months ended August 28, 2015 and August 29, 2014 (in thousands, except per share data):

	Three Months		Nine Months	
	2015	2014	2015	2014
Net income	$174,465	$44,686	$406,846	$180,259
Shares used to compute basic net income per share	498,630	498,468	498,891	497,782
Dilutive potential common shares:				
Unvested restricted stock and performance share awards	6,298	7,558	7,145	8,611
Stock options	881	1,785	1,088	2,182
Shares used to compute diluted net income per share	505,809	507,811	507,124	508,575
Basic net income per share	$0.35	$0.09	$0.82	$0.36
Diluted net income per share	$0.34	$0.09	$0.80	$0.35

For the three and nine months ended August 28, 2015 and August 29, 2014, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of $81.07 and $77.14, respectively, and $70.49 and $65.15, respectively, that would have been anti-dilutive.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12. COMMITMENTS AND CONTINGENCIES

Lease Commitments

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. We own the land and the East and West Tower buildings, and lease the Almaden Tower building.

The lease agreement for the Almaden Tower is effective through March 2017. We are the investors in the lease receivable related to the Almaden Tower lease in the amount of $80.4 million, which is recorded as investment in lease receivable on our Condensed Consolidated Balance Sheets. As of August 28, 2015, the carrying value of the lease receivable related to the Almaden Tower approximated fair value. Under the agreement for the Almaden Tower, we have the option to purchase the building at any time during the lease term for $103.6 million. If we purchase the building, the investment in the lease receivables may be credited against the purchase price. The residual value guarantee under the Almaden Tower obligation is $89.4 million.

The Almaden Tower lease is subject to standard covenants including certain financial ratios that are reported to the lessor quarterly. As of August 28, 2015, we were in compliance with all of the covenants. In the case of a default, the lessor may demand we purchase the building for an amount equal to the lease balance, or require that we remarket or relinquish the building. If we choose to remarket or are required to do so upon relinquishing the building, we are bound to arrange the sale of the building 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 residual value guarantee amount less our investment in lease receivable. The Almaden Tower lease qualifies for operating lease accounting treatment and, as such, the building and the related obligation are not included in our Condensed Consolidated Balance Sheets.

Royalties

We have royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit sold or a percentage of the underlying revenue.

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 and from time to time, we are subject to claims by our customers under these indemnification provisions. 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.

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

Legal Proceedings

In connection with disputes relating to the validity or alleged infringement of third-party intellectual property rights, including 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 may be 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. Third-party intellectual property disputes could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from licensing certain of our products or offering certain of our services, subject us to injunctions restricting our sale of products or services, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements and service agreements.

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Between May 4, 2011 and July 14, 2011, five putative class action lawsuits were filed in Santa Clara Superior Court and Alameda Superior Court in California. On September 12, 2011, the cases were consolidated into In Re High-Tech Employee Antitrust Litigation (“HTEAL”) pending in the United States District Court for the Northern District of California, San Jose Division. In the consolidated complaint, Plaintiffs alleged that Adobe, along with Apple, Google, Intel, Intuit, Lucasfilm and Pixar, agreed not to recruit each other's employees in violation of Federal and state antitrust laws. Plaintiffs claim the alleged agreements suppressed employee compensation and deprived employees of career opportunities. Plaintiffs seek injunctive relief, monetary damages, treble damages, costs and attorneys fees.

All defendants deny the allegations and that they engaged in any wrongdoing of any kind. On October 24, 2013, the court certified a class of all persons who worked in the technical, creative, and/or research and development fields on a salaried basis in the United States for one or more of the following: (a) Apple from March 2005 through December 2009; (b) Adobe from May 2005 through December 2009; (c) Google from March 2005 through December 2009; (d) Intel from March 2005 through December 2009; (e) Intuit from June 2007 through December 2009; (f) Lucasfilm from January 2005 through December 2009; or (g) Pixar from January 2005 through December 2009, excluding retail employees, corporate officers, members of the boards of directors, and senior executives of all defendants. During the first quarter of fiscal 2015, the parties reached an agreement to settle the litigation. In March 2015, the court granted preliminary approval of the settlement and on September 2, 2015, the court granted final approval of the settlement. We expect to incur no additional losses associated with this matter.

In addition to intellectual property disputes, we are subject to legal proceedings, claims and investigations in the ordinary course of business, including claims relating to commercial, employment and other matters. Some of these disputes and legal proceedings may include speculative claims for substantial or indeterminate amounts of damages. We consider all claims on a quarterly basis in accordance with GAAP and based on known facts assess whether potential losses are considered reasonably possible, probable and estimable. Based upon this assessment, we then evaluate disclosure requirements and whether to accrue for such claims in our financial statements. This determination is then reviewed and discussed with our Audit Committee and our independent registered public accounting firm.

We make 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. Unless otherwise specifically disclosed in this note, we have determined that no provision for liability nor disclosure is required related to any claim against us because: (a) there is not a reasonable possibility that a loss exceeding amounts already recognized (if any) may be incurred with respect to such claim; (b) a reasonably possible loss or range of loss cannot be estimated; or (c) such estimate is immaterial.

All legal costs associated with litigation are expensed as incurred. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to the legal matters pending against us. It is possible, nevertheless, that our consolidated financial position, cash flows or results of operations could be negatively affected by an unfavorable resolution of one or more of such proceedings, claims or investigations.

In connection with our anti-piracy efforts, conducted both internally and through organizations such as the Business Software Alliance, 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 laws. 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 negatively affected in any particular period by the resolution of one or more of these counter-claims.

NOTE 13. DEBT

Notes

In February 2010, we issued $600 million of 3.25% senior notes due February 1, 2015 (the “2015 Notes”) and $900 million of 4.75% senior notes due February 1, 2020 (the “2020 Notes”). Our proceeds were $1.5 billion and were net of an issuance discount of $6.6 million. In addition, we incurred issuance costs of $10.7 million. Both the discount and issuance costs were or are being amortized to interest expense over the respective terms of the 2015 and 2020 Notes using the effective interest method. The 2015 and 2020 Notes rank equally with our other unsecured and unsubordinated indebtedness. The effective interest rate including the discount and issuance costs was 3.45% for the 2015 Notes and is 4.92% for the 2020 Notes. Interest is payable semi-

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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annually, in arrears, on February 1 and August 1, and commenced on August 1, 2010. The 2015 Notes were settled on February 1, 2015, as discussed below.

In June 2014, we entered into interest rate swaps with a total notional amount of $900 million designated as a fair value hedge related to our 2020 Notes. The interest rate swaps effectively convert the fixed interest rate on our 2020 Notes to a floating interest rate based on LIBOR plus a fixed number of basis points. Under the terms of the swap, we will pay monthly interest at the one-month LIBOR floating interest rate plus a spread of a fixed number of basis points on the $900 million notional amount. In exchange, we will receive 4.75% fixed rate interest from the swap counterparties. See Note 5 for further details regarding our interest rate swap derivatives.

In December 2014, prior to issuing new long-term fixed rate debt, we entered into an interest rate lock agreement on a notional amount of $600 million to hedge against the variability of future interest payments due to changes in the benchmark interest rate. This instrument was designated as a cash flow hedge. See Note 5 for further details regarding our interest rate lock agreement.

In January 2015, we issued $1 billion of 3.25% senior notes due February 1, 2025 (the “2025 Notes”). Our proceeds were approximately $989.3 million which is net of an issuance discount of $10.7 million. In addition, we incurred issuance costs of $7.9 million. Both the discount and issuance costs are being amortized to interest expense over the term of the 2025 Notes using the effective interest method. The 2025 Notes rank equally with our other unsecured and unsubordinated indebtedness. The effective interest rate including the discount, issuance costs and interest rate agreement is 3.67% for the 2025 Notes. Interest is payable semi-annually, in arrears on February 1 and August 1, commencing on August 1, 2015. A portion of the proceeds from this offering was used to repay $600 million in aggregate principal amount of the 2015 Notes plus accrued and unpaid interest due February 1, 2015. The remaining proceeds were used for general corporate purposes.

As of August 28, 2015, our outstanding notes payable consists of the 2020 Notes and 2025 Notes (the “Notes”) with a total carrying value of $1.9 billion. Based on quoted prices in inactive markets, the fair value of the Notes was $2 billion as of August 28, 2015. The total fair value of $2 billion excludes the effect of fair value hedge of the 2020 Notes for which we entered into interest rate swaps as described above.

We may redeem the Notes at any time, subject to a make-whole premium. In addition, upon the occurrence of certain change of control triggering events, we may be required to repurchase the Notes, at a price equal to 101% of their principal amount, plus accrued and unpaid interest to the date of repurchase. The Notes also include covenants that limit our ability to grant liens on assets and to enter into sale and leaseback transactions, subject to significant allowances. As of August 28, 2015, we were in compliance with all of the covenants.

In February 2015, we made semi-annual interest payments on our 2015 and 2020 Notes totaling $31.1 million. In August 2015, we made semi-annual interest payments on our 2020 and 2025 Notes totaling $38.1 million.

Credit Agreement

On March 2, 2012, we entered into a five-year $1 billion senior unsecured revolving credit agreement (the “Credit Agreement”), providing for loans to us and certain of our subsidiaries. Pursuant to the terms of the Credit Agreement, we may, subject to the agreement of the applicable lenders, request up to an additional $500 million in commitments, for a maximum aggregate commitment of $1.5 billion. Loans under the Credit Agreement will bear interest at either (i) LIBOR plus a margin, based on our public debt ratings, ranging from 0.795% and 1.30% or (ii) the base rate, which is defined as the highest of (a) the agent’s prime rate, (b) the federal funds effective rate plus 0.50% or (c) LIBOR plus 1.00% plus a margin, based on our debt ratings, ranging from 0.00% to 0.30%. Commitment fees are payable quarterly at rates between 0.08% and 0.20% per year, also based on our debt ratings. Subject to certain conditions stated in the Credit Agreement, we and any of our subsidiaries designated as additional borrowers may borrow, prepay and re-borrow amounts under the revolving credit facility at any time during the term of the Credit Agreement.

The Credit Agreement contains customary representations, warranties, affirmative and negative covenants, including a financial covenant, events of default and indemnification provisions in favor of the lenders. The negative covenants include restrictions regarding the incurrence of liens and indebtedness, certain merger and acquisition transactions, dispositions and other

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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matters, all subject to certain exceptions. The financial covenant, based on a quarterly financial test, requires us not to exceed a maximum leverage ratio.

On March 1, 2013, we exercised an option under the Credit Agreement to extend the maturity date of the Credit Agreement by one year to March 2, 2018.

On July 27, 2015, we entered into an amendment to further extend the maturity date of the Credit Agreement to July 27, 2020 and reallocated the facility among the syndicate of lenders that are parties to the Credit Agreement.

The facility will terminate and all amounts owing thereunder will be due and payable on the maturity date unless (a) the commitments are terminated earlier upon the occurrence of certain events, including an event of default, or (b) the maturity date is further extended upon our request, subject to the agreement of the lenders.

As of August 28, 2015, there were no outstanding borrowings under this Credit Agreement and we were in compliance with all covenants.

NOTE 14. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three and nine months ended August 28, 2015 and August 29, 2014 included the following (in thousands):

	Three Months		Nine Months	
	2015	2014	2015	2014
Interest and other income (expense), net:				
Interest income	$7,394	$5,274	$20,527	$15,649
Foreign exchange gains (losses)	(3,690)	(5,094)	(11,930)	(12,160)
Realized gains on fixed income investment	639	1,047	2,323	2,971
Realized losses on fixed income investment	(69)	(13)	(193)	(49)
Other	159	240	783	751
Interest and other income (expense), net	$4,433	$1,454	$11,510	$7,162
Interest expense	$(16,519)	$(13,361)	$(47,669)	$(47,054)
Investment gains (losses), net:				
Realized investment gains	$578	$145	$2,588	$878
Unrealized investment gains	—	524	—	989
Realized investment losses	—	—	(146)	(1,054)
Unrealized investment losses	(1,892)	—	(2,103)	—
Investment gains (losses), net	$(1,314)	$669	$339	$813
Non-operating income (expense), net	$(13,400)	$(11,238)	$(35,820)	$(39,079)

NOTE 15. SEGMENTS

We report segment information based on the "management" approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of our reportable segments.

Our CEO, the chief operating decision maker, reviews revenue and gross margin information for each of our reportable segments, but does not review operating expenses on a segment by segment basis. In addition, with the exception of goodwill and intangible assets, we do not identify or allocate our assets by the reportable segments.

We have the following reportable segments:

- Digital Media—Our Digital Media segment provides tools and solutions that enable individuals, small and medium businesses and enterprises to create, publish, promote and monetize their digital content anywhere. Our customers

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

include traditional content creators, web application developers and digital media professionals, as well as their management in marketing departments and agencies, companies and publishers. Our customers also include knowledge workers who create, collaborate and distribute documents.

- Digital Marketing—Our Digital Marketing segment provides solutions and services for how digital advertising and marketing are created, managed, executed, measured and optimized. Our customers include digital marketers, advertisers, publishers, merchandisers, web analysts, chief marketing officers, chief information officers and chief revenue officers.
- Print and Publishing—Our Print and Publishing segment addresses market opportunities ranging from the diverse authoring and publishing needs of technical and business publishing to our legacy type and OEM printing businesses.

Our segment results for the three and nine months ended August 28, 2015 and August 29, 2014 were as follows (dollars in thousands):

	Digital Media		Digital Marketing		Print and Publishing		Total	
Three months ended August 28, 2015								
Revenue	$769,627		$402,530		$45,611		$1,217,768	
Cost of revenue	56,508		132,401		2,076		190,985	
Gross profit	$713,119		$270,129		$43,535		$1,026,783	
Gross profit as a percentage of revenue	93	%	67	%	95	%	84	%
Three months ended August 29, 2014								
Revenue	$621,459		$336,575		$47,375		$1,005,409	
Cost of revenue	38,711		117,053		1,960		157,724	
Gross profit	$582,748		$219,522		$45,415		$847,685	
Gross profit as a percentage of revenue	94	%	65	%	96	%	84	%

	Digital Media		Digital Marketing		Print and Publishing		Total	
Nine months ended August 28, 2015								
Revenue	$2,219,875		$1,126,161		$143,071		$3,489,107	
Cost of revenue	151,546		384,709		6,701		542,956	
Gross profit	$2,068,329		$741,452		$136,370		$2,946,151	
Gross profit as a percentage of revenue	93	%	66	%	95	%	84	%
Nine months ended August 29, 2014								
Revenue	$1,954,137		$981,363		$138,237		$3,073,737	
Cost of revenue	112,861		340,943		7,333		461,137	
Gross profit	$1,841,276		$640,420		$130,904		$2,612,600	
Gross profit as a percentage of revenue	94	%	65	%	95	%	85	%

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

The following discussion 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, future growth, market opportunities, strategic initiatives, industry positioning, revenue growth, customer acquisition, the amount of recurring revenue and revenue growth, each of which involve risks and uncertainties that could cause actual results to differ materially from these forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Risk Factors" in Part II, Item 1A of this report. You should carefully review the risks described herein and in other documents we file from time to time with the U.S. Securities and Exchange Commission ("the SEC"), including our Annual Report on Form 10-K for fiscal 2014. When used in this report, the words "will," "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "estimates," "looks for," "looks to," similar expressions, as well as statements regarding our 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, except as required by law.

BUSINESS OVERVIEW

Founded in 1982, Adobe Systems Incorporated is one of the largest and most diversified software companies in the world. We offer a line of products and services used by creative professionals, marketers, knowledge workers, application developers, enterprises and consumers for creating, managing, delivering, measuring, optimizing and engaging with compelling content and experiences across multiple operating systems, devices and media. We market and license our products and services directly to enterprise customers through our sales force and to end users through app stores and our own website at www.adobe.com. We offer many of our products via a Software-as-a-Service ("SaaS") model or a managed services model (both of which are referred to as a hosted or cloud-based model) as well as through term subscription and pay-per-use models. We also distribute certain products and services through a network of distributors, value-added resellers ("VARs"), systems integrators, independent software vendors ("ISVs"), retailers and original equipment manufacturers ("OEMs"). In addition, we license our technology to hardware manufacturers, software developers and service providers for use in their products and solutions. Our products run on personal and server-based computers, as well as on smartphones, tablets and other devices, depending on the product. We have operations in the Americas, Europe, Middle East and Africa ("EMEA") and Asia-Pacific ("APAC").

Adobe was originally incorporated in California in October 1983 and was reincorporated in Delaware in May 1997. We maintain executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Our telephone number is 408-536-6000 and our website is www.adobe.com. Investors can obtain copies of our SEC filings from this site free of charge, as well as from the SEC website at www.sec.gov. The information posted to our website is not incorporated into this Quarterly Report on Form 10-Q.

OPERATIONS OVERVIEW

For our third quarter of fiscal 2015, we reported financial results consistent with the continued execution of our long-term plans for our two strategic growth areas, Digital Media and Digital Marketing, while continuing to market and license a broad portfolio of products and solutions.

In our Digital Media segment, we are a market leader with Adobe Creative Cloud, our subscription-based offering for creating and publishing content and applications. Creative Cloud, first delivered in May 2012, is our next-generation offering that supersedes our historical model of licensing our creative products with perpetual licenses. Creative Cloud delivers value through more frequent product updates, storage and access to user files stored in the cloud with syncing of files across users' machines, social and community-based features with our Behance service, app creation capabilities and lower entry point pricing for cost-sensitive customers.

We offer Creative Cloud for individuals and for teams, and we enable larger enterprise customers to acquire Creative Cloud capabilities through Enterprise Term License Agreements ("ETLAs"). The three Creative Cloud offerings address the multiple routes to market we use to license our creative software to targeted customers. Adoption of Creative Cloud has transformed our business model, and we continue to expect this to drive higher long-term revenue growth through an expansion of our customer base by acquiring new users through a lower cost of entry and delivery of additional features and value, as well as keeping existing customers current on our latest release. We have also built out a marketplace for Creative Cloud subscribers, most notably with our acquisition of Fotolia in January of 2015, to enable the delivery and purchase of stock assets in our new service called Adobe Stock. Overall, our strategy with Creative Cloud enables us to increase our revenue with users, attract more new customers, and shift our revenue to be more recurring and predictable as revenue is recognized ratably.

We continue to implement strategies that will accelerate awareness, consideration and purchase of subscriptions to our Creative Cloud offering. These strategies include increasing the value Creative Cloud users receive such as offering new mobile applications, as well as targeted promotions and offers that attract past customers and potential users to try out and ultimately subscribe to Creative Cloud. Because of the shift towards Creative Cloud subscriptions and ETLAs, perpetual revenue for older Creative products has continued to decline, and revenue from perpetual licensing of these products was immaterial for the first three quarters of fiscal 2015.

We are also a market leader with our Document Cloud offerings built around our Acrobat family of products, the Adobe Reader and a set of integrated cloud-based document services. Adobe Acrobat provides for the reliable creation and exchange of electronic documents, regardless of platform or application source type. In the second quarter of fiscal 2015, we delivered the next generation of this offering called Adobe Document Cloud, which we believe enhances the way people manage critical documents at home, in the office and across devices. Adobe Document Cloud includes an all-new Adobe Acrobat DC, a set of integrated services which enables users to create, review, approve, sign and track documents whether on a desktop or mobile device. Acrobat DC, with a touch-enabled user interface, is licensed both via subscription and perpetual pricing.

Annualized Recurring Revenue ("ARR") is currently our key performance metric to assess the health and trajectory of our overall Digital Media segment. ARR should be viewed independently of revenue, deferred revenue and unbilled deferred revenue as ARR is a performance metric and is not intended to be combined with any of these items. We plan to adjust our reported ARR on an annual basis to reflect any material exchange rates changes. We calculate ARR as follows:

Creative ARR	(# of Creative Cloud Subscriptions) x (Average Revenue Per Subscription Per Month) x 12 + Annual Digital Publishing Suite Contract Value + Annual Creative ETLA Contract Value
Document Cloud ARR	Annual Value of Acrobat Subscriptions and Document Cloud Services + Annual Acrobat ETLA Contract Value
Digital Media ARR	Creative ARR + Document Cloud ARR

Total Creative ARR exiting the third quarter of fiscal 2015 was $2.29 billion, up from $1.61 billion at the end of fiscal 2014. We exited the third quarter of fiscal 2015 with 5.334 million paid Creative Cloud subscriptions, up 54% from 3.458 million at the end of fiscal 2014. In addition, net new subscriptions of 684 thousand added in the third quarter of fiscal 2015 grew 36% year-over-year when compared to net new subscriptions added in the third quarter of fiscal 2014. Our paid Creative Cloud subscriptions and ARR reported in the third quarter of fiscal 2015 reflect favorable adjustments due to an issue which caused retail point-of-sale units to be underreported over the prior three quarters. The adjustments added approximately 40 thousand net new subscriptions and $7 million in ARR over the period of the fourth quarter of fiscal 2014 through the second quarter of fiscal 2015.

Digital Media revenue in the second and third quarters of fiscal 2015 benefited from our acquisition of Fotolia, a leading marketplace for photos, images, graphics and video. We closed the acquisition in January 2015, and in June 2015 we launched Adobe Stock to simplify the buying and selling of stock content as part of the creative process.

Our Digital Media segment also includes our Document Cloud products and solutions, including our newly released Acrobat DC product which helped grow Document Cloud ARR to $357.0 million exiting the third quarter fiscal 2015, up from $265.0 million at the end of fiscal 2014.

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Total Digital Media ARR grew to $2.65 billion at the end of the third quarter of fiscal 2015, up from $1.88 billion at the end of fiscal 2014, demonstrating the progress we have made with the transformation of our business to a more recurring, ratable and predictable revenue model. Our reported ARR results in the third quarter of fiscal 2015 are based on currency rates set at the start of fiscal 2015 and held constant throughout the year.

We are a market leader in the fast-growing category addressed by our Digital Marketing segment. Our Adobe Marketing Cloud now includes eight solutions which address the expanding needs of marketers. In the third quarter of fiscal 2015, we achieved record Marketing Cloud revenue of $368.4 million, which represents 27% year-over-year revenue growth. In addition, we drove strong demand for our Marketing Cloud solutions, which we expect will positively benefit revenue growth in future quarters.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America ("GAAP") and pursuant to the rules and regulations of the SEC, we make assumptions, judgments and estimates that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. 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. We also discuss our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition, business combinations, goodwill impairment and income taxes have the greatest potential impact on our Condensed Consolidated Financial Statements. These areas are key components of our results of operations and are based on complex rules requiring us to make judgments and estimates, so we consider these to be our critical accounting policies. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results.

There have been no significant changes in our critical accounting policies and estimates during the nine months ended August 28, 2015, as compared to the critical accounting policies and estimates disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended November 28, 2014.

Recent Accounting Pronouncements Not Yet Effective

On May 28, 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date, which deferred the effective date of the new revenue standard for periods beginning after December 15, 2016 to December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of fiscal 2019. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new standard discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the nine months ended August 28, 2015, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 28, 2014, that are of significance or potential significance to us.

RESULTS OF OPERATIONS

Financial Performance Summary for the Third Quarter of Fiscal 2015

- During the three months ended August 28, 2015, our subscription revenue as a percentage of total revenue increased to 68% compared to 54% in the year-ago period as we transitioned more of our business to a subscription-based model.

- Total Digital Media ARR of approximately $2.65 billion as of August 28, 2015 increased by $769 million, or 41%, from $1.88 billion as of November 28, 2014. The change in our Digital Media ARR is primarily due to increases in the number of paid Creative Cloud individual and team subscriptions and continued adoption of our ETLAs, and to a

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lesser extent, the adoption of our Document Cloud offering through our ETLAs and increase in Document Cloud subscriptions.

- Adobe Marketing Cloud revenue of $368.4 million during the three months ended August 28, 2015 increased by $78.3 million, or 27% compared with the year-ago period. The increase was primarily due to continued adoption of our Adobe Experience Manager ("AEM") offering and increases in Adobe Campaign and Adobe Analytics revenue.

- Our total deferred revenue of $1.31 billion as of August 28, 2015 increased by $150.7 million, or 13%, from $1.16 billion as of November 28, 2014 primarily due to increases in Creative Cloud individual and team subscriptions, ETLAs and new contracts and existing renewals for our Adobe Marketing Cloud services. Also contributing to the increase in deferred revenue were the increases associated with our stock photography offering from the acquisition of Fotolia during the first quarter of fiscal 2015.

- Cost of revenue of $191.0 million during the three months ended August 28, 2015 increased by $33.3 million, or 21% compared with the year-ago period, primarily due to increased royalty costs including royalty payments related to our stock photography offering and amortization of intangibles from Fotolia acquired during the first quarter of fiscal 2015. Also contributing to the increase in cost of revenue were the increases in data center costs and costs associated with compensation and related benefits driven by additional headcount.

- Operating expenses of $780.8 million during the three months ended August 28, 2015 remained relatively stable compared with the year-ago period. The increase in operating expenses due to increases in costs associated with compensation and related benefits driven by additional headcount were offset by decreases in operating expenses due to the HTEAL loss contingency reversal and timing of charitable contributions made to the Adobe Foundation.

- Net income of $174.5 million during the three months ended August 28, 2015 increased by $129.8 million, or 290% compared with the year-ago period primarily due to revenue increases.

- Net cash flow from operations of $1,015.0 million during the nine months ended August 28, 2015 increased by $127.3 million, or 14%, compared to the nine months ended August 29, 2014 primarily due to higher net income coupled with increases in income taxes payable, offset in part by increases in trade receivables associated with higher revenues and invoice timing.

Revenue for the Three and Nine Months Ended August 28, 2015 and August 29, 2014 (dollars in millions)

	Three Months			Nine Months		
	2015	2014	% Change	2015	2014	% Change
Subscription	$829.1	$547.4	51 %	$2,316.5	$1,447.6	60 %
Percentage of total revenue	68 %	54 %		66 %	47 %	
Product	275.3	349.1	(21)%	$840.6	$1,299.8	(35)%
Percentage of total revenue	23 %	35 %		24 %	42 %	
Services and support	113.4	108.9	4 %	332.0	326.3	2 %
Percentage of total revenue	9 %	11 %		10 %	11 %	
Total revenue	$1,217.8	$1,005.4	21 %	$3,489.1	$3,073.7	14 %

Our subscription revenue is comprised primarily of fees we charge for our subscription and hosted service offerings including Creative Cloud and certain of our Adobe Marketing Cloud and Document Cloud services. We recognize subscription revenue ratably over the term of agreements with our customers, beginning on the commencement of the service. We expect our subscription revenue will continue to increase as a result of our investments in new SaaS and subscription models.

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As described in Note 15 of our Notes to Condensed Consolidated Financial Statements, we have the following segments: Digital Media, Digital Marketing and Print and Publishing. Subscription revenue by reportable segment for the three and nine months ended August 28, 2015 and August 29, 2014 are as follows (dollars in millions):

	Three Months			Nine Months		
	2015	2014	% Change	2015	2014	% Change
Digital Media	$588.3	$342.1	72 %	$1,606.3	$862.7	86 %
Digital Marketing	235.2	202.4	16 %	694.8	578.1	20 %
Print and Publishing	5.6	2.9	*	15.4	6.8	*
Total subscription revenue	$829.1	$547.4	51 %	$2,316.5	$1,447.6	60 %

(*) Percentage is not meaningful.

Our services and support revenue is comprised of consulting, training and maintenance and support, primarily related to the licensing of our enterprise, developer and platform products and the sale of our hosted Adobe Marketing Cloud services. Our support revenue also includes technical support and developer support to partners and developer organizations related to our desktop products. Our maintenance and support offerings, which entitle customers to receive desktop product upgrades and enhancements or technical support, depending on the offering, are generally recognized ratably over the term of the arrangement.

Segment Information (dollars in millions)

	Three Months			Nine Months		
	2015	2014	% Change	2015	2014	% Change
Digital Media	$769.7	$621.4	24 %	$2,219.9	$1,954.1	14 %
Percentage of total revenue	63 %	62 %		64 %	64 %	
Digital Marketing	402.5	336.6	20 %	1,126.1	981.4	15 %
Percentage of total revenue	33 %	33 %		32 %	32 %	
Print and Publishing	45.6	47.4	(4)%	143.1	138.2	3 %
Percentage of total revenue	4 %	5 %		4 %	4 %	
Total revenue	$1,217.8	$1,005.4	21 %	$3,489.1	$3,073.7	14 %

Digital Media

Revenue from Digital Media increased $148.3 million and $265.8 million during the three and nine months ended August 28, 2015, as compared to the three and nine months ended August 29, 2014 primarily driven by increases in revenue associated with our creative offerings. Document Cloud revenue remained stable during the three and nine months ended August 28, 2015 as compared to the three and nine months ended August 29, 2014.

Revenue associated with our creative offerings, which includes our Creative Cloud and perpetual creative offerings, increased during the three and nine months ended August 28, 2015, as compared to the three and nine months ended August 29, 2014, primarily due to the increase in subscription revenue associated with our Creative Cloud offerings driven by the increase in number of paid Creative Cloud individual and team subscriptions. Also contributing to the increase in our revenue associated with our creative offerings are the increases in revenue associated with our Creative Cloud Photography Plan subscription offering. The increases associated with our creative products were offset in part by expected declines in revenue associated with our other perpetual creative offerings and distribution of third-party software downloads.

Document Cloud revenue, which includes our Acrobat product family, remained stable during the three and nine months ended August 28, 2015 as compared to the year ago period, as increases in revenue associated with eSign and our Document Cloud subscription offering were offset by decreases in revenue associated with our Document Cloud perpetual license offerings. Driving the increase in our Document Cloud subscription revenue was the adoption of our cloud offering through subscriptions and ETLAs.

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Digital Marketing

Revenue from Digital Marketing increased $65.9 million and $144.7 million during the three and nine months ended August 28, 2015, as compared to the three and nine months ended August 29, 2014 primarily due to continued revenue growth associated with our Adobe Marketing Cloud, which increased 27% and 20% during the three and nine months ended August 28, 2015, as compared to the year-ago period. Contributing to this increase were the continued adoption of our AEM term-based offering, and to a lesser extent, increases in revenue associated with Adobe Campaign, Adobe Analytics and Adobe Target.

Print and Publishing

Revenue from Print and Publishing remained stable during the three and nine months ended August 28, 2015 as compared to the three and nine months ended August 29, 2014.

Geographical Information (dollars in millions)

	Three Months			Nine Months		
	2015	2014	% Change	2015	2014	% Change
Americas	$698.1	$582.0	20 %	$2,011.9	$1,697.8	19 %
Percentage of total revenue	57 %	58 %		58 %	55 %	
EMEA	350.1	275.2	27 %	981.1	871.6	13 %
Percentage of total revenue	29 %	27 %		28 %	28 %	
APAC	169.6	148.2	14 %	496.1	504.3	(2)%
Percentage of total revenue	14 %	15 %		14 %	17 %	
Total revenue	$1,217.8	$1,005.4				