

ADOBE SYSTEMS INC
Form 10-Q
June 29, 2016

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

FORM 10-Q
(Mark One)

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

For the quarterly period ended June 3, 2016

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

For the transition period from _____ to _____

Commission File Number: 0-15175

ADOBE SYSTEMS INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware 77-0019522
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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 No
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 No

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

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reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No
The number of shares outstanding of the registrant's common stock as of June 24, 2016 was 498,290,892.

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)

	June 3, 2016 (Unaudited)	November 27, 2015 (*)
ASSETS		
Current assets:		
Cash and cash equivalents	\$886,379	\$876,560
Short-term investments	3,432,029	3,111,524
Trade receivables, net of allowances for doubtful accounts of \$5,723 and \$7,293, respectively	666,736	672,006
Prepaid expenses and other current assets	253,420	161,802
Total current assets	5,238,564	4,821,892
Property and equipment, net	796,077	787,421
Goodwill	5,444,556	5,366,881
Purchased and other intangibles, net	494,193	510,007
Investment in lease receivable	80,439	80,439
Other assets	162,954	159,832
Total assets	\$12,216,783	\$11,726,472
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	\$75,582	\$93,307
Accrued expenses	661,013	679,884
Income taxes payable	15,774	6,165
Deferred revenue	1,633,221	1,434,200
Total current liabilities	2,385,590	2,213,556
Long-term liabilities:		
Debt	1,918,389	1,907,231
Deferred revenue	48,411	51,094
Income taxes payable	273,221	256,129
Deferred income taxes	245,611	208,209
Other liabilities	96,950	88,673
Total liabilities	4,968,172	4,724,892
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; 498,972 and 497,809 shares outstanding, respectively	61	61
Additional paid-in-capital	4,428,270	4,184,883
Retained earnings	7,444,115	7,253,431
Accumulated other comprehensive income (loss)	(133,047)	(169,080)
Treasury stock, at cost (101,862 and 103,025 shares, respectively), net of reissuances	(4,490,788)	(4,267,715)
Total stockholders' equity	7,248,611	7,001,580
Total liabilities and stockholders' equity	\$12,216,783	\$11,726,472

The Condensed Consolidated Balance Sheet as of November 27, 2015 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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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 3, 2016	May 29, 2015	June 3, 2016	May 29, 2015
Revenue:				
Subscription	\$1,083,708	\$773,963	\$2,153,958	\$1,487,405
Product	196,500	274,538	397,612	565,312
Services and support	118,501	113,657	230,474	218,622
Total revenue	1,398,709	1,162,158	2,782,044	2,271,339
Cost of revenue:				
Subscription	115,399	103,694	222,674	199,221
Product	15,756	21,467	36,055	41,170
Services and support	70,924	60,012	141,922	111,580
Total cost of revenue	202,079	185,173	400,651	351,971
Gross profit	1,196,630	976,985	2,381,393	1,919,368
Operating expenses:				
Research and development	232,484	208,047	469,688	423,556
Sales and marketing	462,789	426,998	937,680	819,739
General and administrative	138,596	130,208	285,531	275,289
Restructuring and other charges	(466	) 34	(885	) 1,789
Amortization of purchased intangibles	18,988	18,081	37,382	32,353
Total operating expenses	852,391	783,368	1,729,396	1,552,726
Operating income	344,239	193,617	651,997	366,642
Non-operating income (expense):				
Interest and other income (expense), net	6,083	3,739	10,270	7,077
Interest expense	(17,174	) (16,605	) (35,643	) (31,150
Investment gains (losses), net	(3,318	) 223	(4,487	) 1,653
Total non-operating income (expense), net	(14,409	) (12,643	) (29,860	) (22,420
Income before income taxes	329,830	180,974	622,137	344,222
Provision for income taxes	85,756	33,481	123,756	111,841
Net income	\$244,074	\$147,493	\$498,381	\$232,381
Basic net income per share	\$0.49	\$0.30	\$1.00	\$0.47
Shares used to compute basic net income per share	499,974	499,290	499,534	499,022
Diluted net income per share	\$0.48	\$0.29	\$0.99	\$0.46
Shares used to compute diluted net income per share	504,725	505,582	505,666	507,061

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 3, 2016	May 29, 2015	June 3, 2016	May 29, 2015
	Increase/(Decrease)		Increase/(Decrease)	
Net income	\$244,074	\$147,493	\$498,381	\$232,381
Other comprehensive income (loss), net of taxes:				
Available-for-sale securities:				
Unrealized gains / losses on available-for-sale securities	20,250	876	18,623	59
Reclassification adjustment for recognized gains / losses on available-for-sale securities	(1,070)	(633)	(1,114)	(1,560)
Net increase (decrease) from available-for-sale securities	19,180	243	17,509	(1,501)
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments	(2,433)	8,144	(4,144)	20,354
Reclassification adjustment for recognized gains / losses on derivative instruments	(3,373)	(21,953)	(6,308)	(45,580)
Net increase (decrease) from derivatives designated as hedging instruments	(5,806)	(13,809)	(10,452)	(25,226)
Foreign currency translation adjustments	5,259	(12,096)	28,976	(94,652)
Other comprehensive income (loss), net of taxes	18,633	(25,662)	36,033	(121,379)
Total comprehensive income, net of taxes	\$262,707	\$121,831	\$534,414	\$111,002

See accompanying Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 3, 2016		May 29, 2015	
Cash flows from operating activities:				
Net income	\$ 498,381		\$ 232,381	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation, amortization and accretion	165,661		165,564	
Stock-based compensation	177,879		168,860	
Deferred income taxes	50,853		(25,431))
Unrealized losses (gains) on investments, net	5,387		(9,963))
Tax benefit from stock-based compensation	65,286		44,721	
Excess tax benefits from stock-based compensation	(65,289)	)	(44,739))
Other non-cash items	(875)	)	(702))
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:				
Trade receivables, net	8,622		91,267	
Prepaid expenses and other current assets	(103,044)	)	(27,307))
Trade payables	(18,723)	)	(13,763))
Accrued expenses	(14,490)	)	(51,199))
Income taxes payable	24,872		60,994	
Deferred revenue	191,722		63,816	
Net cash provided by operating activities	986,242		654,499	
Cash flows from investing activities:				
Purchases of short-term investments	(1,126,282))	(679,378))
	366,442		174,139	

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Maturities of short-term investments			
Proceeds from sales of short-term investments	450,187		661,182
Acquisitions, net of cash acquired	(48,427)	)	(805,979)
Purchases of property and equipment	(99,959)	)	(71,276)
Purchases of long-term investments and other assets	(52,563)	)	(17,954)
Proceeds from sale of long-term investments	255		1,986
Net cash used for investing activities	(510,347)	)	(737,280)
Cash flows from financing activities:			
Purchases of treasury stock	(375,000)	)	(400,000)
Proceeds from issuance of treasury stock	52,285		71,169
Cost of issuance of treasury stock	(207,833)	)	(161,955)
Excess tax benefits from stock-based compensation	65,289		44,739
Proceeds from debt issuance	—		989,280
Repayment of debt and capital lease obligations	(21)	)	(602,189)
Debt issuance costs	—		(7,871)
Net cash used for financing activities	(465,280)	)	(66,827)
Effect of foreign currency exchange rates on cash and cash equivalents	(796)	)	(11,645)
Net increase (decrease) in cash and cash equivalents	9,819		(161,253)
Cash and cash equivalents at beginning of period	876,560		1,117,400
Cash and cash equivalents at end of period	\$ 886,379		\$ 956,147
Supplemental disclosures:			
	\$ 33,943		\$ 20,208

Cash paid for income taxes, net of refunds				
Cash paid for interest	\$	33,946	\$	23,806
Non-cash investing activities:				
Issuance of common stock and stock awards assumed in business acquisitions	\$	—	\$	677

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 27, 2015 on file with the SEC (our “Annual Report”).

Fiscal Year

Our fiscal year is a 52- or 53-week year that ends on the Friday closest to November 30. Our financial results for the six months ended June 3, 2016 benefited from an extra week in the first quarter of fiscal 2016 due to our 52/53 week financial calendar whereby fiscal 2016 is a 53-week year compared with fiscal 2015 which was a 52-week year.

Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Cash Flows.

Significant Accounting Policies

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

Recent Accounting Pronouncements Not Yet Effective

On May 28, 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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.

On February 24, 2016, the FASB issued ASU No. 2016-02, Leases, requiring lessees to recognize a right-of-use asset and a lease liability on the balance sheet for all leases with the exception of short-term leases. For lessees, leases will continue to be classified as either operating or finance leases in the income statement. Lessor accounting is similar to the current model but updated to align with certain changes to the lessee model. Lessors will continue to classify leases as operating, direct financing or sales-type leases. The effective date of the new standard for public companies is for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition and requires application of the new guidance at the beginning of the earliest comparative period presented. The updated standard is effective for us beginning in the first quarter of fiscal 2020. We are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

On March 30, 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies various aspects related to the accounting and presentation of share-based payments. The amendments require entities to record all tax effects related to share-based payments at settlement or expiration

through the income statement and the windfall tax benefit to be recorded when it arises, subject to normal valuation allowance considerations. All tax-related cash flows

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

resulting from share-based payments are required to be reported as operating activities in the statement of cash flows. The updates relating to the income tax effects of the share-based payments including the cash flow presentation must be adopted either prospectively or retrospectively. Further, the amendments allow the entities to make an accounting policy election to either estimate forfeitures or recognize forfeitures as they occur. If an election is made, the change to recognize forfeitures as they occur must be adopted using a modified retrospective approach with a cumulative effect adjustment recorded to opening retained earnings. The effective date of the new standard for public companies is for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. The updated standard is effective for us beginning in the first quarter of fiscal 2018. Early adoption is permitted. 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 standards discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the six months ended June 3, 2016, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015, that are of significance or potential significance to us.

NOTE 2. ACQUISITIONS

We completed an immaterial acquisition during the three and six months ended June 3, 2016.

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 final purchase price was allocated to Fotolia's net tangible and intangible assets based upon their estimated fair values as of January 27, 2015. The total final purchase price for Fotolia was \$807.5 million of which \$745.1 million was allocated to goodwill that was non-deductible for tax purposes, \$204.4 million to identifiable intangible assets and \$142.0 million to net liabilities assumed.

Pro forma information has not been presented for these acquisitions 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 June 3, 2016 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	\$283,680	\$ —	\$ —	\$283,680
Cash equivalents:				
Corporate bonds and commercial paper	10,997	—	—	10,997
Money market mutual funds	576,242	—	—	576,242
Time deposits	15,460	—	—	15,460
Total cash equivalents	602,699	—	—	602,699
Total cash and cash equivalents	886,379	—	—	886,379
Short-term fixed income securities:				
Asset-backed securities	97,655	290	(3	) 97,942
Corporate bonds and commercial paper	2,111,343	12,609	(881	) 2,123,071
Foreign government securities	1,277	4	—	1,281
Municipal securities	140,958	165	(49	) 141,074
U.S. agency securities	58,107	87	—	58,194
U.S. Treasury securities	1,009,734	893	(160	) 1,010,467
Total short-term investments	3,419,074	14,048	(1,093	) 3,432,029
Total cash, cash equivalents and short-term investments	\$4,305,453	\$ 14,048	\$ (1,093) \$4,318,408

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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 27, 2015 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	\$352,371	\$ —	\$ —	\$352,371
Cash equivalents:				
Money market mutual funds	482,479	—	—	482,479
Municipal securities	1,850	—	(1)	1,849
Time deposits	13,461	—	—	13,461
U.S. Treasury securities	26,400	—	—	26,400
Total cash equivalents	524,190	—	(1)	524,189
Total cash and cash equivalents	876,561	—	(1)	876,560
Short-term fixed income securities:				
Asset-backed securities	83,449	11	(146)	83,314
Corporate bonds and commercial paper	1,890,253	2,273	(5,612)	1,886,914
Foreign government securities	1,276	—	(8)	1,268
Municipal securities	137,280	101	(49)	137,332
U.S. agency securities	130,397	85	(14)	130,468
U.S. Treasury securities	873,400	101	(1,273)	872,228
Total short-term investments	3,116,055	2,571	(7,102)	3,111,524
Total cash, cash equivalents and short-term investments	\$3,992,616	\$ 2,571	\$ (7,103)	\$3,988,084

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 June 3, 2016 and November 27, 2015 (in thousands):

	2016		2015	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	\$249,383	\$ (608)	\$1,112,883	\$ (5,377)
Asset-backed securities	8,090	(3)	60,057	(147)
Municipal securities	59,541	(45)	35,594	(50)
Foreign government securities	—	—	1,268	(8)
U.S. Treasury and agency securities	305,013	(160)	820,570	(1,287)
Total	\$622,027	\$ (816)	\$2,030,372	\$ (6,869)

There were 245 securities and 914 securities in an unrealized loss position for less than twelve months at June 3, 2016 and at November 27, 2015, 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 June 3, 2016 and November 27, 2015 (in thousands):

	2016		2015	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	\$51,656	\$ (273)	\$30,218	\$ (233)
Municipal securities	1,185	(4)	1,300	(1)
Total	\$52,841	\$ (277)	\$31,518	\$ (234)

There were 37 securities and 15 securities in an unrealized loss position for more than twelve months at June 3, 2016 and at November 27, 2015, 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 June 3, 2016 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	\$1,075,024	\$1,075,472
Due between one and two years	1,228,003	1,230,460
Due between two and three years	725,076	729,900
Due after three years	390,971	396,197
Total	\$3,419,074	\$3,432,029

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 six months ended June 3, 2016, 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 six months ended June 3, 2016.

The fair value of our financial assets and liabilities at June 3, 2016 was determined using the following inputs (in thousands):

	Fair Value Measurements at Reporting Date			
	Using	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Total	(Level 1)	(Level 2)	(Level 3)
Assets:				
Cash equivalents:				
Corporate bonds and commercial paper	\$10,997	\$—	\$10,997	\$ —
Money market mutual funds	576,242	576,242	—	—
Time deposits	15,460	15,460	—	—
Short-term investments:				
Asset-backed securities	97,942	—	97,942	—
Corporate bonds and commercial paper	2,123,071	—	2,123,071	—
Foreign government securities	1,281	—	1,281	—
Municipal securities	141,074	—	141,074	—
U.S. agency securities	58,194	—	58,194	—
U.S. Treasury securities	1,010,467	—	1,010,467	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	8,214	—	8,214	—
Other assets:				
Deferred compensation plan assets	39,301	1,095	38,206	—
Interest rate swap derivatives	30,201	—	30,201	—
Total assets	\$4,112,444	\$592,797	\$3,519,647	\$ —
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$2,511	\$—	\$—	\$—
Total liabilities	\$2,511	\$—	\$—	\$—

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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 27, 2015 was determined using the following inputs (in thousands):

	Fair Value Measurements at Reporting Date			
	Using	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	\$482,479	\$482,479	\$—	\$—
Municipal securities	1,849	—	1,849	—
Time deposits	13,461	13,461	—	—
U.S. Treasury securities	26,400	—	26,400	—
Short-term investments:				
Asset-backed securities	83,314	—	83,314	—
Corporate bonds and commercial paper	1,886,914	—	1,886,914	—
Foreign government securities	1,268	—	1,268	—
Municipal securities	137,332	—	137,332	—
U.S. agency securities	130,468	—	130,468	—
U.S. Treasury securities	872,228	—	872,228	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	19,126	—	19,126	—
Other assets:				
Deferred compensation plan assets	32,063	971	31,092	—
Interest rate swap derivatives	19,821	—	19,821	—
Total assets	\$3,706,723	\$496,911	\$3,209,812	\$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$2,154	\$—	\$2,154	\$—
Total liabilities	\$2,154	\$—	\$2,154	\$—

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 six months ended June 3, 2016, we determined there was an immaterial other-than-temporary impairment on certain of our cost method investments and wrote down the investments to fair value. For the three and six months ended May 29, 2015, we determined there were no other-than-temporary impairments on our cost method investments. As of June 3, 2016, 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 11 for further details regarding our investment in lease receivable.

The fair value of our senior notes was \$2.03 billion as of June 3, 2016, based on observable market prices in less active markets and categorized as Level 2. See Note 12 for further details regarding our debt.

NOTE 5. DERIVATIVES AND HEDGING ACTIVITIES

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 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 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 United States, 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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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 12 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”). In effect, the interest rate swaps 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 12 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 June 3, 2016 and November 27, 2015 were as follows (in thousands):

	2016		2015	
	Fair Value	Fair Value	Fair Value	Fair Value
	Asset	Liability	Asset	Liability
	Derivatives	Derivatives	Derivatives	Derivatives
Derivatives designated as hedging instruments:				
Foreign exchange option contracts ^{(1) (3)}	\$7,324	\$ —	\$16,979	\$ —
Interest rate swap ⁽²⁾	30,201	—	19,821	—

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Derivatives not designated as hedging instruments:

Foreign exchange forward contracts ⁽¹⁾	890	2,511	2,147	2,154
Total derivatives	\$38,415	\$ 2,511	\$38,947	\$ 2,154

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(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.

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 six months ended June 3, 2016 was as follows (in thousands):

	Three Months		Six 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⁾	\$ (2,433)	\$ —	\$ (4,144)	\$ —
Net gain (loss) reclassified from accumulated OCI into income, net of tax ⁽²⁾	\$ 3,609	\$ —	\$ 6,828	\$ —
Net gain (loss) recognized in income ⁽³⁾	\$ (6,369)	\$ —	\$ (11,509)	\$ —
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income ⁽⁴⁾	\$ —	\$ (1,739)	\$ —	\$ (2,704)

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 six months ended May 29, 2015 was as follows (in thousands):

	Three Months		Six 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⁾	\$ 8,144	\$ —	\$ 30,383	\$ —
Net gain (loss) reclassified from accumulated OCI into income, net of tax ⁽²⁾	\$ 22,209	\$ —	\$ 45,922	\$ —
Net gain (loss) recognized in income ⁽³⁾	\$ (4,206)	\$ —	\$ (7,140)	\$ —
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income ⁽⁴⁾	\$ —	\$ 2,005	\$ —	\$ 4,075

(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.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of June 3, 2016 and November 27, 2015 was \$5.44 billion and \$5.37 billion, respectively. The increase was due to foreign currency translation adjustments and an immaterial acquisition during the six months ended June 3, 2016. During the second quarter of fiscal 2016, 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 June 3, 2016 and November 27, 2015 were as follows (in thousands):

	2016			2015		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	\$190,898	\$ (106,090)	\$84,808	\$199,053	\$ (104,704)	\$94,349
Customer contracts and relationships	\$554,883	\$ (244,073)	\$310,810	\$506,639	\$ (204,578)	\$302,061
Trademarks	81,389	(46,677)	34,712	81,219	(41,175)	40,044
Acquired rights to use technology	145,384	(110,637)	34,747	144,202	(100,278)	43,924
Localization	802	(492)	310	1,500	(358)	1,142
Other intangibles	41,090	(12,284)	28,806	36,280	(7,793)	28,487
Total other intangible assets	\$823,548	\$ (414,163)	\$409,385	\$769,840	\$ (354,182)	\$415,658
Purchased and other intangible assets, net	\$1,014,446	\$ (520,253)	\$494,193	\$968,893	\$ (458,886)	\$510,007

Amortization expense related to purchased and other intangible assets was \$37.8 million and \$75.4 million for the three and six months ended June 3, 2016, respectively. Comparatively, amortization expense related to purchased and other intangible assets was \$45.6 million and \$85.2 million for the three and six months ended May 29, 2015, respectively. Of these amounts \$18.5 million and \$37.4 million were included in cost of sales for the three and six months ended June 3, 2016, respectively and \$27.3 million and \$52.2 million for the three and six months ended May 29, 2015, respectively.

As of June 3, 2016, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2016	\$ 15,027	\$ 59,353
2017	24,707	104,278
2018	17,588	92,712
2019	11,413	65,824
2020	9,204	35,599
Thereafter	6,869	51,619
Total expected amortization expense	\$ 84,808	\$ 409,385

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7. ACCRUED EXPENSES

Accrued expenses as of June 3, 2016 and November 27, 2015 consisted of the following (in thousands):

	2016	2015
Accrued compensation and benefits	\$303,470	\$312,776
Sales and marketing allowances	55,122	66,876
Accrued corporate marketing	49,882	38,512
Taxes payable	34,377	27,996
Royalties payable	23,096	23,334
Accrued interest expense	25,977	26,538
Other	169,089	183,852
Accrued expenses	\$661,013	\$679,884

Other primarily includes general corporate accruals including accrued restructuring charges, 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 six months ended June 3, 2016 and the fiscal year ended November 27, 2015 was as follows (in thousands):

	2016	2015
Beginning outstanding balance	10,069	13,564
Awarded	3,626	4,012
Released	(4,712)	(6,561)
Forfeited	(466)	(946)
Ending outstanding balance	8,517	10,069

Information regarding restricted stock units outstanding at June 3, 2016 and May 29, 2015 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value ^(*) (millions)
2016			
Restricted stock units outstanding	8,517	1.37	\$ 840.6
Restricted stock units vested and expected to vest	7,630	1.31	\$ 741.3
2015			
Restricted stock units outstanding	10,505	1.23	\$ 830.8
Restricted stock units vested and expected to vest	9,405	1.16	\$ 734.2

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 values as of June 3, 2016 and May 29, 2015 were \$98.70 and \$79.09, respectively.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Summary of Performance Shares

Our 2016, 2015 and 2014 Performance Share Programs aim 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. The Executive Compensation Committee of our Board of Directors approves the terms of each of our Performance Share Programs, including the award calculation methodology, under the terms of our 2003 Equity Incentive Plan. Shares may be earned based on the achievement of an objective relative total stockholder return measured over a three-year performance period. 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 each grant date. Program participants generally have the ability to receive up to 200% of the target number of shares originally granted.

In the first quarter of fiscal 2016, the Executive Compensation Committee approved the 2016 Performance Share Program, the terms of which are similar to prior year performance share programs as discussed above.

In the first quarter of fiscal 2016, the Executive Compensation Committee also certified the actual performance achievement of participants in the 2013 Performance Share Program. Actual performance resulted in participants achieving 198% of target or approximately 1.4 million shares. The shares granted and achieved under the 2013 Performance Share Program fully vested on the third-year anniversary of the grant on January 24, 2016, if not forfeited. As of June 3, 2016, the shares awarded under our 2016, 2015 and 2014 Performance Share Programs are yet to be achieved.

The following table sets forth the summary of performance share activity under our Performance Share Programs for the six months ended June 3, 2016 and the fiscal year ended November 27, 2015 (in thousands):

	2016		2015	
	Shares Granted	Maximum Shares Eligible to Receive	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	1,940	3,881	1,517	3,034
Achieved	(1,373)	(1,387)	—	—
Awarded	1,206 ⁽¹⁾	1,053	671	1,342
Forfeited	(117)	(234)	(248)	(495)
Ending outstanding balance	1,656	3,313	1,940	3,881

Included in the 1.2 million shares awarded during the six months ended June 3, 2016 were 0.7 million shares

⁽¹⁾ awarded for the final achievement of the 2013 Performance Share program. The remaining awarded shares were for the 2016 Performance Share Program.

Summary of Employee Stock Purchase Plan Shares

There were no stock purchases under the Employee Stock Purchase Plan ("ESPP") during the three months ended June 3, 2016 and May 29, 2015. 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 six months ended June 3, 2016 and May 29, 2015 were as follows:

2016	2015
------	------

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Expected life (in years)	0.5 - 2.0	0.5 - 2.0
Volatility	27% - 29%	27% - 30%
Risk free interest rate	0.49% - 1.06%	0.12% - 0.67%

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Employees purchased 0.7 million shares at an average price of \$58.79 and 0.7 million shares at an average price of \$50.31 for the six months ended June 3, 2016 and May 29, 2015, respectively. The intrinsic value of shares purchased during the six months ended June 3, 2016 and May 29, 2015 was \$23.7 million and \$16.0 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.

Summary of Stock Options

The Executive Compensation Committee of Adobe's Board of Directors eliminated the use of stock option grants for all employees and the Board of Directors effective fiscal 2012 and fiscal 2014, respectively. As of June 3, 2016 and November 27, 2015, we had 0.9 million and 1.3 million stock options outstanding, respectively.

Compensation Costs

As of June 3, 2016, there was \$565.8 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 2.1 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 June 3, 2016 and May 29, 2015 were as follows (in thousands):

Income Statement Classifications	2016		2015	
	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	\$413	\$ 1,758	\$371	\$ 1,780
Cost of revenue—services and support	1,433	1,738	1,404	1,429
Research and development	3,751	25,408	3,639	25,292
Sales and marketing	4,463	27,969	4,630	28,255
General and administrative	1,214	17,205	1,133	17,191
Total	\$11,274	\$ 74,078	\$11,177	\$ 73,947

Total stock-based compensation costs included in our Condensed Consolidated Statements of Income for six months ended June 3, 2016 and May 29, 2015 were as follows (in thousands):

Income Statement Classifications	2016		2015	
	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	\$786	\$ 3,561	\$812	\$ 3,309
Cost of revenue—services and support	2,866	3,633	2,620	3,286
Research and development	7,625	54,892	7,695	51,997

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Sales and marketing	9,013	57,325	9,228	55,540
General and administrative	2,447	35,952	2,596	33,952
Total	\$22,737	\$ 155,363	\$22,951	\$ 148,084

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the six months ended June 3, 2016 were as follows (in thousands):

Balance as of November 27, 2015	\$7,253,431
Net income	498,381
Re-issuance of treasury stock	(307,697)
Balance as of June 3, 2016	\$7,444,115

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 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 June 3, 2016 were as follows (in thousands):

	November 27, 2015	Increase / Decrease	Reclassification Adjustments	June 3, 2016
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	\$ 2,542	\$ 13,022	\$ (1,545)	\$ 14,019
Unrealized losses on available-for-sale securities	(7,095)	5,601	431	(1,063)
Total net unrealized gains on available-for-sale securities	(4,553)	18,623	(1,114)	(1) ⁽¹⁾ 12,956
Net unrealized gains / losses on derivative instruments designated as hedging instruments	2,915	(4,144)	(6,308)	(2) ⁽²⁾ (7,537)
Cumulative foreign currency translation adjustments	(167,442)	28,976	—	(138,466)
Total accumulated other comprehensive income (loss), net of taxes	\$ (169,080)	\$ 43,455	\$ (7,422)	\$ (133,047)

(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 for the three and six months ended June 3, 2016 and May 29, 2015 (in thousands):

	Three Months		Six Months	
	2016	2015	2016	2015
Available-for-sale securities:				
Unrealized gains / losses	\$(51)	\$(49)	\$(22)	\$(156)
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments ⁽¹⁾	—	—	—	6,147
Reclassification adjustments ⁽¹⁾	(164)	(157)	(315)	(210)
Subtotal derivatives designated as hedging instruments	(164)	(157)	(315)	5,937

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Foreign currency translation adjustments	711	(336)	1,345	(2,431)
Total taxes, other comprehensive income	\$496	\$(542)	\$1,008	\$3,350

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(1) 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 six months ended June 3, 2016 and May 29, 2015, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling \$375 million and \$400 million, respectively. The prepayment of \$375 million during the six months ended June 3, 2016 was under the current \$2 billion authority. Of the prepayment of \$400 million during the six months ended May 29, 2015, \$200 million was under the current \$2 billion authority and \$200 million 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 six months ended June 3, 2016, we repurchased approximately 3.7 million shares at an average price of \$90.61 through structured repurchase agreements entered into during fiscal 2015 and the six months ended June 3, 2016. During the six months ended May 29, 2015, we repurchased approximately 5.0 million shares at an average price of \$74.44 through structured repurchase agreements entered into during fiscal 2014 and the six months ended May 29, 2015.

For the six months ended June 3, 2016, 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 June 3, 2016 were excluded from the computation of earnings per share. As of June 3, 2016, \$75.0 million of prepayment remained under this agreement.

Subsequent to June 3, 2016, 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 \$400 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the \$400 million stock repurchase agreement, \$800 million remains under our current authority.

NOTE 10. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three and six months ended June 3, 2016 and May 29, 2015 (in thousands, except per share data):

	Three Months		Six Months	
	2016	2015	2016	2015
Net income	\$244,074	\$147,493	\$498,381	\$232,381
Shares used to compute basic net income per share	499,974	499,290	499,534	499,022
Dilutive potential common shares:				

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Unvested restricted stock and performance share awards	4,239	5,233	5,557	6,857
Stock options	512	1,059	575	1,182
Shares used to compute diluted net income per share	504,725	505,582	505,666	507,061
Basic net income per share	\$0.49	\$0.30	\$1.00	\$0.47
Diluted net income per share	\$0.48	\$0.29	\$0.99	\$0.46

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the three and six months ended June 3, 2016 and May 29, 2015, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of \$94.09 and \$90.93, respectively, and \$76.78 and \$75.12, respectively, that would have been anti-dilutive.

NOTE 11. 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 East and West Tower buildings, lease the Almaden Tower building and own the land under each of them.

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 June 3, 2016, 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 June 3, 2016, 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 ordinary 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 officers and directors for certain events or occurrences while the officer or director is or was serving at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that reduces our exposure and enables us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

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

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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.

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 12. 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 Notes ranked, 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-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.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 June 3, 2016, our outstanding notes payable consists of the 2020 Notes and 2025 Notes (the “Notes”) with a total carrying value of \$1.92 billion. Based on quoted prices in inactive markets, the fair value of the Notes was \$2.03 billion as of June 3, 2016. The total fair value of \$2.03 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 June 3, 2016, we were in compliance with all of the covenants.

In February 2016, we made semi-annual interest payments on our 2020 and 2025 Notes totaling \$37.6 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 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 June 3, 2016, there were no outstanding borrowings under this Credit Agreement and we were in compliance with all covenants.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three and six months ended June 3, 2016 and May 29, 2015 included the following (in thousands):

	Three Months		Six Months	
	2016	2015	2016	2015
Interest and other income (expense), net:				
Interest income	\$11,482	\$6,846	\$22,159	\$13,134
Foreign exchange gains (losses)	(6,474)	(3,994)	(13,004)	(8,241)
Realized gains on fixed income investment	1,212	717	1,545	1,684
Realized losses on fixed income investment	(142)	(84)	(431)	(124)
Other	5	254	1	624
Interest and other income (expense), net	\$6,083	\$3,739	\$10,270	\$7,077
Interest expense	\$(17,174)	\$(16,605)	\$(35,643)	\$(31,150)
Investment gains (losses), net:				
Realized investment gains	\$134	\$315	\$1,189	\$2,011
Unrealized investment gains	1,543	54	—	—
Realized investment losses	(4,995)	(146)	(5,120)	(146)
Unrealized investment losses	—	—	(556)	(212)
Investment gains (losses), net	\$(3,318)	\$223	\$(4,487)	\$1,653
Non-operating income (expense), net	\$(14,409)	\$(12,643)	\$(29,860)	\$(22,420)

NOTE 14. 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 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.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Our segment results for the three months ended June 3, 2016 and May 29, 2015 were as follows (dollars in thousands):

	Digital Media	Digital Marketing	Print and Publishing	Total
Three months ended June 3, 2016				
Revenue	\$943,137	\$412,172	\$43,400	\$1,398,709
Cost of revenue	58,172	142,002	1,905	202,079
Gross profit	\$884,965	\$270,170	\$41,495	\$1,196,630
Gross profit as a percentage of revenue	94	% 66	% 96	% 86
Three months ended May 29, 2015				
Revenue	\$747,475	\$366,464	\$48,219	\$1,162,158
Cost of revenue	50,693	131,933	2,547	185,173
Gross profit	\$696,782	\$234,531	\$45,672	\$976,985
Gross profit as a percentage of revenue	93	% 64	% 95	% 84

Our segment results for the six months ended June 3, 2016 and May 29, 2015 were as follows (dollars in thousands):

	Digital Media	Digital Marketing	Print and Publishing	Total
Six months ended June 3, 2016				
Revenue	\$1,874,855	\$818,418	\$88,771	\$2,782,044
Cost of revenue	112,719	283,919	4,013	400,651
Gross profit	\$1,762,136	\$534,499	\$84,758	\$2,381,393
Gross profit as a percentage of revenue	94	% 65	% 95	% 86
Six months ended May 29, 2015				
Revenue	\$1,450,248	\$723,631	\$97,460	\$2,271,339
Cost of revenue	95,038	252,308	4,625	351,971
Gross profit	\$1,355,210	\$471,323	\$92,835	\$1,919,368
Gross profit as a percentage of revenue	93	% 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, customer acquisition, the amount of recurring revenue and revenue growth. In addition, when used in this report, the words "will," "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "for," "looks to," "continues" and similar expressions, as well as statements regarding our focus for the future, are generally intended to identify forward-looking statements. Each of the forward-looking statements we make in this report involves 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 2015. 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 second quarter of fiscal 2016, we reported strong 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 delivers value through more frequent product updates, storage and access to user files stored in the cloud with syncing of files across users' machines, access to marketplace, social and community-based features with our Adobe Stock and Behance services, app creation capabilities and lower entry point pricing for cost-sensitive customers.

We offer Creative Cloud for individuals, teams and enterprises, and we enable larger enterprise customers to acquire Creative Cloud desktop apps through Enterprise Term License Agreements (“ETLAs”). These 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 to enable the delivery and purchase of stock content in our new service called Adobe Stock. Overall, our strategy with Creative Cloud is designed to

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enable 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 second quarter of fiscal 2016.

We are also a market leader with our Adobe Document Cloud offerings built around our Acrobat family of products, the Adobe Reader and a set of integrated cloud-based document services, including Adobe Sign. Adobe Acrobat provides 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 Adobe Acrobat DC and Adobe Sign, and a set of integrated services enables users to create, review, approve, sign and track documents whether on a desktop or mobile device. Adobe Acrobat DC, with a touch-enabled user interface, is licensed both through 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 adjust our reported ARR on an annual basis to reflect any material exchange rates changes. Our reported ARR results in the second quarter of fiscal 2016 are based on currency rates set at the start of fiscal 2016 and held constant throughout the year. We calculate ARR as follows:

	Annual Value of Creative Cloud Subscriptions and Services
	+
Creative ARR	Annual Digital Publishing Suite Contract Value
	+
	Annual Creative ETLA Contract Value
Document Cloud ARR	Annual Value of Document Cloud Subscriptions and Services
	+

Annual
Document
Cloud ETLA
Contract
Value

Digital Media ARR
+
Creative ARR
Document
Cloud ARR

Creative ARR exiting the second quarter of fiscal 2016 was \$3.00 billion, up from \$2.50 billion at the end of fiscal 2015. Document Cloud ARR exiting the second quarter fiscal 2016 was \$415 million, up from \$385 million at the end of fiscal 2015. Total Digital Media ARR grew to \$3.41 billion at the end of the second quarter of fiscal 2016, up from \$2.88 billion at the end of fiscal 2015.

Our success in driving growth in ARR has begun to positively affect our revenue growth. Creative revenue in the second quarter of fiscal 2016 was \$754.9 million, up from \$550.9 million in the second quarter of fiscal 2015 and representing 37% year-over-year growth. Document Cloud revenue in the second quarter of fiscal 2016 was \$188.2 million, slightly down from \$196.6 million in the second quarter of fiscal 2015. Total Digital Media segment revenue grew to \$943.1 million in second quarter of fiscal 2016, up from \$747.5 million in the second quarter of fiscal 2015 and representing 26% year-over-year growth.

We are a market leader in the fast-growing category addressed by our Digital Marketing segment. Our Digital Marketing business provides comprehensive solutions that include analytics, social marketing, targeting, media optimization, digital experience management, cross-channel campaign management, audience management, premium video delivery and monetization. We deliver these capabilities through our Adobe Marketing Cloud, an integrated offering enabling marketers to measure, personalize and optimize marketing campaigns and digital experiences across channels for optimal marketing performance. With its broad set

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of solutions, including Adobe Analytics, Adobe Target, Adobe Social, Adobe Media Optimizer, Adobe Experience Manager, Adobe Campaign, Adobe Audience Manager and Adobe Primetime, as well as real-time dashboards and a collaborative interface, customers of Adobe Marketing Cloud are able to combine data, insights and digital content to deliver a personalized, relevant experience to their constituents.

In addition to chief marketing officers and digital marketers, users of our Adobe Marketing Cloud solutions include marketing professionals such as search engine marketers, media managers, media buyers and marketing research analysts. Customers also include web content editors, web analysts and web marketing managers. These customers often are involved in workflows that utilize other Adobe products, such as our Digital Media offerings and our video workflow and delivery technologies. By combining the creativity of our Digital Media business with the science of our Digital Marketing business, we help our customers to more efficiently and effectively make, manage, measure and monetize their content across every channel with an end-to-end workflow and feedback loop.

We utilize a direct salesforce to market and license our Adobe Marketing Cloud solutions, as well as an extensive ecosystem of partners including marketing agencies, systems integrators and developers that help license and deploy our solutions to their customers. We have made significant investments to broaden the scale and size of all of these routes to market, and our recent financial results reflect the success of these investments. In the second quarter of fiscal 2016, we achieved record Marketing Cloud revenue of \$385.4 million, which represents 18% year-over-year revenue growth. In addition, we drove strong demand for our Marketing Cloud solutions, which we expect will 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 six months ended June 3, 2016, 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 27, 2015.

Recent Accounting Pronouncements Not Yet Effective

See Note 1 of our Notes to Condensed Consolidated Financial Statement for information regarding recent accounting pronouncements that are of significance or potential significance to us.

RESULTS OF OPERATIONS

Financial Performance Summary for the Second Quarter of Fiscal 2016

During the three months ended June 3, 2016, our subscription revenue as a percentage of total revenue increased to 78% compared to 67% in the year-ago period as we transitioned more of our business to a subscription-based model.

Total Digital Media ARR of approximately \$3.41 billion as of June 3, 2016 increased by \$531 million, or 18%, from \$2.88 billion as of November 27, 2015. The change in our Digital Media ARR is primarily due to increases in the number of paid Creative Cloud and Document Cloud subscriptions.

Digital Media revenue of \$943.1 million during the three months ended June 3, 2016 increased by \$195.6 million, or 26%, compared with the year-ago period primarily due to the increase in subscription revenue associated with our Creative Cloud offering.

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Adobe Marketing Cloud revenue of \$385.4 million during the three months ended June 3, 2016 increased by \$58.8 million, or 18%, 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 \$1.68 billion as of June 3, 2016 increased by \$196.3 million, or 13%, from \$1.49 billion as of November 27, 2015 primarily due to new contracts and existing renewals for our Adobe Marketing Cloud services and increases in Creative Cloud individual and team subscriptions.

Cost of revenue of \$202.1 million during the three months ended June 3, 2016 increased by \$16.9 million, or 9%, compared with the year-ago period primarily due to increases in costs associated with compensation and related benefits driven by increased headcount, data center costs and royalty costs related to our stock photography offering.

Operating expenses of \$852.4 million during the three months ended June 3, 2016 increased by \$69.0 million, or 9%, compared with the year-ago period primarily due to increases in costs associated with compensation and related benefits driven by increased headcount.

Net income of \$244.1 million during the three months ended June 3, 2016 increased by \$96.6 million, or 65%, compared with the year-ago period primarily due to revenue increases.

Net cash flow from operations of \$986.2 million during the six months ended June 3, 2016 increased by \$331.7 million, or 51%, compared to the six months ended May 29, 2015 primarily due to higher net income and the increase in deferred revenue.

Revenue for the Three and Six Months Ended June 3, 2016 and May 29, 2015 (dollars in millions)

Revenue for the six months ended June 3, 2016 benefited from an extra week in the first quarter of fiscal 2016 due to our 52/53 week financial calendar whereby fiscal 2016 is a 53-week year compared with fiscal 2015 which was a 52-week year.

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change
Subscription	\$1,083.7	\$774.0	40 %	\$2,153.9	\$1,487.4	45 %
Percentage of total revenue	78 %	67 %		78 %	65 %	
Product	196.5	274.5	(28)%	397.6	565.3	(30)%
Percentage of total revenue	14 %	23 %		14 %	25 %	
Services and support	118.5	113.7	4 %	230.5	218.6	5 %
Percentage of total revenue	8 %	10 %		8 %	10 %	
Total revenue	\$1,398.7	\$1,162.2	20 %	\$2,782.0	\$2,271.3	22 %

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.

As described in [Note 14 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 six months ended June 3, 2016 and May 29, 2015 are as follows (dollars in millions):

	Three Months		Six Months	
	2016	2015	2016	2015

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			%				%	
			Change				Change	
Digital Media	\$797.8	\$534.2	49	%	\$1,579.3	\$1,018.0	55	%
Digital Marketing	277.9	234.6	18	%	558.8	459.5	22	%
Print and Publishing	8.0	5.2	54	%	15.8	9.9	60	%
Total subscription revenue	\$1,083.7	\$774.0	40	%	\$2,153.9	\$1,487.4	45	%

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

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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			Six Months		
	2016	2015	% Change	2016	2015	% Change
Digital Media	\$943.1	\$747.5	26 %	\$1,874.8	\$1,450.2	29 %
Percentage of total revenue	68 %	64 %		67 %	64 %	
Digital Marketing	412.2	366.5	12 %	818.4	723.6	13 %
Percentage of total revenue	29 %	32 %		30 %	32 %	
Print and Publishing	43.4	48.2	(10)%	88.8	97.5	(9)%
Percentage of total revenue	3 %	4 %		3 %	4 %	
Total revenue	\$1,398.7	\$1,162.2	20 %	\$2,782.0	\$2,271.3	22 %

Digital Media

Revenue from Digital Media increased \$195.6 million and \$424.6 million during the three and six months ended June 3, 2016, as compared to the three and six months ended May 29, 2015 primarily driven by increases in revenue associated with our creative offerings.

Revenue associated with our creative offerings, which includes our Creative Cloud, perpetual creative and stock photography offerings, increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 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 revenue associated with our creative offerings were increases in revenue associated with our Creative Cloud Photography Plan subscription offering and stock photography offerings. The increases associated with our creative products were slightly offset 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, decreased slightly during the three and six months ended June 3, 2016 as compared to the year ago period primarily due to expected decreases in revenue associated with our Document Cloud perpetual license offerings and partially offset by increases in revenue associated with our Document Cloud subscription offerings and increases in Adobe Sign revenue.

Digital Marketing

Revenue from Digital Marketing increased \$45.7 million and \$94.8 million during the three and six months ended June 3, 2016, as compared to the three and six months ended May 29, 2015 primarily due to continued revenue growth associated with our Adobe Marketing Cloud, which increased 18% and 20% during the three and six months ended June 3, 2016, respectively, as compared to the year-ago periods. Primarily contributing to these increases were the continued adoption of our AEM offerings and, to a lesser extent, the increases in revenue associated with Adobe Campaign and Adobe Analytics.

Geographical Information (dollars in millions)

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change

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Americas	\$820.0	\$669.2	23 %	\$1,626.5	\$1,313.8	24 %
Percentage of total revenue	59 %	58 %		58 %	58 %	
EMEA	380.6	323.9	18 %	766.2	631.0	21 %
Percentage of total revenue	27 %	28 %		28 %	28 %	
APAC	198.1	169.1	17 %	389.3	326.5	19 %
Percentage of total revenue	14 %	14 %		14 %	14 %	
Total revenue	\$1,398.7	\$1,162.2	20 %	\$2,782.0	\$2,271.3	22 %

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Overall revenue during the three and six months ended June 3, 2016 increased in all geographic regions as compared to the three and six months ended May 29, 2015 primarily due to increases in Digital Media and Digital Marketing revenue, slightly offset by the decline in Print and Publishing revenue. Within each geographic region, the fluctuations in revenue by reportable segment were attributable to the factors noted in the segment information above. The overall increase in revenue was partially offset by declines due to the relative strength of the U.S. Dollar against EMEA currencies during the three and six months ended June 3, 2016 as compared to the year-ago periods.

Foreign currency impacts to revenue for the three and six months ended June 3, 2016 are shown below.

(in millions)	Three Months	Six Months
Revenue impact:	Increase/ (Decrease)	
EMEA:		
Euro	\$(10.5)	\$(39.1)
British Pound	(5.6)	(10.6)
Other currencies	(1.0)	(2.4)
Total EMEA	(17.1)	(52.1)
Japanese Yen	0.9	(3.4)
Other currencies	(5.5)	(14.3)
Total revenue impact	(21.7)	(69.8)
Hedging impact:		
Euro	0.3	1.5
British Pound	3.3	5.2
Japanese Yen	—	0.1
Total hedging impact	3.6	6.8
Total impact	\$(18.1)	\$(63.0)

During the three and six months ended June 3, 2016, the relative strength of the U.S. Dollar against EMEA currencies caused revenue in EMEA measured in U.S. Dollar equivalents to decrease as compared to the year-ago period. These decreases were slightly offset by hedging gains from our Euro and British Pound hedging programs during the three and six months ended June 3, 2016.

Cost of Revenue for the Three and Six Months Ended June 3, 2016 and May 29, 2015 (dollars in millions)

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change
Subscription	\$115.4	\$103.7	11 %	\$222.7	\$199.2	12 %
Percentage of total revenue	8 %	9 %		8 %	9 %	
Product	15.8	21.5	(27)%	36.1	41.2	(12)%
Percentage of total revenue	1 %	2 %		1 %	2 %	
Services and support	70.9	60.0	18 %	141.9	111.6	27 %
Percentage of total revenue	5 %	5 %		5 %	5 %	
Total cost of revenue	\$202.1	\$185.2	9 %	\$400.7	\$352.0	14 %
Subscription						

Cost of subscription revenue consists of third-party royalties and expenses related to operating our network infrastructure, including depreciation expenses and operating lease payments associated with computer equipment, data center costs, salaries and related expenses of network operations, implementation, account management and technical support personnel, amortization of intangible assets and allocated overhead. We enter into contracts with third parties for the use of their data center facilities and our data center costs largely consist of the amounts we pay to these third parties for rack space, power and similar items.

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Cost of subscription revenue increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 due to the following:

	% Change 2016-2015		% Change 2016-2015	
	QTD		YTD	
Data center costs	8	%	7	%
Compensation and related benefits associated with headcount	2		2	
Depreciation expense	2		2	
Royalty cost	1		2	
Amortization of purchased intangibles	(4	)	(3)
Various individually insignificant items	2		2	
Total change	11	%	12	%

Data center costs increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 primarily due to higher transaction volumes in our Adobe Marketing Cloud and Creative Cloud services. Depreciation expense increased during the three and six months ended June 3, 2016 as compared to the year-ago periods primarily due to higher capital expenditures in recent periods as we continue to invest in our network and data center infrastructure to support the growth of our subscription and hosted services business. Additionally, royalty cost increased during the three and six months ended June 3, 2016 as compared to the year-ago period due to increased royalty payments related to our stock photography offerings. These increases were partially offset by the decreases in amortization of purchased intangibles driven by the decrease in amortization expense associated with intangible assets purchased through our acquisitions of Omniture and Efficient Frontier that were fully amortized during the three and six months ended June 3, 2016.

Product

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

Cost of product revenue decreased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 primarily due to decreases in amortization of purchased intangibles driven by the decline in revenue from our perpetual offerings, and decreases in localization costs impacted by the shift of our focus and development efforts towards our Creative Cloud and other subscription offerings. These decreases were partially offset by an increase in royalty costs related to our stock photography perpetual offering.

Services and Support

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

Cost of services and support revenue increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 due to the following:

	% Change 2016-2015		% Change 2016-2015	
	QTD		YTD	
Compensation and related benefits associated with headcount	11	%	15	%
Professional and consulting fees	6		11	
Various individually insignificant items	1		1	
Total change	18	%	27	%

Professional and consulting fees increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 primarily due to increases in third-party fees related to consulting and

training services provided to our customers.

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Operating Expenses for the Three and Six Months Ended June 3, 2016 and May 29, 2015 (dollars in millions)

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change
Research and development	\$232.5	\$208.1	12 %	\$469.7	\$423.5	11 %
Percentage of total revenue	17 %	18 %		17 %	19 %	
Sales and marketing	462.8	427.0	8 %	937.7	819.7	14 %
Percentage of total revenue	33 %	37 %		34 %	36 %	
General and administrative	138.6	130.2	6 %	285.5	275.3	4 %
Percentage of total revenue	10 %	11 %		10 %	12 %	
Restructuring and other charges	(0.5)	—	**	(0.9)	1.8	**
Percentage of total revenue	*	*		*	*	
Amortization of purchased intangibles	19.0	18.1	5 %	37.4	32.4	15 %
Percentage of total revenue	1 %	2 %		1 %	1 %	
Total operating expenses	\$852.4	\$783.4	9 %	\$1,729.4	\$1,552.7	11 %

(*) Percentage is less than 1%.

(**) Percentage is not meaningful.

Research and Development, Sales and Marketing, and General and Administrative Expenses

The increase in research and development, sales and marketing and general and administrative expenses during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 was primarily due to the increase in costs associated with compensation and related benefits driven by increased headcount.

Research and Development

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

Research and development expenses increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 due to the following:

	% Change		% Change	
	2016-2015	2016-2015	2016-2015	2016-2015
	QTD	YTD	QTD	YTD
Compensation and related benefits associated with headcount	6 %	5 %		
Compensation associated with cash and stock-based incentives	1	3		
Professional and consulting fees	5	4		
Various individually insignificant items	—	(1)		
Total change	12 %	11 %		

We believe that investments in research and development, including the recruiting and hiring of software developers, are critical to remain competitive in the marketplace and are directly related to continued timely development of new and enhanced offerings and solutions. We will continue to focus on long-term opportunities available in our end markets and make significant investments in the development of our subscription and service offerings, applications and tools.

Sales and Marketing

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

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Sales and marketing expenses increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 due to the following:

	% Change 2016-2015		% Change 2016-2015	
	QTD		YTD	
Compensation and related benefits associated with headcount	5	%	6	%
Compensation associated with cash and stock-based incentives	—		2	
Marketing spending related to offering launches and overall marketing efforts	1		4	
Various individually insignificant items	2		2	
Total change	8	%	14	%

General and Administrative

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

General and administrative expenses increased during the three and six months ended June 3, 2016 as compared to the three and six months ended May 29, 2015 due to the following:

	% Change 2016-2015		% Change 2016-2015	
	QTD		YTD	
Compensation and related benefits associated with headcount	3	%	4	%
Compensation associated with cash and stock-based incentives	1		2	
Charitable contributions	—		(6)
Software licenses	(1	)	1	
Various individually insignificant items	3		3	
Total change	6	%	4	%

The decrease in charitable contributions during the six months ended June 3, 2016 as compared to the six months ended May 29, 2015 is primarily due to the timing of planned contributions to the Adobe Foundation.

Non-Operating Income (Expense), Net for the Three and Six Months Ended June 3, 2016 and May 29, 2015 (dollars in millions)

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change
Interest and other income (expense), net	\$6.1	\$3.8	61 %	\$10.3	\$7.1	45 %
Percentage of total revenue	*	*		*	*	
Interest expense	(17.2)	(16.6)	4 %	(35.7)	(31.2)	14 %
Percentage of total revenue	(1)%	(1)%		(1)%	(1)%	
Investment gains (losses), net	(3.3)	0.2	**	(4.5)	1.7	**
Percentage of total revenue	*	*		*	*	
Total non-operating income (expense), net	\$(14.4)	\$(12.6)	14 %	\$(29.9)	\$(22.4)	33 %

(*) Percentage is less than 1%.

(**) Percentage is not meaningful.

Interest and Other Income (Expense), Net

Interest and other income (expense), net consists primarily of interest earned on cash, cash equivalents and short-term fixed income investments. Interest and other income (expense), net also includes gains and losses on fixed income investments and foreign exchange gains and losses other than any gains recorded to revenue from hedging Euros, British Pounds and Yen currencies.

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Interest Expense

Interest expense primarily represents interest associated with our senior notes and interest rate swaps. Interest on our senior notes is payable semi-annually, in arrears, on February 1 and August 1. Floating interest payments on the interest rate swaps are paid monthly. The fixed-rate interest receivable on the swaps is received semi-annually concurrent with the senior notes interest payments. See Notes 5 and 12 of our Notes to Condensed Consolidated Financial Statements for further details regarding our senior notes and interest rate swaps.

Investment Gains (Losses), Net

Investment gains (losses), net consists principally of realized gains and losses from the sale of marketable equity investments, other-than-temporary declines in the value of marketable and non-marketable equity securities and unrealized holding gains and losses associated with our deferred compensation plan assets (classified as trading securities) and gains and losses associated with our direct and indirect investments in privately held companies.

Provision for Income Taxes for the Three and Six Months Ended June 3, 2016 and May 29, 2015 (dollars in millions)

	Three Months			Six Months		
	2016	2015	% Change	2016	2015	% Change
Provision	\$85.8	\$33.5	156 %	\$123.8	\$111.8	11 %
Percentage of total revenue	6	% 3	%	4	% 5	%
Effective tax rate	26	% 19	%	20	% 32	%

Our effective tax rate increased by seven percentage points for the three months ended June 3, 2016 as compared to the three months ended May 29, 2015. The increase was primarily due to a one-time tax cost associated with licensing acquired company assets to Adobe's trading companies and stronger U.S. earnings, offset by tax benefits from the fiscal 2016 U.S. Research and Development credit. In addition, the effective tax rate during the three months ended May 29, 2015 included tax benefits recognized as a result of the completion of certain income tax examinations. Our effective tax rate decreased by twelve percentage points for the six months ended June 3, 2016 as compared to the six months ended May 29, 2015. The decrease was primarily due to tax benefits related to the permanent extension of the U.S. Research and Development credit for 2015 and onward. The reinstatement of the credit was retroactive to January 1, 2015. A tax benefit for the credit relating to fiscal 2015 was reflected in its entirety in the first quarter of fiscal 2016. In addition, the fiscal 2015 effective tax rate included a one-time tax cost associated with licensing acquired company assets to Adobe's trading companies, offset by tax benefits for the temporary reinstatement of the U.S. Research and Development credit in December 2014.

We are a United States-based multinational company subject to tax in multiple U.S. and foreign tax jurisdictions. A significant portion of our foreign earnings for the current fiscal year were earned by our Irish subsidiaries. In addition to providing for U.S. income taxes on earnings from the United States, we provide for U.S. income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered permanently reinvested outside the United States. While we do not anticipate changing our intention regarding permanently reinvested earnings, if certain foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings. Currently, there is a significant amount of foreign earnings upon which U.S. income taxes have not been provided.

Accounting for Uncertainty in Income Taxes

The gross liability for unrecognized tax benefits at June 3, 2016 was \$270.6 million, exclusive of interest and penalties. If the total unrecognized tax benefits at June 3, 2016 were recognized in the future, \$231.6 million of unrecognized tax benefits would decrease the effective tax rate, which is net of an estimated \$39.0 million federal benefit related to deducting certain payments on future state tax returns.

As of June 3, 2016, the combined amount of accrued interest and penalties related to tax positions taken on our tax returns was \$32.7 million. This amount is included in non-current income taxes payable.

The timing of the resolution of income tax examinations is highly uncertain as are the amounts and timing of tax payments that are part of any audit settlement process. These events could cause large fluctuations in the balance sheet classification of current and non-current assets and liabilities. We believe that within the next 12 months, it is

reasonably possible that either certain audits will conclude or statutes of limitations on certain income tax examination periods will expire, or both. Given the uncertainties described above, we can only determine a range of estimated potential decreases in underlying unrecognized tax benefits ranging from \$0 to approximately \$10.0 million.

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LIQUIDITY AND CAPITAL RESOURCES

This data should be read in conjunction with our Condensed Consolidated Statements of Cash Flows.

	As of	
(in millions)	June 3, 2016	November 27, 2015
Cash and cash equivalents	\$886.4	\$ 876.6
Short-term investments	\$3,432.0	\$ 3,111.5
Working capital	\$2,853.0	\$ 2,608.3
Stockholders' equity	\$7,248.6	\$ 7,001.6

A summary of our cash flows is as follows:

	Six Months Ended	
(in millions)	June 3, 2016	May 29, 2015
Net cash provided by operating activities	\$986.2	\$654.5
Net cash used for investing activities	(510.3)	(737.3)
Net cash used for financing activities	(465.3)	(66.8)
Effect of foreign currency exchange rates on cash and cash equivalents	(0.8)	(11.6)
Net increase (decrease) in cash and cash equivalents	\$9.8	\$(161.2)

Our primary source of cash is receipts from revenue. The primary uses of cash are payroll-related expenses, general operating expenses including marketing, travel and office rent, and cost of revenue. Other sources of cash are proceeds from the exercise of employee stock options and participation in the employee stock purchase plan. Other uses of cash include our stock repurchase program, which is described below, business acquisitions and purchases of property and equipment.

Cash Flows from Operating Activities

Net cash provided by operating activities of \$986.2 million for the six months ended June 3, 2016 was primarily comprised of net income plus the net effect of non-cash items. The primary working capital sources of cash were net income coupled with increases in deferred revenue and income taxes payable. The increase in deferred revenue is primarily due to increases in Digital Marketing hosted services and increased subscriptions for our Creative Cloud offerings. The increase in income taxes payable is primarily due to the increase in our tax provision during the six months ended June 3, 2016.

The primary working capital uses of cash were increases in prepaid expenses and other current assets and decreases in trade payables. Prepaid expenses increased primarily due to prepayments made to our vendors and higher prepaid employee benefit expenses largely associated with recognition of yearly fringe benefit expenses which are estimated and recorded at the beginning of the fiscal year and expensed throughout the fiscal year. Other current assets increased primarily due to the tax benefit associated with the reinstatement of the U.S. Research and Development credit and bonus depreciation provisions. Trade payables decreased primarily due to the timing of invoice receipts and cash payments.

Cash Flows from Investing Activities

Net cash used for investing activities of \$510.3 million for the six months ended June 3, 2016 was primarily due to purchases of short-term investments. Other uses of cash during the six months ended June 3, 2016 represented purchases of property and equipment, an immaterial acquisition, and purchases of long-term investments and other assets. These cash outflows were offset in part by sales and maturities of short-term investments.

Cash Flows from Financing Activities

Net cash used for financing activities of \$465.3 million was primarily due to payments for our treasury stock repurchases and costs associated with the issuance of treasury stock, offset in part by proceeds from the issuance of

treasury stock and excess tax benefits from stock-based compensation. See the section titled “Stock Repurchase Program” discussed below.

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

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Other Liquidity and Capital Resources Considerations

Our existing cash, cash equivalents and investment balances may fluctuate during fiscal 2016 due to changes in our planned cash outlay, including changes in incremental costs such as direct and integration costs related to our acquisitions. Our intent is to permanently reinvest a significant portion of our earnings from foreign operations, and current plans do not anticipate that we will need funds generated from foreign operations to fund our domestic operations. In the event funds from foreign operations are needed to fund operations in the United States and if U.S. tax has not already been previously provided, we would provide for and pay additional U.S. taxes in connection with repatriating these funds.

Cash from operations could also be affected by various risks and uncertainties, including, but not limited, to the risks detailed in Part II, Item 1A titled “Risk Factors”. However, based on our current business plan and revenue prospects, we believe that our existing cash, cash equivalents and investment balances, our anticipated cash flows from operations and our available credit facility will be sufficient to meet our working capital and operating resource expenditure requirements for the next twelve months.

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. On March 1, 2013, we exercised our 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. As of June 3, 2016, there were no outstanding borrowings under this Credit Agreement and the entire \$1 billion credit line remains available for borrowing.

As of June 3, 2016, the amount outstanding under our senior notes was \$1.9 billion, consisting of \$900 million of 4.75% senior notes due February 1, 2020 and \$1 billion of 3.25% senior notes due February 1, 2025.

Our short-term investment portfolio is primarily invested in corporate bonds and commercial paper, U.S. agency securities and U.S. Treasury securities, foreign government securities, municipal securities and asset-backed securities. We use professional investment management firms to manage a large portion of our invested cash. External investment firms managed, on average, 61% of our consolidated invested balances during the three months ended June 3, 2016.

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 six months ended June 3, 2016 and May 29, 2015, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling \$375 million and \$400 million, respectively. The prepayment of \$375 million for the six months ended June 3, 2016 was under the current \$2 billion authority. Of the prepayment of \$400 million during the six months ended May 29, 2015, \$200 million was under the current \$2 billion authority and \$200 million 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 six months ended June 3, 2016, we repurchased approximately 3.7 million

shares at an average price of \$90.61 through structured repurchase agreements entered into during fiscal 2015 and the six months ended June 3, 2016. During the six months ended May 29, 2015, we repurchased approximately 5.0 million shares at an average price of \$74.44 through structured repurchase agreements entered into during fiscal 2014 and the six months ended May 29, 2015.

For the six months ended June 3, 2016, 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 June 3, 2016 were excluded from the computation of earnings per share. As of June 3, 2016, \$75.0 million of prepayments remained under the agreement.

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Subsequent to June 3, 2016, 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 \$400 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the \$400 million stock repurchase agreement, \$800 million remains under our current authority.

Refer to Part II, Item 2 in this report for share repurchases during the quarter ended June 3, 2016.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

We presented our contractual obligations in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015. Our principal commitments as of June 3, 2016 consist of obligations under operating leases, royalty agreements and various service agreements. Except as discussed below, there have been no material changes in those obligations during the six months ended June 3, 2016. See Notes 11 and 12 of our Notes to Condensed Consolidated Financial Statements for more detailed information regarding our contractual commitments.

Senior Notes

Interest on our senior notes is payable semi-annually, in arrears on February 1 and August 1. At June 3, 2016, our maximum commitment for interest payments was \$463.5 million for the remaining duration of our senior notes.

Covenants

Our credit facility contains a financial covenant requiring us not to exceed a maximum leverage ratio. Our Almaden Tower lease includes certain financial ratios as defined in the lease agreements that are reported to the lessor quarterly. As of June 3, 2016, we were in compliance with all of our covenants. We believe these covenants will not impact our credit or cash in the coming fiscal year or restrict our ability to execute our business plan. Our senior notes do not contain any financial covenants.

Under the terms of our credit agreement and lease agreements, we are not prohibited from paying cash dividends unless payment would trigger an event of default or one currently exists. We do not anticipate paying any cash dividends in the foreseeable future.

Royalties

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We believe that there have been no material changes in our market risk exposures for the six months ended June 3, 2016, as compared with those discussed in our Annual Report on Form 10-K for the fiscal year ended November 27, 2015.

ITEM 4. CONTROLS AND PROCEDURES

Based on their evaluation as of June 3, 2016, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) were effective at the reasonable assurance level to ensure that the information required to be disclosed by us in this Quarterly Report on Form 10-Q was (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting during the quarter ended June 3, 2016 that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting.

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

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 11 "Commitments and Contingencies" of our Notes to Condensed Consolidated Financial Statements regarding our legal proceedings.

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ITEM 1A. RISK FACTORS

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

If we cannot continue to develop, market and offer new products and services or enhancements to existing products and services that meet customer requirements, our operating results could suffer.

The process of developing new high technology products and services and enhancing existing products and services is complex, costly and uncertain. If we fail to anticipate customers' changing needs and emerging technological trends, our market share and results of operations could suffer. We must make long-term investments, develop or obtain appropriate intellectual property and commit significant resources before knowing whether our predictions will accurately reflect customer demand for our products and services. If we are unable to extend our core technologies into new applications and new platforms and to anticipate or respond to technological changes, the market's acceptance of our products and services could decline and our results would suffer. Additionally, any delay in the development, production, marketing or offering of a new product or service or enhancement to an existing product or service could result in customer attrition or impede our ability to attract new customers, causing a decline in our revenue, earnings or stock price and weakening our competitive position. Third parties market certain of our offerings and support certain product functionality. If we are unsuccessful in establishing or maintaining our strategic relationships with these third parties, our ability to compete in the marketplace, to reach new customers and geographies or to grow our revenue could be impaired and our operating results could suffer.

We offer our products on a variety of personal computers, tablet and mobile devices. Recent trends have shown a technological shift from personal computers to tablet and mobile devices. If we cannot continue to adapt our products to tablet and mobile devices, our business could be harmed. To the extent that consumer purchases of these devices slow down, or to the extent that significant demand arises for our products or competitive products on other platforms before we offer our products on those platforms, our business could be harmed. Releases of new devices or operating systems may make it more difficult for our products to perform or may require significant costs in order for us to adapt our solutions to such devices or operating systems. These potential costs and delays could harm our business. Introduction of new products, services and business models by competitors or others could harm our competitive position and results of operations.

The markets for our products and services are characterized by intense competition, evolving industry standards, emerging business and distribution models, disruptive technology developments, short life cycles, price sensitivity and frequent new product introductions (including alternatives with limited functionality available at lower costs or free of charge). Any of these factors could create downward pressure on pricing and gross margins and could adversely affect our renewal and upgrade rates, as well as our ability to attract new customers. Our future success will depend on our ability to enhance and better integrate our existing products and services, introduce new products and services on a timely and cost-effective basis, meet changing customer needs, extend our core technology into new applications, and anticipate emerging standards, business models, software delivery methods and other technological developments, such as the evolution and emergence of digital application marketplaces as a direct sales and software delivery environment. These digital application marketplaces often have exclusive distribution for certain platforms, which may make it more difficult for us to compete in these markets. If any competing products, services or operating systems that do not support our solutions achieve widespread acceptance, our operating results could suffer. In addition, consolidation has occurred among some of the competitors in the markets in which we compete. Further consolidations in these markets may subject us to increased competitive pressures and may therefore harm our results of operations.

The introduction of certain technologies may reduce the effectiveness of our products. For example, some of our products rely on third-party cookies, which are placed on individual browsers when consumers visit websites that contain advertisements. We use these cookies to help our customers more effectively advertise, to gauge the performance of their advertisements, and to detect and prevent fraudulent activity. Consumers can block or delete cookies through their browsers or "ad-blocking" software or applications. The most common Internet browsers allow consumers to modify their browser settings to prevent cookies from being accepted by their browsers, or are set to

block third-party cookies by default. Increased use of methods, software or applications that block cookies could harm our business.

For additional information regarding our competition and the risks arising out of the competitive environment in which we operate, see the section entitled “Competition” contained in Item 1 of our Annual Report on Form 10-K for the fiscal year ended November 27, 2015.

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If we fail to successfully manage transitions to new business models and markets, our results of operations could suffer.

We often release new offerings and employ new product and services delivery methods in connection with our diversification into new business models and markets. It is uncertain whether these strategies will prove successful or whether we will be able to develop the necessary infrastructure and business models more quickly than our competitors. Market acceptance of new product and service offerings will be dependent in part on our ability to (1) include functionality and usability that satisfy customer requirements and (2) optimally price our products and services in light of marketplace conditions, our costs and customer demand. New product and service offerings may increase our risk of liability related to the provision of services and cause us to incur significant technical, legal or other costs. Market acceptance of such services is affected by a variety of factors, including information security, reliability, performance, customer preference, social and community engagement, local government regulations regarding online services and user-generated content, the sufficiency of technological infrastructure to support our products and services in certain geographies, customer concerns with entrusting a third party to store and manage customer data, consumer concerns regarding data privacy and the enactment of laws or regulations that restrict our ability to provide such services to customers in the United States or internationally. If we are unable to respond to these factors, our business could be harmed.

From time to time we open-source certain of our technology initiatives, provide broader open access to our technology, license certain of our technology on a royalty-free basis or release selected technology for industry standardization. Additionally, customer requirements for open standards or open-source products could impact adoption or use of some of our products or services. To the extent we incorrectly predict customer requirements for such products or services, or if there is a delay in market acceptance of such products or services, our business could be harmed.

We also devote significant resources to the development of technologies and service offerings in markets where our operating history is less extensive. These new offerings and markets may require a considerable investment of technical, financial, compliance and sales resources, and a scalable organization. Some of our competitors may have advantages over us due to their larger presence, larger developer network, deeper market experience and larger sales, consulting and marketing resources. In addition, the metrics we use to gauge the status of our business model transition may evolve over the course of the transition as significant trends emerge. If we are unable to successfully establish new offerings in light of the competitive environment, our results of operations could suffer.

Subscription offerings and ETLAs could create risks related to the timing of revenue recognition.

Our subscription model creates certain risks related to the timing of revenue recognition and potential reductions in cash flows. A portion of the subscription-based revenue we report each quarter results from the recognition of deferred revenue relating to subscription agreements entered into during previous quarters. A decline in new or renewed subscriptions in any period may not be immediately reflected in our reported financial results for that period, but may result in a decline in our revenue in future quarters. If we were to experience significant downturns in subscription sales and renewal rates, our reported financial results might not reflect such downturns until future periods. Our subscription model could also make it difficult for us to rapidly increase our revenue from subscription-based or hosted services through additional sales in any period, as revenue from new customers will be recognized over the applicable subscription term. Further, any increases in sales under our subscription sales model could result in decreased revenue over the short term if they are offset by a decline in sales from perpetual license customers. Additionally, in connection with our sales efforts to enterprise customers and our use of ETLAs, a number of factors could affect our revenue, including longer-than-expected sales and implementation cycles, potential deferral of revenue due to multiple-element revenue arrangements and alternative licensing arrangements. If any of our assumptions about revenue from our new businesses or our addition of a subscription-based model prove incorrect, our actual results may vary materially from those anticipated, estimated or projected.

Uncertainty about current and future economic conditions and other adverse changes in general political conditions in any of the major countries in which we do business could adversely affect our operating results.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in economic and political conditions, both domestically and globally. Uncertainty about the effects of current and future

economic and political conditions on us, our customers, suppliers and partners makes it difficult for us to forecast operating results and to make decisions about future investments. If economic growth in countries where we do business slows, customers may delay or reduce technology purchases, advertising spending or marketing spending. This could result in reductions in sales of our products and services, more extended sales cycles, slower adoption of new technologies and increased price competition. Our customers include government entities, including the U.S. federal government, and if spending cuts impede the government's ability to purchase our products and services, our revenue could decline. Deterioration in economic conditions in any of the countries in which we do business could also cause slower or impaired collections on accounts receivable, which may adversely impact our liquidity and financial condition.

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A financial institution credit crisis could impair credit availability and the financial stability of our customers, including our distribution partners and channels. A disruption in the financial markets may also have an effect on our derivative counterparties and could also impair our banking partners, on which we rely for operating cash management. Any of these events would likely harm our business, results of operations and financial condition. Political instability or adverse political developments in or around any of the major countries in which we do business would also likely harm our business, results of operations and financial condition.

Our cloud strategy may give rise to risks that could harm our business.

Over the past several years, our business has shifted away from pre-packaged software to focus on a subscription model that prices and delivers our products and services in a way that differs from our historical pricing and delivery methods. These changes reflect a significant shift from perpetual license sales and distribution of our software in favor of providing our customers the right to access certain of our software in a hosted environment or use downloaded software for a specified subscription period. This cloud strategy requires continued investment in product development and cloud operations, and may give rise to a number of risks, including the following:

- if customers desire only perpetual licenses or to purchase or renew subscriptions for specific products rather than acquire the entire Creative Cloud offering, our subscription sales may lag behind our expectations;
- our cloud strategy may raise concerns among our customer base, including concerns regarding changes to pricing over time, service availability, information security of a cloud solution and access to files while offline or once a subscription has expired;

- customers may turn to competitive or open-source offerings;

- our sales cycles may be delayed if we need to educate customers about the benefits of our cloud solutions, including technical capabilities, security, privacy and return on investment;

- we may be unsuccessful in maintaining our target pricing, new seat adoption and projected renewal rates; or we may have to rely heavily on promotional rates to achieve target seat adoption, which could reduce average revenue per user; and

- we may incur costs at a higher-than-forecasted rate as we expand our cloud operations.

We may be unable to predict subscription renewal rates and the impact these rates may have on our future revenue and operating results.

The hosted business model we use in our Adobe Marketing Cloud offerings typically involves selling services on a subscription basis pursuant to service agreements that are generally one to three years in length. Our individual Creative Cloud and Document Cloud subscription agreements are generally month-to-month or one year in length, ETLAs for our Digital Media products and services are generally three years in length, and subscription agreements for other products and services may provide for shorter or longer terms. Our customers have no obligation to renew their subscriptions for our services after the expiration of their initial subscription period, and some customers elect not to renew. We cannot provide assurance that our subscriptions will be renewed at the same or higher level of service, for the same number of seats or licenses or for the same duration of time, if at all. Moreover, under certain circumstances, some of our customers have the right to cancel their service agreements prior to the expiration of the terms of their agreements. We cannot provide assurance that we will be able to accurately predict future customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including their level of satisfaction with our services, our ability to continue to regularly add features and functionality, the reliability (including uptime) of our subscription services, the prices of our services, the actual or perceived information security of our systems and services, the prices of services offered by our competitors, mergers and acquisitions affecting our customer base, reductions in our customers' spending levels, or declines in customer activity as a result of economic downturns or uncertainty in financial markets. If our customers do not renew their subscriptions for our services or if they renew on terms less favorable to us, our revenue may decline.

Our future growth is also affected by our ability to sell additional features and services to our current customers, which depends on a number of factors, including customers' satisfaction with our products and services, the level of

innovation reflected in those additional features, the prices of our offerings and general economic conditions. If our efforts to cross-sell and upsell to our customers are unsuccessful, the rate at which our business grows may decline.

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Security vulnerabilities in our products and systems could lead to reduced revenue or to liability claims. Maintaining the security of our products, computers and networks is a critical issue for us and our customers. Security researchers, criminal hackers and other third parties regularly develop new techniques to penetrate computer and network security measures and, as we have previously disclosed, certain parties have in the past managed to breach certain of our data security systems and misused certain of our systems and software in order to access our end users' authentication and payment information. In addition, cyber-attackers also develop and deploy viruses, worms and other malicious software programs, some of which may be specifically designed to attack our products, systems, computers or networks. Sophisticated hardware and operating system applications that we develop or procure from third parties may contain defects in design or manufacture, including bugs and other problems that could unexpectedly compromise the security of the system or impair a customer's ability to operate or use our products. The costs to prevent, eliminate or alleviate cyber- or other security problems, bugs, viruses, worms, malicious software programs and security vulnerabilities are significant, and our efforts to address these problems may not be successful and could result in interruptions, delays, cessation of service and loss of existing or potential customers. It is impossible to predict the extent, frequency or impact of these problems on us.

Outside parties have in the past and may in the future attempt to fraudulently induce our employees or users of our products or services to disclose sensitive information via illegal electronic spamming, phishing or other tactics. Unauthorized parties may also attempt to gain physical access to our facilities in order to infiltrate our information systems. These actual and potential breaches of our security measures and the accidental loss, inadvertent disclosure or unauthorized dissemination of proprietary information or sensitive, personal or confidential data about us, our employees, our customers or their end users, including the potential loss or disclosure of such information or data as a result of hacking, fraud, trickery or other forms of deception, could expose us, our employees, our customers or the individuals affected to a risk of loss or misuse of this information. This may result in litigation and potential liability or fines, governmental inquiry or oversight or a loss of customer confidence, any of which could harm our business or damage our brand and reputation, possibly impeding our present and future success in retaining and attracting new customers and thereby requiring time and resources to repair our brand and reputation.

These problems affect our products and services in particular because cyber-attackers tend to focus their efforts on the most popular offerings (such as those with a large user base), and we expect them to continue to do so. Critical vulnerabilities may be identified in certain of our applications. These vulnerabilities could cause such applications to crash and could allow an attacker to take control of the affected system, which could result in liability to us or limit our ability to conduct our business and deliver our products and services to customers. We devote significant resources to address security vulnerabilities through engineering more secure products, enhancing security and reliability features in our products and systems, code hardening, conducting rigorous penetration tests, deploying updates to address security vulnerabilities and improving our incident response time, but these security vulnerabilities cannot be totally eliminated. The cost of these steps could reduce our operating margins, and we may be unable to implement these measures quickly enough to prevent cyber-attackers from gaining unauthorized access into our systems and products. Despite our preventative efforts, actual or perceived security vulnerabilities in our products and systems may harm our reputation or lead to claims against us (and have in the past led to such claims), and could lead some customers to seek to return products, to stop using certain services, to reduce or delay future purchases of products or services, or to use competing products or services. If we do not make the appropriate level of investment in our technology systems or if our systems become out-of-date or obsolete and we are not able to deliver the quality of data security customers require, our business could be adversely affected. Customers may also adopt security measures designed to protect their existing computer systems from attack, which could delay adoption of new technologies. Further, if we or our customers are subject to a future attack, or our technology is used in a third-party attack, it may be necessary for us to take additional extraordinary measures and make additional expenditures to take appropriate responsive and preventative steps. Any of these events could adversely affect our revenue or margins. Moreover, delayed sales, lower margins or lost customers resulting from the disruptions of cyber-attacks or preventative measures could adversely affect our financial results, stock price and reputation.

The success of certain of our product and service offerings depends on our ability to continue to attract and retain customers of and contributors to our online marketplaces for creative content.

The success of certain of our product and service offerings, such as Adobe Stock, depends on our ability to continue to attract new customers and contributors to these online marketplaces for creative content, as well as our ability to continue to retain existing customers and contributors. To maintain and grow these businesses, we must regularly add new customers and retain existing customers. An increase in paying customers has generally resulted in more content from contributors, which increases the size of our collection and in turn attracts new paying customers. To attract new customers and contributors and retain existing ones, we rely on the functionality and features of our online marketplaces, the size and content of our collection and the effectiveness of our marketing efforts. New technologies may render the features of our online marketplaces obsolete, our collection may fail to grow as anticipated and our marketing efforts may be unsuccessful, any of which may adversely affect our results of operations.

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Some of our lines of business rely on us or our third-party service providers to host and deliver services and data, and any interruptions or delays in these hosted services, security or privacy breaches, or failures in data collection could expose us to liability and harm our business and reputation.

Some of our lines of business and services, including our online store at adobe.com, Creative Cloud, Document Cloud, other hosted Digital Media offerings and our Adobe Marketing Cloud solutions, rely on hardware and services hosted and controlled directly by us or by our third-party service providers. We do not have redundancy for all of our systems, many of our critical applications reside in only one of our data centers, and our disaster recovery planning may not account for all eventualities. If our business relationship with a third-party provider of hosting or content delivery services is negatively affected, or if one of our content delivery suppliers were to terminate its agreement with us, we might not be able to deliver the corresponding hosted offerings to our customers, which could subject us to reputational harm and cause us to lose customers and future business, thereby reducing our revenue.

We hold large amounts of customer data, some of which is hosted in third-party facilities. A security incident at those facilities or ours may compromise the confidentiality, integrity or availability of customer data. Unauthorized access to customer data stored on our computers or networks may be obtained through break-ins, breaches of our secure network by an unauthorized party, employee theft or misuse, or other misconduct. It is also possible that unauthorized access to customer data may be obtained through inadequate use of security controls by customers. Accounts created with weak passwords could allow cyber-attackers to gain access to customer data. Additionally, failure by customers to remove accounts of their own employees, or the granting of accounts by the customer in an uncontrolled manner, may allow for access by former or unauthorized customer representatives. If there were an inadvertent disclosure of personal information, or if a third party were to gain unauthorized access to the personal information we possess on behalf of our customers, our operations could be disrupted, our reputation could be damaged and we could be subject to claims or other liabilities. In addition, such perceived or actual unauthorized disclosure of the information we collect or breach of our security could damage our reputation, result in the loss of customers and harm our business. Because of the large amount of data that we collect and manage on behalf of our customers, it is possible that hardware or software failures or errors in our systems (or those of our third-party service providers) could result in data loss or corruption or cause the information that we collect to be incomplete or contain inaccuracies that our customers regard as significant. Furthermore, our ability to collect and report data may be delayed or interrupted by a number of factors, including access to the Internet, the failure of our network or software systems, security breaches or significant variability in visitor traffic on customer websites. In addition, computer viruses or other malware may harm our systems, causing us to lose data, and the transmission of computer viruses or other malware could expose us to litigation. We may also find, on occasion, that we cannot deliver data and reports to our customers in near real time because of a number of factors, including significant spikes in customer activity on their websites or failures of our network or software. If we supply inaccurate information or experience interruptions in our ability to capture, store and supply information in near real time or at all, our reputation could be harmed and we could lose customers, or we could be found liable for damages or incur other losses.

We may not realize the anticipated benefits of past or future acquisitions, and integration of these acquisitions may disrupt our business and management.

We may not realize the anticipated benefits of an acquisition of a company, division, product or technology, each of which involves numerous risks. These risks include:

- difficulty in integrating the operations and personnel of the acquired business;
- difficulty in effectively integrating the acquired technologies, products or services with our current technologies, products or services;
- difficulty in maintaining controls, procedures and policies during the transition and integration;
- entry into markets in which we have minimal prior experience and where competitors in such markets have stronger market positions;
- disruption of our ongoing business and distraction of our management and other employees from other opportunities and challenges;
- inability to retain personnel of the acquired business;
- inability to retain key customers, distributors, vendors and other business partners of the acquired business;

inability to achieve the financial and strategic goals for the acquired and combined businesses;

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- inability to take advantage of anticipated tax benefits as a result of unforeseen difficulties in our integration activities;
- incurring acquisition-related costs or amortization costs for acquired intangible assets that could impact our operating results;
- potential elevated delinquency or bad debt write-offs related to receivables of the acquired business we assume;
- potential additional exposure to fluctuations in currency exchange rates;
- potential additional costs of bringing acquired companies into compliance with laws and regulations applicable to us as a multinational corporation;
- potential impairment of our relationships with employees, customers, partners, distributors or third-party providers of our technologies, products or services;
- potential failure of our due diligence processes to identify significant problems, liabilities or other challenges of an acquired company or technology, including, but not limited to, issues with the acquired company's intellectual property, product quality or product architecture, data back-up and security (including security from cyber-attacks), privacy practices, revenue recognition or other accounting practices, employee, customer or partner issues or legal and financial contingencies;
- exposure to litigation or other claims in connection with, or inheritance of claims or litigation risk as a result of, an acquisition, including, but not limited to, claims from terminated employees, customers, former stockholders or other third parties;
- incurring significant exit charges if products or services acquired in business combinations are unsuccessful;
- potential inability to conclude that our internal controls over financial reporting are effective;
- potential inability to obtain, or obtain in a timely manner, approvals from governmental authorities, which could delay or prevent such acquisitions;
- the failure of strategic investments to perform as expected or to meet financial projections;
- potential delay in customer and distributor purchasing decisions due to uncertainty about the direction of our product and service offerings; and
- potential incompatibility of business cultures.

Mergers and acquisitions of high technology companies are inherently risky. If we do not complete an announced acquisition transaction or integrate an acquired business successfully and in a timely manner, we may not realize the benefits of the acquisition to the extent anticipated, and in certain circumstances an acquisition could harm our financial position. Furthermore, our existing stockholders will experience dilution.

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

In connection with the enforcement of our intellectual property rights, the acquisition of third-party intellectual property rights, or 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 and complex, protracted litigation. Intellectual property disputes and litigation are typically 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 many past lawsuits and other disputes, we may not prevail in every case in the future. Third-party intellectual property disputes, including those initiated by patent assertion entities, 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. In addition, we may incur significant costs in acquiring the necessary third-party intellectual property rights for use in our products, in some cases to fulfill contractual obligations with our customers. Any of these occurrences could significantly harm our business.

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Our intellectual property portfolio is a valuable asset and we may not be able to protect our intellectual property rights, including our source code, from infringement or unauthorized copying, use or disclosure.

Our intellectual property portfolio is a valuable asset. Infringement or misappropriation of assets in this portfolio can result in lost revenues and thereby ultimately reduce their value. Preventing unauthorized use or infringement of our intellectual property rights is inherently difficult. We actively combat software piracy as we enforce our intellectual property rights, but we nonetheless lose significant revenue due to illegal use of our software. If piracy activities continue at historical levels or increase, they may further harm our business.

Additionally, we take significant measures to protect the secrecy of our confidential information and trade secrets, including our source code. Despite these measures, as we have previously disclosed, hackers have managed to access certain of our source code and may obtain access in the future. If unauthorized disclosure of our source code occurs through security breach, cyber-attack or otherwise, we could potentially lose future trade secret protection for that source code. The loss of future trade secret protection could make it easier for third parties to compete with our products by copying functionality, which could cause us to lose customers and could adversely affect our revenue and operating margins. We also seek to protect our confidential information and trade secrets through the use of non-disclosure agreements with our customers, contractors, vendors and partners. However, there is a risk that our confidential information and trade secrets may be disclosed or published without our authorization, and in these situations, enforcing our rights may be difficult or costly.

Increasing regulatory focus on privacy issues and expanding laws and regulations could impact our business models and expose us to increased liability.

Our industry is highly regulated, including for privacy and data security. We are also expanding our business in countries that have more stringent data protection laws than those in the United States, and such laws may be inconsistent across jurisdictions and are subject to evolving and differing interpretations. Governments, privacy advocates and class action attorneys are increasingly scrutinizing how companies collect, process, use, store, share and transmit personal data. New laws and industry self-regulatory codes have been enacted and more are being considered that may affect our ability to reach current and prospective customers, to understand how our products and services are being used, to respond to customer requests allowed under the laws, and to implement our new business models effectively. Any perception of our practices, products or services as an invasion of privacy, whether or not consistent with current regulations and industry practices, may subject us to public criticism, class action lawsuits, reputational harm or claims by regulators, industry groups or other third parties, all of which could disrupt our business and expose us to increased liability. Additionally, both laws regulating privacy and third-party products purporting to address privacy concerns could affect the functionality of, and demand for, our products and services, thereby affecting our revenue.

On behalf of certain customers, we collect and store anonymous and personal information derived from the activities of end users with various channels, including traditional websites, mobile websites and applications, email interactions, direct mail, point of sale, text messaging and call centers. Federal, state and foreign governments and agencies have adopted or are considering adopting laws regarding the collection, use and disclosure of this information. Our compliance with privacy laws and regulations and our reputation among consumers depend in part on our customers' adherence to privacy laws and regulations and their use of our services in ways consistent with such consumers' expectations. We also rely on contractual representations made to us by customers that their own use of our services and the information they provide to us via our services do not violate any applicable privacy laws, rules and regulations or their own privacy policies. As a component of our standardized customer contract, we obligate customers to provide their consumers the opportunity to "opt out" of the information collection associated with our services, as applicable. We do not formally audit such customers to confirm compliance with these representations. If these representations are false or if our customers do not otherwise comply with applicable privacy laws, we could face adverse publicity and possible legal or other regulatory action. In addition, some countries are considering enacting laws that would expand the scope of privacy-related obligations required of service providers, such as Adobe, that would require additional compliance expense and increased liability.

In the past we have relied on the U.S.-European Union and the U.S.-Swiss Safe Harbor frameworks, as agreed to by the U.S. Department of Commerce and the European Union ("EU") and Switzerland, as a means to legally transfer EU

citizens' personal information from the EU to the United States. However, on October 6, 2015, the European Court of Justice invalidated the U.S.-EU Safe Harbor framework and the Swiss data protection authorities later invalidated the U.S.-Swiss Safe Harbor framework. As a result, we have worked to establish alternate legitimate means of transferring personal data from the European Economic Area and Switzerland to the United States; however, we continue to face uncertainty as to the legitimacy of these alternate means. At least one regulator has determined that, with respect to a small number of vendors that process certain of our EU employee data, we did not implement these alternate means quickly enough, resulting in a fine levied against us. We are closely monitoring developments regarding requirements for transferring personal data outside the EU, such as Privacy Shield. Once finalized, these requirements may result in an increase in the obligations required of us to provide our services in the EU and in

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potential sanctions and fines for non-compliance. These developments could harm our business, financial condition and results of operations.

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

Because our products are distributed and used globally, our operating results are subject to fluctuations in foreign currency exchange rates. We attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. We have established a program to partially hedge our exposure to foreign currency exchange rate fluctuations for various currencies. We regularly review our hedging program and make adjustments as necessary based on the factors discussed above. Our hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movement in foreign currency exchange rates, which could adversely affect our financial condition or results of operations.

If we fail to process transactions effectively, our revenue and earnings may be harmed.

We process a significant volume of transactions on a daily basis in our Digital Marketing and Digital Media businesses. Due to the size and volume of transactions that we handle, effective processing systems and controls are essential, but even the most sophisticated systems and processes may not be effective in preventing all errors. The systems supporting our business are comprised of multiple technology platforms that may be difficult to scale. If we are unable to effectively manage these systems and processes, we may be unable to process customer data in an accurate, reliable and timely manner, which may harm our customer relationships or results of operations.

Failure to manage our sales and distribution channels and third-party customer service and technical support providers effectively could result in a loss of revenue and harm to our business.

We contract with a number of software distributors, none of which is individually responsible for a material amount of our total net revenue for any recent period. Nonetheless, if any single agreement with one of our distributors were terminated, any prolonged delay in securing a replacement distributor could have a negative impact on our results of operations.

Successfully managing our indirect distribution channel efforts to reach various customer segments for our products and services is a complex process across the broad range of geographies where we do business or plan to do business. Our distributors and other channel partners are independent businesses that we do not control. Notwithstanding the independence of our channel partners, we face potential legal risk and reputational harm from the activities of these third parties including, but not limited to, export control violations, workplace conditions, corruption and anti-competitive behavior. We cannot be certain that our distribution channel will continue to market or sell our products and services effectively. If our distribution channel is not successful, we may lose sales opportunities, customers and revenue.

Our distributors also sell our competitors' products and services, and if they favor our competitors' products or services for any reason, they may fail to market our products or services effectively or to devote resources necessary to provide effective sales, which would cause our results to suffer. We also distribute some products and services through our OEM channel, and if our OEMs decide not to bundle our applications on their devices, our results could suffer. In addition, the financial health of our distributors and our continuing relationships with them are important to our success. Some of these distributors may be adversely impacted by changes to our business model or unable to withstand adverse changes in economic conditions, which could result in insolvency and/or the inability of such distributors to obtain credit to finance purchases of our products and services. In addition, weakness in the end-user market could negatively affect the cash flows of our distributors who could, in turn, delay paying their obligations to us, which would increase our credit risk exposure. Our business could be harmed if the financial condition of some of these distributors substantially weakened and we were unable to timely secure replacement distributors.

We also sell certain of our products and services through our direct sales force. Risks associated with this sales channel include more extended sales and collection cycles associated with direct sales efforts, challenges related to hiring, retaining and motivating our direct sales force, and substantial amounts of training for sales representatives, including regular updates to cover new and upgraded systems, products and services. Moreover, recent hires may not

become as productive as we would like, as in most cases it takes a significant period of time before they achieve full productivity. Our business could be seriously harmed if our expansion efforts do not generate a corresponding significant increase in revenue and we are unable to achieve the efficiencies we anticipate. In addition, the loss of key sales employees could impact our customer relationships and future ability to sell to certain accounts covered by such employees.

We also provide products and services, directly and indirectly, to a variety of government entities, both domestically and internationally. Risks associated with licensing and selling products and services to government entities include more extended

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sales and collection cycles, varying governmental budgeting processes and adherence to complex procurement regulations and other government-specific contractual requirements. Ineffectively managing these risks could result in various civil and criminal penalties and administrative sanctions, including termination of contracts, payment of fines, and suspension or debarment from future government business, as well as harm to our reputation.

We outsource a substantial portion of our customer service and technical support activities to third-party service providers. We rely heavily on these third-party customer service and technical support representatives working on our behalf, and we expect to continue to rely heavily on third parties in the future. This strategy provides us with lower operating costs and greater flexibility, but also presents risks to our business due to the fact that we may not be able to influence the quality of support as directly as we would be able to do if our own employees performed these activities. Our customers may react negatively to providing information to, and receiving support from, third-party organizations, especially if these third-party organizations are based overseas. If we encounter problems with our third-party customer service and technical support providers, our reputation may be harmed and we could lose customers and associated revenue.

Certain of our enterprise offerings have extended and complex sales cycles, which can make our sales cycles unpredictable.

Sales cycles for some of our enterprise offerings, including our Adobe Marketing Cloud solutions and ETLAs in our Digital Media business, are multi-phased and complex. The complexity in these sales cycles is due to a number of factors, including:

- the need for our sales representatives to educate customers about the use and benefit of our large-scale deployments of our products and services, including technical capabilities, security features, potential cost savings and return on investment;
- the desire of large and medium size organizations to undertake significant evaluation processes to determine their technology requirements prior to making information technology expenditures;
- the need for our representatives to spend a significant amount of time assisting potential customers in their testing and evaluation of our products and services;
- the negotiation of large, complex, enterprise-wide contracts, as often required by our and our customers' business and legal representatives;
- the need for our customers to obtain requisition approvals from various decision makers within their organizations;
- and
- customer budget constraints, economic conditions and unplanned administrative delays.

We spend substantial time and expense on our sales efforts without any assurance that potential customers will ultimately purchase our solutions. As we target our sales efforts at larger enterprise customers, these trends are expected to continue and could have a greater impact on our results of operations. Additionally, our enterprise sales pattern has historically been uneven, where a higher percentage of a quarter's total sales occur during the final weeks of each quarter, which is common in our industry. Our extended sales cycle for these products and services makes it difficult to predict when a given sales cycle will close.

Net revenue, margin or earnings shortfalls or the volatility of the market generally may cause the market price of our stock to decline.

The market price for our common stock has in the past experienced significant fluctuations and may do so in the future. A number of factors may affect the market price for our common stock, including:

- shortfalls in our revenue, margins, earnings, the number of paid Creative Cloud and Document Cloud subscribers, Annualized Recurring Revenue ("ARR"), bookings within our Adobe Marketing Cloud business or other key performance metrics;
- changes in estimates or recommendations by securities analysts;
- whether our results meet analysts' expectations;
- compression or expansion of multiples used by investors and analysts to value high technology SaaS companies;
- the announcement of new products and services, product enhancements or service introductions by us or our competitors;

the loss of large customers or our inability to increase sales to existing customers, retain customers or attract new customers;

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variations in our or our competitors' results of operations, changes in the competitive landscape generally and developments in our industry; and unusual events such as significant acquisitions, divestitures, litigation, general socio-economic, regulatory, political or market conditions and other factors, including factors unrelated to our operating performance.

In addition, the technology industry as a whole may experience uneven investor confidence, which may cause the market price for our common stock to decline for reasons unrelated to our operating performance.

We are subject to risks associated with compliance with laws and regulations globally which may harm our business. We are a global company subject to varied and complex laws, regulations and customs, both domestically and internationally. These laws and regulations relate to a number of aspects of our business, including trade protection, import and export control, data and transaction processing security, payment card industry data security standards, records management, user-generated content hosted on websites we operate, privacy practices, data residency, corporate governance, employee and third-party complaints, gift policies, conflicts of interest, employment and labor relations laws, securities regulations and other regulatory requirements affecting trade and investment. The application of these laws and regulations to our business is often unclear and may at times conflict. Compliance with these laws and regulations may involve significant costs or require changes in our business practices that result in reduced revenue and profitability. Non-compliance could also result in fines, damages, criminal sanctions against us, our officers or our employees, prohibitions on the conduct of our business, and damage to our reputation. We incur additional legal compliance costs associated with our global operations and could become subject to legal penalties if we fail to comply with local laws and regulations in U.S. jurisdictions or in foreign countries, which laws and regulations may be substantially different from those in the United States. In many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by U.S. regulations applicable to us, including the Foreign Corrupt Practices Act. We cannot provide assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain of our business operations, including those based in or from countries where practices that violate such U.S. laws may be customary, will not take actions in violation of our internal policies or U.S. laws and regulations. Any such violation could have an adverse effect on our business.

We face various risks associated with our operating as a multinational corporation.

As a global business that generates approximately 41% of our total revenue from sales to customers outside of the Americas, we are subject to a number of risks, including:

- foreign currency fluctuations;
- changes in government preferences for software procurement;
- international and regional economic, political and labor conditions, including any instability or security concerns abroad;
- tax laws (including U.S. taxes on foreign subsidiaries);
- increased financial accounting and reporting burdens and complexities;
- unexpected changes in, or impositions of, legislative or regulatory requirements;
- changes in laws governing the free flow of data across international borders;
- failure of laws to protect our intellectual property rights adequately;
- inadequate local infrastructure and difficulties in managing and staffing international operations;
- delays resulting from difficulty in obtaining export licenses for certain technology, tariffs, quotas and other trade barriers;
- the imposition of governmental economic sanctions on countries in which we do business or where we plan to expand our business;
- costs and delays associated with developing products in multiple languages;
- operating in locations with a higher incidence of corruption and fraudulent business practices; and
- other factors beyond our control, including terrorism, war, natural disasters and pandemics.

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If sales to any of our customers outside of the Americas are delayed or canceled because of any of the above factors, our revenue may decline.

In addition, approximately 52% of our employees are located outside the United States. Accordingly, we are exposed to changes in laws governing our employee relationships in various U.S. and foreign jurisdictions, including laws and regulations regarding wage and hour requirements, fair labor standards, employee data privacy, unemployment tax rates, workers' compensation rates, citizenship requirements and payroll and other taxes, which likely would have a direct impact on our operating costs. We may continue to expand our international operations and international sales and marketing activities. Expansion in international markets has required, and will continue to require, significant management attention and resources. We may be unable to scale our infrastructure effectively or as quickly as our competitors in these markets, and our revenue may not increase to offset these expected increases in costs and operating expenses, which would cause our results to suffer.

If we are unable to recruit and retain key personnel, our business may be harmed.

Much of our future success depends on the continued service, availability and performance of our senior management. These individuals have acquired specialized knowledge and skills with respect to Adobe. The loss of any of these individuals could harm our business, especially in the event that we have not been successful in developing adequate succession plans. Our business is also dependent on our ability to retain, hire and motivate talented, highly skilled personnel across all levels of our organization. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense in many areas where our employees are located. If we are unable to continue to successfully attract and retain key personnel, our business may be harmed. Effective succession planning is also a key factor for our long-term success. Our failure to enable the effective transfer of knowledge and facilitate smooth transitions of our key employees could adversely affect our long-term strategic planning and execution.

We believe that a critical contributor to our success to date has been our corporate culture, which we have built to foster innovation, teamwork and employee satisfaction. As we grow, including from the integration of employees and businesses acquired in connection with previous or future acquisitions, we may find it difficult to maintain important aspects of our corporate culture, which could negatively affect our ability to retain and recruit personnel who are essential to our future success.

We have issued \$1.9 billion of notes in debt offerings and may incur other debt in the future, which may adversely affect our financial condition and future financial results.

We have \$1.9 billion in senior unsecured notes outstanding. We also have a \$1 billion senior unsecured revolving credit agreement, which is currently undrawn. This debt may adversely affect our financial condition and future financial results by, among other things:

requiring the dedication of a portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of expected cash flow available for other purposes, including capital expenditures and acquisitions; and

limiting our flexibility in planning for, or reacting to, changes in our business and our industry.

Our senior unsecured notes and senior unsecured revolving credit agreement impose restrictions on us and require us to maintain compliance with specified covenants. Our ability to comply with these covenants may be affected by events beyond our control. If we breach any of the covenants and do not obtain a waiver from the lenders or noteholders, then, subject to applicable cure periods, any outstanding indebtedness may be declared immediately due and payable.

In addition, changes by any rating agency to our credit rating may negatively impact the value and liquidity of both our debt and equity securities, as well as the potential costs associated with a refinancing of our debt. Under certain circumstances, if our credit ratings are downgraded or other negative action is taken, the interest rate payable by us under our revolving credit facility could increase. Downgrades in our credit ratings could also restrict our ability to obtain additional financing in the future and could affect the terms of any such financing.

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

We are a U.S.-based multinational company subject to tax in multiple U.S. and foreign tax jurisdictions. A significant portion of our foreign earnings for the current fiscal year were earned by our Irish subsidiaries. In addition to

providing for U.S. income taxes on earnings from the United States, we provide for U.S. income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered permanently reinvested outside the United States. While we do not anticipate changing our intention regarding permanently reinvested earnings, if certain foreign earnings previously treated as permanently reinvested are repatriated, the related U.S. tax liability may be reduced by any foreign income taxes paid on these earnings.

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Our income tax expense has differed from the tax computed at the U.S. federal statutory income tax rate due primarily to discrete items and to earnings considered as permanently reinvested in foreign operations. Unanticipated changes in our tax rates could affect our future results of operations. Our future effective tax rates could be unfavorably affected by changes in the tax rates in jurisdictions where our income is earned, by changes in or our interpretation of tax rules and regulations in the jurisdictions in which we do business, by unanticipated decreases in the amount of earnings in countries with low statutory tax rates, or by changes in the valuation of our deferred tax assets and liabilities. The United States, countries in the EU and other countries where we do business have been considering changes in relevant tax, accounting and other laws, regulations and interpretations, including changes to tax laws applicable to corporate multinationals such as Adobe. These potential changes could adversely affect our effective tax rates or result in other costs to us.

In addition, we are subject to the continual examination of our income tax returns by the U.S. Internal Revenue Service (“IRS”) and other domestic and foreign tax authorities, including a current examination by the IRS of our fiscal 2010, 2011 and 2012 tax returns. These tax examinations are expected to focus on our intercompany transfer pricing practices as well as other matters. We regularly assess the likelihood of outcomes resulting from these examinations to determine the adequacy of our provision for income taxes and have reserved for potential adjustments that may result from the current examinations. We cannot provide assurance that the final determination of any of these examinations will not have an adverse effect on our operating results and financial position.

Changes in accounting principles, or interpretations thereof, could have a significant impact on our financial position and results of operations.

We prepare our Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America (“GAAP”). These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles. A change in these principles can have a significant effect on our reported results and may even retroactively affect previously reported transactions. Additionally, the adoption of new or revised accounting principles may require that we make significant changes to our systems, processes and controls.

For example, the Financial Accounting Standards Board (“FASB”) is currently working together with the International Accounting Standards Board (“IASB”) on several projects to further align accounting principles and facilitate more comparable financial reporting between companies who are required to follow GAAP under SEC regulations and those who are required to follow International Financial Reporting Standards outside of the United States. These efforts by the FASB and IASB may result in different accounting principles under GAAP that may result in materially different financial results for us in areas including, but not limited to, principles for recognizing revenue and lease accounting. Additionally, significant changes to GAAP resulting from the FASB’s and IASB’s efforts may require that we change how we process, analyze and report financial information and that we change financial reporting controls. It is not clear if or when these potential changes in accounting principles may become effective, whether we have the proper systems and controls in place to accommodate such changes and the impact that any such changes may have on our financial position and results of operations.

If our goodwill or amortizable intangible assets become impaired we could be required to record a significant charge to earnings.

Under GAAP, we review our goodwill and amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. GAAP requires us to test for goodwill impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include declines in stock price, market capitalization or cash flows and slower growth rates in our industry. We could be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets were determined, negatively impacting our results of operations.

Catastrophic events may disrupt our business.

We are a highly automated business and rely on our network infrastructure and enterprise applications, internal technology systems and our website for our development, marketing, operational, support, hosted services and sales activities. In addition, some of our businesses rely on third-party hosted services, and we do not control the operation

of third-party data center facilities serving our customers from around the world, which increases our vulnerability. A disruption, infiltration or failure of these systems or third-party hosted services in the event of a major earthquake, fire, flood, tsunami or other weather event, power loss, telecommunications failure, software or hardware malfunctions, cyber-attack, war, terrorist attack or other catastrophic event could cause system interruptions, reputational harm, loss of intellectual property, delays in our product development, lengthy interruptions in our services, breaches of data security and loss of critical data. Any of these events could prevent us from fulfilling our customers' orders or could negatively impact a country or region in which we sell our products, which could in turn decrease that country's

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or region's demand for our products. Our corporate headquarters, a significant portion of our research and development activities, certain of our data centers and certain other critical business operations are located in the San Francisco Bay Area, and additional facilities where we conduct significant operations are located in the Salt Lake Valley Area, both of which are near major earthquake faults. A catastrophic event that results in the destruction or disruption of any of our data centers or our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our future operating results could be adversely affected.

Climate change may have a long-term impact on our business.

Access to clean water and reliable energy in the communities where we conduct our business, whether for our offices or for our vendors, is a priority. Our major sites in California and India are vulnerable to prolonged droughts due to climate change. While we seek to partner with organizations that mitigate their business risks associated with climate change, we recognize that there are inherent risks wherever business is conducted. In the event of a natural disaster that disrupts business due to limited access to these resources, Adobe has the potential to experience losses to our business, time required to recover, and added costs to resume operations.

Additionally, climate change may pose regulatory and environmental challenges that affect where we locate our offices, who we partner with, and how we deliver products and services to our customers.

Our investment portfolio may become impaired by deterioration of the financial markets.

Our cash equivalent and short-term investment portfolio as of June 3, 2016 consisted of corporate bonds and commercial paper, U.S. agency securities and U.S. Treasury securities, foreign government securities, money market mutual funds, municipal securities, time deposits and asset-backed securities. We follow an established investment policy and set of guidelines to monitor and help mitigate our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

Should financial market conditions worsen in the future, investments in some financial instruments may pose risks arising from market liquidity and credit concerns. In addition, any deterioration of the capital markets could cause our other income and expense to vary from expectations. As of June 3, 2016, we had no material impairment charges associated with our short-term investment portfolio, and although we believe our current investment portfolio has little risk of material impairment, we cannot predict future market conditions or market liquidity, or credit availability, and can provide no assurance that our investment portfolio will remain materially unimpaired.

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

Below is a summary of stock repurchases for the three months ended June 3, 2016. See Note 9 of our Notes to Condensed Consolidated Financial Statements for information regarding our stock repurchase program.

Period	Average Shares Repurchased Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Approximate Dollar Value that May Yet be Purchased Under the Plans ⁽¹⁾
(in thousands, except average price per share)			
Beginning repurchase authority			\$ 1,479,762
March 5—April 1, 2016	Shares repurchased 638, \$ 85.77	638	\$(54,762)
April 2—April 29, 2016	Shares repurchased 799, \$ 93.84	799	\$(75,000) ⁽²⁾
April 30—June 3, 2016	Shares repurchased 791, \$ 94.92	791	\$(75,034) ⁽²⁾
Total	2,228	2,228	\$ 1,274,966

In January 2015, the Board of Directors approved a new stock repurchase program granting authority to repurchase ⁽¹⁾ up to \$2 billion in common stock through the end of fiscal 2017. The new stock repurchase program approved by our Board of Directors is similar to our previous \$2 billion stock repurchase program.

In March 2016, we entered into a structured stock repurchase agreement with a large financial institution ⁽²⁾ whereupon we provided them with a prepayment of \$225 million. As of June 3, 2016, \$75.0 million of the prepayment remained under this agreement.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

The exhibits listed in the accompanying “Index to Exhibits” are filed or incorporated by reference as part of this Form 10-Q.

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SIGNATURE

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

ADOBE SYSTEMS
INCORPORATED

By: /s/ MARK GARRETT

Mark Garrett
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)

Date: June 29, 2016

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SUMMARY OF TRADEMARKS

The following trademarks of Adobe Systems Incorporated or its subsidiaries, which may be registered in the United States and/or other countries, are referenced in this Form 10-Q:

Adobe
Acrobat
Behance
Creative Cloud
Fotolia
Reader

All other trademarks are the property of their respective owners.

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INDEX TO EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
3.1	Restated Certificate of Incorporation of Adobe Systems Incorporated	8-K	4/26/11	3.3	000-15175	
3.2	Amended and Restated Bylaws	8-K	10/30/12	3.1	000-15175	
4.1	Specimen Common Stock Certificate	10-Q	6/25/14	4.1	000-15175	
4.2	Form of Indenture	S-3	1/15/10	4.1	333-164378	
4.3	Forms of Global Note for Adobe Systems Incorporated's 4.750% Notes due 2020, together with Form of Officer's Certificate setting forth the terms of the Note	8-K	1/26/10	4.1	000-15175	
4.4	Form of Global Note for Adobe Systems Incorporated's 3.250% Notes due 2025, together with Form of Officer's Certificate setting forth the terms of the Note	8-K	1/26/15	4.1	000-15175	
10.1A	Amended 1994 Performance and Restricted Stock Plan*	10-Q	4/9/10	10.1	000-15175	
10.1B	Form of Restricted Stock Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*	10-K	1/23/09	10.3	000-15175	
10.1C	Form of Restricted Stock Unit Agreement used in connection with the Amended 1994 Performance and Restricted Stock Plan*	10-K	1/26/12	10.13	000-15175	
10.2A	1996 Outside Directors Stock Option Plan, as amended*	10-Q	4/12/06	10.6	000-15175	
10.2B	Forms of Stock Option Agreements used in connection with the 1996 Outside Directors Stock Option Plan*	S-8	6/16/00	4.8	333-39524	
10.3	1997 Employee Stock Purchase Plan, as amended*					X
10.4A	2003 Equity Incentive Plan, as amended*	8-K	4/14/16	10.1	000-15175	
10.4B	Form of Stock Option Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.4	000-15175	
10.4C	Form of RSU Grant Notice and Award Agreement pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/15	10.6	000-15175	

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Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
10.4D	Form of Restricted Stock Agreement used in connection with the 2003 Equity Incentive Plan*	10-Q	10/7/04	10.11	000-15175	
10.4E	2013 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/13	10.2	000-15175	
10.4F	Form of Performance Share Award Grant Notice and Performance Share Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2013 Performance Share Program)*	8-K	1/28/13	10.3	000-15175	
10.4G	2014 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/29/14	10.2	000-15175	
10.4H	Form of Performance Share Award Grant Notice and Performance Share Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2014 Performance Share Program)*	8-K	1/29/14	10.3	000-15175	
10.4I	2015 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/28/15	10.2	000-15175	
10.4J	Form of 2015 Performance Share Award Grant Notice and Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2015 Performance Share Program)*	8-K	1/28/15	10.3	000-15175	
10.4K	2016 Performance Share Program pursuant to the 2003 Equity Incentive Plan*	8-K	1/29/16	10.2	000-15175	
10.4L	Form of 2016 Performance Share Award Grant Notice and Award Agreement pursuant to the 2003 Equity Incentive Plan (applicable to the 2016 Performance Share Program)*	8-K	1/29/16	10.3	000-15175	
10.4M	Form of Director Initial Grant Restricted Stock Unit Award Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.6	000-15175	
10.4N	Form of Director Annual Grant Restricted Stock Unit Award Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.7	000-15175	
10.4O	Form of Director Annual Grant Stock Option Agreement used in connection with the 2003 Equity Incentive Plan*	8-K	12/20/10	99.8	000-15175	

10.5A 2005 Equity Incentive Assumption Plan, as amended and restated* 10-Q 6/28/13 10.17 000-15175

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Exhibit Number	Exhibit Description	Incorporated by Reference**			SEC File No.	Filed Herewith
		Form	Filing Date	Exhibit Number		
10.5B	Form of Stock Option Agreement used in connection with the 2005 Equity Incentive Assumption Plan*	8-K	12/20/10	99.10	000-15175	
10.5C	Form of RSU Grant Notice and Award Agreement pursuant to the 2005 Equity Incentive Assumption Plan*	8-K	1/28/13	10.7	000-15175	
10.6	Retention Agreement between Adobe Systems Incorporated and Shantanu Narayen, effective December 5, 2014	8-K	12/11/14	10.20	000-15175	
10.7	Form of Indemnity Agreement*	10-Q	6/26/09	10.12	000-15175	
10.8A	Lease between Adobe Systems Incorporated and Selco Service Corporation, dated March 26, 2007	8-K	3/28/07	10.1	000-15175	
10.8B	Participation Agreement among Adobe Systems Incorporated, Selco Service Corporation, et al. dated March 26, 2007	8-K	3/28/07	10.2	000-15175	
10.8C	Master Amendment No. 2 among Adobe Systems Incorporated, Selco Service Corporation and KeyBank National Association dated October 31, 2011	10-K	1/22/13	10.13	000-15175	
10.9	Adobe Systems Incorporated Deferred Compensation Plan, as Amended and Restated*	10-K	1/20/15	10.19	000-15175	
10.10A	Credit Agreement, dated as of March 2, 2012, among Adobe Systems Incorporated and certain subsidiaries as Borrowers, The Royal Bank of Scotland PLC and U.S. Bank National Association as Co-Documentation Agents, JPMorgan Chase Bank, N.A., as Syndication Agent, Bank of America, N.A. as Administrative Agent and Swing Line Lender, and the Other Lenders Party Thereto	8-K	3/7/12	10.1	000-15175	
10.10B	Amendment to Credit Agreement, dated as of July 27, 2015, among Adobe Systems Incorporated and Bank of America, N.A. as Administrative Agent and Swing Line Lender and the Other Lenders Party Thereto	8-K	7/30/15	10.1	000-15175	
10.11	Omniture, Inc. 2006 Equity Incentive Plan and related forms*	10-Q	8/6/09	10.3	000-52076	
10.12	Omniture, Inc. 2007 Equity Incentive Plan and related forms*	10-K	2/27/09	10.9	000-52076	

10.13 Omniture, Inc. 2008 Equity Incentive Plan and related forms* 10-K 2/27/09 10.10 000-52076

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Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
10.14	Demdex, Inc. 2008 Stock Plan, as amended*	S-8	1/27/11	99.1	333-171902	
10.15	2013 Executive Annual Incentive Plan*	8-K	1/28/13	10.5	000-15175	
10.16	2014 Executive Annual Incentive Plan*	8-K	1/29/14	10.5	000-15175	
10.17	2015 Executive Annual Incentive Plan*	8-K	1/28/15	10.5	000-15175	
10.18	2016 Executive Annual Incentive Plan*	8-K	1/29/16	10.5	000-15175	
10.19	2016 Executive Cash Performance Bonus Plan*	8-K	1/29/16	10.4	000-15175	
10.20	EchoSign, Inc. 2005 Stock Plan, as amended*	S-8	7/29/11	99.1	333-175910	
10.21	TypeKit, Inc. 2009 Equity Incentive Plan, as amended*	S-8	10/7/11	99.1	333-177229	
10.22	Auditude, Inc. 2009 Equity Incentive Plan, as amended*	S-8	11/18/11	99.1	333-178065	
10.23	Auditude, Inc. Employee Stock Option Plan, as amended*	S-8	11/18/11	99.2	333-178065	
10.24	Efficient Frontier, Inc. 2003 Stock Option/Stock Issuance Plan, as Amended and Restated*	S-8	1/27/12	99.1	333-179221	
10.25A	Behance, Inc. 2012 Equity Incentive Plan*	S-8	1/23/13	99.1	333-186143	
10.25B	Amendment No. 1 to the Behance, Inc. 2012 Equity Incentive Plan*	S-8	1/23/13	99.2	333-186143	
10.26	Neolane 2008 Stock Option Plan*	S-8	8/27/13	99.1	333-190846	
10.27	2012 Neolane Stock Option Plan for The United States*	S-8	8/27/13	99.2	333-190846	
10.28	Description of 2013 Director Compensation*	10-K	1/21/14	10.80	000-15175	
10.29	Description of 2014 Director Compensation*	10-K	1/21/14	10.81	000-15175	
10.30	Description of 2015 Director Compensation*	10-K	1/20/15	10.52	000-15175	
10.31	Description of 2016 Director Compensation*	10-K	1/19/16	10.32	000-15175	

10.32A Aviary, Inc. 2008 Stock Plan, as amended*

S-8 9/26/14 99.1 333-198973

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Exhibit Number	Exhibit Description	Incorporated by Reference**		Exhibit Number	SEC File No.	Filed Herewith
		Form	Filing Date			
10.32B	Form of Stock Option Grant Notice and Award Agreement pursuant to the Aviary, Inc. 2008 Stock Plan (Installment Vesting)*	S-8	9/26/14	99.2	333-198973	
10.32C	Form of Stock Option Grant Notice and Award Agreement pursuant to the Aviary, Inc. 2008 Stock Plan (Installment Vesting, Non-U.S.)*	S-8	9/26/14	99.3	333-198973	
10.33	Adobe Systems Incorporated 2014 Executive Severance Plan in the Event of a Change of Control*	8-K	12/11/14	10.1	000-15175	
31.1	Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934					X
31.2	Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934					X
32.1	Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934†					X
32.2	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934†					X
101.INS	XBRL Instance					X
101.SCH	XBRL Taxonomy Extension Schema					X
101.CAL	XBRL Taxonomy Extension Calculation					X
101.LAB	XBRL Taxonomy Extension Labels					X
101.PRE	XBRL Taxonomy Extension Presentation					X
101.DEF	XBRL Taxonomy Extension Definition					X

* Compensatory plan or arrangement.

** References to Exhibits 10.11 through 10.13 are to filings made by Omniture, Inc.

† The certifications attached as Exhibits 32.1 and 32.2 that accompany this Quarterly Report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any

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filing of Adobe Systems Incorporated under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.