

ADOBE SYSTEMS INC  
Form 10-Q  
March 29, 2017

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

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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 March 3, 2017

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)

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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 March 24, 2017 was 494,697,996.

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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)

	March 3, 2017 (Unaudited)	December 2, 2016 (*)
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 1,068,896	\$ 1,011,315
Short-term investments	3,578,721	3,749,985
Trade receivables, net of allowances for doubtful accounts of \$8,265 and \$6,214, respectively	850,840	833,033
Prepaid expenses and other current assets	257,105	245,441
Total current assets	5,755,562	5,839,774
Property and equipment, net	821,730	816,264
Goodwill	5,753,575	5,406,474
Purchased and other intangibles, net	489,202	414,405
Investment in lease receivable	80,439	80,439
Other assets	144,275	139,890
Total assets	\$ 13,044,783	\$ 12,697,246
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Trade payables	\$ 191,484	\$ 88,024
Accrued expenses	763,012	739,630
Income taxes payable	11,565	38,362
Deferred revenue	1,988,008	1,945,619
Total current liabilities	2,954,069	2,811,635
Long-term liabilities:		
Debt	1,884,074	1,892,200
Deferred revenue	72,238	69,131
Income taxes payable	148,796	184,381
Deferred income taxes	286,407	217,660
Other liabilities	110,509	97,404
Total liabilities	5,456,093	5,272,411
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; 495,130 and 494,254 shares outstanding, respectively	61	61
Additional paid-in-capital	4,719,966	4,616,331
Retained earnings	8,299,362	8,114,517
Accumulated other comprehensive income (loss)	(185,409 )	(173,602 )
Treasury stock, at cost (105,704 and 106,580 shares, respectively), net of reissuances	(5,245,290 )	(5,132,472 )
Total stockholders' equity	7,588,690	7,424,835
Total liabilities and stockholders' equity	\$ 13,044,783	\$ 12,697,246

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The condensed consolidated balance sheet as of December 2, 2016 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	
	March 3, 2017	March 4, 2016
Revenue:		
Subscription	\$1,383,856	\$1,070,250
Product	183,385	201,112
Services and support	114,405	111,973
Total revenue	1,681,646	1,383,335
Cost of revenue:		
Subscription	141,181	107,275
Product	14,333	20,299
Services and support	81,823	70,998
Total cost of revenue	237,337	198,572
Gross profit	1,444,309	1,184,763
Operating expenses:		
Research and development	285,077	237,204
Sales and marketing	520,297	474,891
General and administrative	150,808	146,516
Amortization of purchased intangibles	19,128	18,394
Total operating expenses	975,310	877,005
Operating income	468,999	307,758
Non-operating income (expense):		
Interest and other income (expense), net	7,206	4,187
Interest expense	(18,130)	(18,469)
Investment gains (losses), net	2,557	(1,169)
Total non-operating income (expense), net	(8,367)	(15,451)
Income before income taxes	460,632	292,307
Provision for income taxes	62,186	38,000
Net income	\$398,446	\$254,307
Basic net income per share	\$0.81	\$0.51
Shares used to compute basic net income per share	494,612	499,125
Diluted net income per share	\$0.80	\$0.50
Shares used to compute diluted net income per share	500,861	505,676

See accompanying notes to condensed consolidated financial statements.

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## ADOBE SYSTEMS INCORPORATED

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended	
	March 3, 2017	March 4, 2016
	Increase/(Decrease)	
Net income	\$398,446	\$254,307
Other comprehensive income (loss), net of taxes:		
Available-for-sale securities:		
Unrealized gains / losses on available-for-sale securities	1,024	(1,627 )
Reclassification adjustment for recognized gains / losses on available-for-sale securities	(160 )	(44 )
Net increase (decrease) from available-for-sale securities	864	(1,671 )
Derivatives designated as hedging instruments:		
Unrealized gains / losses on derivative instruments	6,709	(1,711 )
Reclassification adjustment for recognized gains / losses on derivative instruments	(18,184 )	(2,935 )
Net increase (decrease) from derivatives designated as hedging instruments	(11,475 )	(4,646 )
Foreign currency translation adjustments	(1,196 )	23,718
Other comprehensive income (loss), net of taxes	(11,807 )	17,401
Total comprehensive income, net of taxes	\$386,639	\$271,708

See accompanying notes to condensed consolidated financial statements.



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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended	
	March 3, 2017	March 4, 2016
Cash flows from operating activities:		
Net income	\$398,446	\$254,307
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	80,809	81,200
Stock-based compensation	98,310	92,310
Deferred income taxes	60,315	56,906
Unrealized losses (gains) on investments, net	(1,021)	) 2,047
Excess tax benefits from stock-based compensation	—	(14,859)
Other non-cash items	115	(1,420)
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Trade receivables, net	184,250	74,274
Prepaid expenses and other current assets	(10,758)	) (84,832)
Trade payables	32,816	(21,601)
Accrued expenses	(92,105)	) (81,111)
Income taxes payable	(61,639)	) 16,940
Deferred revenue	40,832	123,366
Net cash provided by operating activities	730,370	497,527
Cash flows from investing activities:		
Purchases of short-term investments	(476,014)	) (534,310)
Maturities of short-term investments	219,091	178,939
Proceeds from sales of short-term investments	426,243	194,515
Acquisitions, net of cash acquired	(459,626)	) —
Purchases of property and equipment	(30,903)	) (46,200)
Purchases of long-term investments and other assets	(18,218)	) (51,892)
Proceeds from sale of long-term investments	545	106
Net cash used for investing activities	(338,882)	) (258,842)
Cash flows from financing activities:		
Purchases of treasury stock	(200,000)	) (150,000)
Proceeds from issuance of treasury stock	51,787	45,544
Taxes paid related to net share settlement of equity awards	(183,014)	) (194,795)
Excess tax benefits from stock-based compensation	—	14,859
Repayment of capital lease obligations	(268)	) —
Net cash used for financing activities	(331,495)	) (284,392)
Effect of foreign currency exchange rates on cash and cash equivalents	(2,412)	) (157)
Net increase (decrease) in cash and cash equivalents	57,581	(45,864)
Cash and cash equivalents at beginning of period	1,011,315	876,560
Cash and cash equivalents at end of period	\$1,068,896	\$830,696
Supplemental disclosures:		
Cash paid for income taxes, net of refunds	\$27,254	\$15,973
Cash paid for interest	\$24,888	\$26,077
Non-cash investing activities:		
Issuance of common stock and stock awards assumed in business acquisitions	\$10,348	\$—

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 U.S. 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 December 2, 2016 on file with the SEC (our “Annual Report”).

Reclassifications

Certain immaterial prior year amounts have been reclassified to conform to current year presentation in the condensed consolidated balance sheets, condensed consolidated statements of income and condensed consolidated statements of cash flows.

Recently Adopted Accounting Guidance

On March 30, 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“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. Tax-related cash flows 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. Early adoption is permitted.

We early adopted this standard during the first quarter of fiscal 2017. As required by the standard, excess tax benefits recognized on stock-based compensation expense were reflected in our condensed consolidated statements of income as a component of the provision for income taxes rather than paid-in capital on a prospective basis. Accordingly, we recorded excess tax benefits within our provision for income taxes, rather than additional paid-in capital, during the three months ended March 3, 2017. The cumulative effect to retained earnings from previously unrecognized excess tax benefits, after offset by the related valuation allowance, was not significant to our condensed consolidated balance sheets.

We also elected to prospectively apply the change in presentation of excess tax benefits wherein excess tax benefits recognized on stock-based compensation expense were classified as operating activities in our condensed consolidated statements of cash flows for the three months ended March 3, 2017. Prior period classification of cash flows related to excess tax benefits were not adjusted in our condensed consolidated statements of cash flows.

Presentation requirements for cash flows related to employee taxes paid for withheld shares had no impact to all periods presented as such cash flows have historically been presented as financing activities. Further, we did not elect an accounting policy change to record forfeitures as they occur and thus we continue to estimate forfeitures at each period.

Significant Accounting Policies

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

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Recent Accounting Pronouncements Not Yet Effective

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

While we are continuing to assess all potential impacts of the new standard, we currently believe the most significant impact relates to our accounting for arrangements that include term-based software licenses bundled with maintenance and support. Under current GAAP, the revenue attributable to these software licenses is recognized ratably over the term of the arrangement because VSOE does not exist for the undelivered maintenance and support element as it is not sold separately. The requirement to have VSOE for undelivered elements to enable the separation of revenue for the delivered software licenses is eliminated under the new standard. Accordingly, under the new standard we will be required to recognize as revenue a portion of the arrangement fee upon delivery of the software license. While we currently expect revenue related to our professional services and cloud offerings for business enterprises, individuals and teams to remain substantially unchanged, we are still in the process of evaluating the impact of the new standard on these arrangements. Due to the complexity of certain of our contracts, the actual revenue recognition treatment required under the new standard for these arrangements may be dependent on contract-specific terms and, therefore, may vary in some instances.

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 and we do not plan to early adopt. 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 three months ended March 3, 2017, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended December 2, 2016, that are of significance or potential significance to us.

NOTE 2. ACQUISITIONS

On December 19, 2016, we completed our acquisition of TubeMogul, a publicly held video advertising platform company. During the first quarter of fiscal 2017, we began integrating TubeMogul into our Digital Marketing reportable segment.

Under the acquisition method of accounting, the total purchase price was preliminarily allocated to TubeMogul's net tangible and intangible assets based upon their estimated fair values as of December 19, 2016. The total purchase

price for TubeMogul was \$560.8 million which was preliminarily allocated to goodwill that is non-deductible for tax purposes for \$349.4 million, to identifiable intangible assets for \$113.1 million and to net assets acquired for \$98.3 million. The fair values assigned to assets acquired and liabilities assumed are based on management's best estimates and assumptions as of the reporting date and are considered preliminary pending finalization of valuation analyses pertaining to intangible assets acquired and tax liabilities assumed including calculation of deferred tax assets and liabilities.

Pro forma financial information has not been presented for this acquisition 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 March 3, 2017 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	\$284,102	\$ —	\$ —	\$284,102
Cash equivalents:				
Corporate bonds and commercial paper	1,030	—	—	1,030
Money market mutual funds	762,830	—	—	762,830
Time deposits	20,934	—	—	20,934
Total cash equivalents	784,794	—	—	784,794
Total cash and cash equivalents	1,068,896	—	—	1,068,896
Short-term fixed income securities:				
Asset-backed securities	111,952	8	(437	) 111,523
Corporate bonds and commercial paper	2,394,514	3,755	(8,440	) 2,389,829
Municipal securities	137,243	62	(198	) 137,107
U.S. agency securities	28,541	15	—	28,556
U.S. Treasury securities	913,704	55	(2,053	) 911,706
Total short-term investments	3,585,954	3,895	(11,128	) 3,578,721
Total cash, cash equivalents and short-term investments	\$4,654,850	\$ 3,895	\$(11,128	) \$4,647,617

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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 December 2, 2016 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	\$208,635	\$ —	\$ —	\$208,635
Cash equivalents:				
Corporate bonds and commercial paper	1,249	—	—	1,249
Money market mutual funds	782,210	—	—	782,210
Municipal securities	1,301	—	—	1,301
Time deposits	17,920	—	—	17,920
Total cash equivalents	802,680	—	—	802,680
Total cash and cash equivalents	1,011,315	—	—	1,011,315
Short-term fixed income securities:				
Asset-backed securities	111,009	95	(190 )	110,914
Corporate bonds and commercial paper	2,464,769	3,135	(9,554 )	2,458,350
Municipal securities	134,710	37	(525 )	134,222
U.S. agency securities	39,538	42	—	39,580
U.S. Treasury securities	1,008,195	194	(1,470 )	1,006,919
Total short-term investments	3,758,221	3,503	(11,739 )	3,749,985
Total cash, cash equivalents and short-term investments	\$4,769,536	\$ 3,503	\$(11,739 )	\$4,761,300

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 March 3, 2017 and December 2, 2016 (in thousands):

	2017		2016	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	\$1,228,225	\$(8,420 )	\$1,282,076	\$(9,474 )
Asset-backed securities	99,481	(436 )	54,063	(189 )
Municipal securities	58,653	(198 )	114,810	(525 )
U.S. Treasury and agency securities	812,832	(2,053 )	580,529	(1,470 )
Total	\$2,199,191	\$(11,107 )	\$2,031,478	\$(11,658 )

There were 1,019 securities and 1,052 securities in an unrealized loss position for less than twelve months at March 3, 2017 and at December 2, 2016, 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 March 3, 2017 and December 2, 2016 (in thousands):

	2017		2016	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	\$16,445	\$ (20 )	\$39,162	\$ (80 )
Asset-backed securities	510	(1 )	1,331	(1 )
Total	\$16,955	\$ (21 )	\$40,493	\$ (81 )

There were 12 securities and 23 securities in an unrealized loss position for more than twelve months at March 3, 2017 and at December 2, 2016, 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 March 3, 2017 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	\$1,072,212	\$1,072,109
Due between one and two years	1,332,306	1,330,659
Due between two and three years	771,270	767,999
Due after three years	410,166	407,954
Total	\$3,585,954	\$3,578,721

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 three months ended March 3, 2017 and March 4, 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 three months ended March 3, 2017.

The fair value of our financial assets and liabilities at March 3, 2017 was determined using the following inputs (in thousands):

	Total	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:				
Corporate bonds and commercial paper	\$1,030	\$—	\$1,030	\$ —
Money market mutual funds	762,830	762,830	—	—
Time deposits	20,934	20,934	—	—
Short-term investments:				
Asset-backed securities	111,523	—	111,523	—
Corporate bonds and commercial paper	2,389,829	—	2,389,829	—
Municipal securities	137,107	—	137,107	—
U.S. agency securities	28,556	—	28,556	—
U.S. Treasury securities	911,706	—	911,706	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	26,962	—	26,962	—
Other assets:				
Deferred compensation plan assets	48,892	1,698	47,194	—
Interest rate swap derivatives	4,104	—	4,104	—
Total assets	\$4,443,473	\$785,462	\$3,658,011	\$ —
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$1,585	\$—	\$1,585	\$—
Total liabilities	\$1,585	\$—	\$1,585	\$—

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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 December 2, 2016 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:	Total			
Cash equivalents:				
Corporate bonds and commercial paper	\$1,249	\$—	\$1,249	\$—
Money market mutual funds	782,210	782,210	—	—
Municipal securities	1,301	—	1,301	—
Time deposits	17,920	17,920	—	—
Short-term investments:				
Asset-backed securities	110,914	—	110,914	—
Corporate bonds and commercial paper	2,458,350	—	2,458,350	—
Municipal securities	134,222	—	134,222	—
U.S. agency securities	39,580	—	39,580	—
U.S. Treasury securities	1,006,919	—	1,006,919	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	38,112	—	38,112	—
Other assets:				
Deferred compensation plan assets	42,180	1,831	40,349	—
Interest rate swap derivatives	13,117	—	13,117	—
Total assets	\$4,646,074	\$801,961	\$3,844,113	\$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	\$5,246	\$—	\$5,246	\$—
Total liabilities	\$5,246	\$—	\$5,246	\$—

See Note 3 for further information regarding the fair value of our financial instruments.

Our fixed income available-for-sale debt 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 independent pricing vendors who use matrix pricing valuation techniques including market approach methodologies that model information generated by market transactions involving identical or comparable assets, as well as discounted cash flow methodologies. Inputs include quoted prices in active markets for identical assets or inputs other than quoted prices that are observable either directly or indirectly in determining fair value, including benchmark yields, issuer spreads off benchmark yields, interest rates and U.S. Treasury or swap curves. We

therefore classify all of our fixed income available-for-sale securities as Level 2. We perform routine procedures such as comparing prices obtained from multiple independent sources to ensure that appropriate fair values are recorded. The fair values of our money market mutual funds and time deposits are based on the closing price of these assets as of the reporting date. We classify our money market mutual funds and time deposits as Level 1.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Our Level 2 over-the-counter foreign currency and interest rate swap derivatives are valued using pricing models and discounted cash flow methodologies based on observable foreign exchange and interest rate data at the measurement date.

Our deferred compensation plan assets consist of money market mutual funds and other mutual funds.

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 months ended March 3, 2017, we determined there were no other-than-temporary impairments on our cost method investments. For the three months ended March 4, 2016, we determined there were immaterial other-than-temporary impairments on certain of our cost method investments and wrote down the investments to fair value.

As of March 3, 2017, 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 \$1.98 billion as of March 3, 2017, 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 on 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 in 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.

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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 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.

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 (loss) on 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 (loss) 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.

## 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. In effect, the interest rate swaps convert the fixed interest rate on these senior 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 on our condensed consolidated balance sheets.

The fair value of derivative instruments on our condensed consolidated balance sheets as of March 3, 2017 and December 2, 2016 were as follows (in thousands):

	2017		2016	
	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 <sup>(1) (3)</sup>	\$25,140	\$ —	\$34,355	\$ —
Interest rate swap <sup>(2)</sup>	4,104	—	13,117	—

Derivatives not designated as hedging instruments:

Foreign exchange forward contracts <sup>(1)</sup>	1,822	1,585	3,757	5,246
Total derivatives	\$31,066	\$ 1,585	\$51,229	\$ 5,246

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(1) Included in prepaid expenses and other current assets and accrued expenses for asset derivatives and liability derivatives, respectively, on our condensed consolidated balance sheets.

(2) Included in other assets or other liabilities on our condensed consolidated balance sheets.

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



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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The effect of foreign currency derivative instruments designated as cash flow hedges and of foreign currency derivative instruments not designated as hedges in our condensed consolidated statements of income for the three months ended March 3, 2017 and March 4, 2016 was as follows (in thousands):

	2017		2016	
	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 <sup>(1)</sup>	\$6,709	\$ —	\$(1,711)	\$ —
Net gain (loss) reclassified from accumulated OCI into income, net of tax <sup>(2)</sup>	\$18,309	\$ —	\$3,220	\$ —
Net gain (loss) recognized in income <sup>(3)</sup>	\$(6,037)	\$ —	\$(5,140)	\$ —
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income <sup>(4)</sup>	\$ —	\$ 1,088	\$ —	\$ (965)

<sup>(1)</sup> Net change in the fair value of the effective portion classified in other comprehensive income ("OCI").

<sup>(2)</sup> Effective portion classified as revenue.

<sup>(3)</sup> Ineffective portion and amount excluded from effectiveness testing classified in interest and other income (expense), net.

<sup>(4)</sup> Classified in interest and other income (expense), net.

## NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of March 3, 2017 and December 2, 2016 was \$5.75 billion and \$5.41 billion, respectively. The increase was due to our acquisition of TubeMogul, offset in part by foreign currency translation adjustments.

Purchased and other intangible assets subject to amortization as of March 3, 2017 and December 2, 2016 were as follows (in thousands):

	2017			2016		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	\$233,280	\$(92,233)	\$141,047	\$149,253	\$(82,091)	\$67,162
Customer contracts and relationships	\$568,859	\$(293,595)	\$275,264	\$541,366	\$(274,380)	\$266,986
Trademarks	76,355	(49,305)	27,050	76,355	(46,846)	29,509
Acquired rights to use technology	72,672	(48,635)	24,037	87,403	(60,929)	26,474
Localization	683	(361)	322	631	(177)	454
Other intangibles	38,693	(17,211)	21,482	38,693	(14,873)	23,820
Total other intangible assets	\$757,262	\$(409,107)	\$348,155	\$744,448	\$(397,205)	\$347,243
Purchased and other intangible assets, net	\$990,542	\$(501,340)	\$489,202	\$893,701	\$(479,296)	\$414,405

Amortization expense related to purchased and other intangible assets was \$38.1 million and \$37.6 million for the three months ended March 3, 2017 and March 4, 2016, respectively. Of these amounts \$18.7 million and 19.0 million were included in cost of sales for the three months ended March 3, 2017 and March 4, 2016, respectively.



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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of March 3, 2017, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2017	\$ 33,543	\$ 82,632
2018	37,851	95,004
2019	32,615	68,152
2020	30,405	39,046
2021	5,819	16,741
Thereafter	814	46,580
Total expected amortization expense	\$ 141,047	\$ 348,155

## NOTE 7. ACCRUED EXPENSES

Accrued expenses as of March 3, 2017 and December 2, 2016 consisted of the following (in thousands):

	2017	2016
Accrued compensation and benefits	\$272,303	\$339,487
Sales and marketing allowances	126,227	60,825
Accrued corporate marketing	59,050	55,218
Taxes payable	41,106	43,113
Royalties payable	24,221	25,089
Accrued interest expense	7,178	25,805
Other	232,927	190,093
Accrued expenses	\$763,012	\$739,630

Other primarily includes general corporate accruals including 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 three months ended March 3, 2017 and the fiscal year ended December 2, 2016 was as follows (in thousands):

	2017	2016
Beginning outstanding balance	8,316	10,069
Awarded	3,909	4,440
Released	(2,787)	(5,471)
Forfeited	(211)	(722)
Increase due to acquisition	595	—
Ending outstanding balance	9,822	8,316

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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Information regarding restricted stock units outstanding at March 3, 2017 and March 4, 2016 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value <sup>(*)</sup> (millions)
2017			
Restricted stock units outstanding	9,822	1.59	\$ 1,002.3
Restricted stock units vested and expected to vest	8,646	1.53	\$ 882.2
2016			
Restricted stock units outstanding	8,851	1.52	\$ 762.7
Restricted stock units vested and expected to vest	7,716	1.45	\$ 654.2

The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ<sup>(\*)</sup> Global Select Market, the market values as of March 3, 2017 and March 4, 2016 were \$120.04 and \$86.18, respectively.

**Summary of Performance Shares**

Our 2017, 2016 and 2015 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 2017, the Executive Compensation Committee approved the 2017 Performance Share Program, the terms of which are similar to prior year performance share programs as discussed above.

In the first quarter of fiscal 2017, the Executive Compensation Committee also certified the actual performance achievement of participants in the 2014 Performance Share Program. Actual performance resulted in participants achieving 198% of target or approximately 1.1 million shares. The shares granted and achieved under the 2014 Performance Share Program fully vested on the three-year anniversary of the grant on January 24, 2017, if not forfeited.

In the first quarter of fiscal 2016, the Executive Compensation Committee 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 three-year anniversary of the grant on January 24, 2016, if not forfeited.

As of March 3, 2017, the shares awarded under our 2017, 2016 and 2015 Performance Share Programs are yet to be achieved.

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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table sets forth the summary of performance share activity under our Performance Share Programs for the three months ended March 3, 2017 and the fiscal year ended December 2, 2016 (in thousands):

	2017		2016	
	Shares Granted	Maximum Shares Eligible to Receive	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	1,630	3,261	1,940	3,881
Awarded	1,082 <sup>(1)</sup>	1,040	1,206 <sup>(2)</sup>	1,053
Achieved	(1,135)	(1,147)	(1,373)	(1,387)
Forfeited	(37)	(74)	(143)	(286)
Ending outstanding balance	1,540	3,080	1,630	3,261

Included in the 1.1 million shares awarded during the three months ended March 3, 2017 were 0.6 million shares

<sup>(1)</sup> awarded for the final achievement of the 2014 Performance Share program. The remaining awarded shares were for the 2017 Performance Share Program.

Included in the 1.2 million shares awarded during the fiscal year ended December 2, 2016 were 0.7 million shares

<sup>(2)</sup> 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

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 three months ended March 3, 2017 and March 4, 2016 were as follows:

	Three Months	
	2017	2016
Expected life (in years)	0.5 - 2.0	0.5 - 2.0
Volatility	22% - 25%	27% - 29%
Risk free interest rate	0.62% - 1.2%	0.49% - 1.06%

Employees purchased 0.7 million shares at an average price of \$71.72 and 0.7 million shares at an average price of \$58.79 for the three months ended March 3, 2017 and March 4, 2016, respectively. The intrinsic value of shares purchased during the three months ended March 3, 2017 and March 4, 2016 was \$20.4 million and \$23.7 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 March 3, 2017 and December 2, 2016, we had 0.5 million and 0.6 million stock options outstanding, respectively.



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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## Compensation Costs

As of March 3, 2017, there was \$887.4 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 2.3 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 March 3, 2017 and March 4, 2016 were as follows (in thousands):

Income Statement Classifications	2017		2016	
	Option Grants and Stock Purchase Rights	Restricted Stock Units and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock Units and Performance Share Awards
Cost of revenue—subscription	\$393	\$ 2,161	\$373	\$ 1,803
Cost of revenue—services and support	1,723	3,065	1,433	1,895
Research and development	4,032	33,094	3,874	29,484
Sales and marketing	4,388	32,465	4,550	29,356
General and administrative	1,230	18,316	1,233	18,747
Total	\$11,766	\$ 89,101	\$11,463	\$ 81,285

## NOTE 9. STOCKHOLDERS' EQUITY

## Retained Earnings

The changes in retained earnings for the three months ended March 3, 2017 were as follows (in thousands):

Balance as of December 2, 2016	\$8,114,517
Net income	398,446
Re-issuance of treasury stock	(213,601 )
Balance as of March 3, 2017	\$8,299,362

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.



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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The components of accumulated other comprehensive income (loss) and activity, net of related taxes, as of March 3, 2017 were as follows (in thousands):

	December 2, 2016	Increase / Decrease	Reclassification Adjustments	March 3, 2017
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	\$ 3,499	\$ 673	\$ (294 )	\$ 3,878
Unrealized losses on available-for-sale securities	(11,565 )	351	134	(11,080 )
Total net unrealized gains on available-for-sale securities	(8,066 )	1,024	(160 )	(7,202 ) <sup>(1)</sup>
Net unrealized gains / losses on derivative instruments designated as hedging instruments	21,689	6,709	(18,184 )	10,214 <sup>(2)</sup>
Cumulative foreign currency translation adjustments	(187,225 )	(1,196 )	—	(188,421 )
Total accumulated other comprehensive income (loss), net of taxes	\$ (173,602 )	\$ 6,537	\$ (18,344 )	\$ (185,409)

(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 months ended March 3, 2017 and March 4, 2016 (in thousands):

	Three Months	
	2017	2016
Available-for-sale securities:		
Unrealized gains / losses	\$248	\$28
Reclassification adjustments	(109 )	—
Subtotal available-for-sale securities	139	28
Derivatives designated as hedging instruments:		
Unrealized gains / losses on derivative instruments <sup>(1)</sup>	—	—
Reclassification adjustments <sup>(1)</sup>	(284 )	(151 )
Subtotal derivatives designated as hedging instruments	(284 )	(151 )
Foreign currency translation adjustments	386	633
Total taxes, other comprehensive income	\$241	\$510

(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. Our Board of Directors has approved our stock repurchase program wherein we were granted authority to repurchase common stock up to a specified amount and period.

In fiscal 2015, the Board of Directors approved our current stock repurchase authority to repurchase up to \$2 billion in common stock through the end of fiscal 2017. Subsequent to March 3, 2017, as part of this \$2 billion stock repurchase authority, we entered into a structured stock repurchase agreement with a large financial institution whereupon we provided them with a prepayment of \$300 million. This amount will be classified as treasury stock on our condensed consolidated balance sheets. Upon completion of the \$300 million stock repurchase agreement, there will be no remaining amount under the \$2 billion authority.

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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In the first quarter of fiscal 2017, the Board of Directors approved a new stock repurchase authority to repurchase up to \$2.5 billion in common stock through the end of fiscal 2019.

During the three months ended March 3, 2017 and March 4, 2016, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling \$200 million and \$150 million, respectively. The prepayment of \$200 million during the three months ended March 3, 2017 and the prepayment of \$150 million during the three months ended March 4, 2016 were under the \$2 billion authority granted in fiscal 2015. 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 three months ended March 3, 2017, we repurchased approximately 2.2 million shares at an average price of \$107.54 through structured repurchase agreements entered into during fiscal 2016 and the three months ended March 3, 2017. During the three months ended March 4, 2016 we repurchased approximately 1.5 million shares at an average price of \$88.67 through structured repurchase agreements entered into during fiscal 2015 and the three months ended March 4, 2016.

For the three months ended March 3, 2017, 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 March 3, 2017 were excluded from the computation of earnings per share. As of March 3, 2017, \$62.5 million of prepayment remained under this agreement.

## NOTE 10. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three months ended March 3, 2017 and March 4, 2016 (in thousands, except per share data):

	Three Months	
	2017	2016
Net income	\$398,446	\$254,307
Shares used to compute basic net income per share	494,612	499,125
Dilutive potential common shares:		
Unvested restricted stock units and performance share awards	5,867	5,922
Stock options	382	629
Shares used to compute diluted net income per share	500,861	505,676
Basic net income per share	\$0.81	\$0.51
Diluted net income per share	\$0.80	\$0.50

For the three months ended March 3, 2017 and March 4, 2016, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of \$110.75 and \$87.98, respectively that would have been anti-dilutive.



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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 land and the East and West Tower buildings, and lease the Almaden Tower building as of March 3, 2017.

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 March 3, 2017. The carrying value of the lease receivable related to the Almaden Tower approximated fair value as of March 3, 2017. 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 receivable may be credited against the purchase price. The residual value guarantee under the Almaden Tower obligation is \$89.4 million.

Subsequent to March 3, 2017, we exercised our option to purchase the Almaden Tower for a total purchase price of \$103.6 million. Upon purchase, our investment in the lease receivable of \$80.4 million was credited against the total purchase price. We capitalized the Almaden Tower as property and equipment on our condensed consolidated balance sheets at \$104.2 million, the lesser of cost or fair value, which represented the total purchase price plus other direct costs associated with the purchase.

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 and channel partners 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. We may not prevail in any ongoing or future litigation and disputes. Third-party intellectual property disputes could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from licensing certain of our products or offering certain of our services, subject us to injunctions restricting our sale of products or services, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers including contractual provisions under various license

arrangements and service agreements.

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## ADOBE SYSTEMS INCORPORATED

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 in any particular period 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 \$900 million of 4.75% senior notes due February 1, 2020 (the “2020 Notes”). Our proceeds were \$900 million and were net of an issuance discount of \$5.5 million. In addition, we incurred issuance costs of \$6.4 million. Both the discount and issuance costs are being amortized to interest expense over the term of the 2020 Notes using the effective interest method. The 2020 Notes rank equally with our other unsecured and unsubordinated indebtedness. The effective interest rate including the discount and issuance costs 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.

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. Under the terms of the swap, 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. 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 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 senior notes plus accrued and unpaid interest due February 1, 2015. The remaining proceeds were used for general corporate purposes.



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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

As of March 3, 2017, our outstanding notes payable consist of the 2020 Notes and 2025 Notes (the “Notes”) with a total carrying value of \$1.88 billion which includes the fair value of the interest rate swap and is net of debt issuance costs. Based on quoted prices in inactive markets, the fair value of the Notes was \$1.98 billion as of March 3, 2017. The total fair value of \$1.98 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 March 3, 2017, we were in compliance with all of the covenants.

In February 2017, 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 to March 2, 2018. On July 27, 2015, we entered into an amendment to further extend the maturity date 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 March 3, 2017, 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 months ended March 3, 2017 and March 4, 2016 included the following (in thousands):

	Three Months	
	2017	2016
Interest and other income (expense), net:		
Interest income	\$14,157	\$10,677
Foreign exchange gains (losses)	(7,131 )	(6,530 )
Realized gains on fixed income investment	294	333
Realized losses on fixed income investment	(134 )	(289 )
Other	20	(4 )
Interest and other income (expense), net	\$7,206	\$4,187
Interest expense	\$(18,130)	\$(18,469)
Investment gains (losses), net:		
Realized investment gains	\$1,959	\$1,055
Realized investment losses	—	(125 )
Unrealized investment gains	598	—
Unrealized investment losses	—	(2,099 )
Investment gains (losses), net	\$2,557	\$(1,169 )
Non-operating income (expense), net	\$(8,367 )	\$(15,451)

## 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 March 3, 2017 and March 4, 2016 were as follows (dollars in thousands):

	Digital Media	Digital Marketing	Print and Publishing	Total
Three months ended March 3, 2017				
Revenue	\$ 1,138,079	\$ 501,143	\$ 42,424	\$ 1,681,646
Cost of revenue	55,052	180,576	1,709	237,337
Gross profit	\$ 1,083,027	\$ 320,567	\$ 40,715	\$ 1,444,309
Gross profit as a percentage of revenue	95 %	64 %	96 %	86 %
Three months ended March 4, 2016				
Revenue	\$ 931,718	\$ 406,246	\$ 45,371	\$ 1,383,335
Cost of revenue	54,547	141,917	2,108	198,572
Gross profit	\$ 877,171	\$ 264,329	\$ 43,263	\$ 1,184,763
Gross profit as a percentage of revenue	94 %	65 %	95 %	86 %

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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 2016. 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 personal computers, 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](http://www.adobe.com). We offer many of our products via a Software-as-a-Service 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, systems integrators, independent software vendors, retailers, software developers and original equipment manufacturers. 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](http://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](http://www.sec.gov). The information posted to our website is not incorporated into this Quarterly Report on Form 10-Q.

**OPERATIONS OVERVIEW**

For our first quarter of fiscal 2017, 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. Our first quarter of fiscal 2016 financial results benefited from an extra week in the quarter due to our 52/53 week financial calendar whereby fiscal 2016 was a 53-week year compared with fiscal 2017 which is a 52-week year.

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 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

affordable pricing for cost-sensitive customers.

We offer Creative Cloud for individuals, students, teams and enterprises. 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

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and purchase of stock content in our Adobe Stock service. Overall, our strategy with Creative Cloud is designed to enable us to increase our revenue with users, attract more new customers, and grow a recurring and predictable revenue stream that is recognized ratably.

We continue to implement strategies that will accelerate awareness, consideration and purchase of subscriptions to our Creative Cloud offerings. 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 Enterprise Term License Agreements (“ETLAs”), revenue from perpetual licensing of our Creative products is now immaterial to our business.

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. Adobe Document Cloud, which we believe enhances the way people manage critical documents at home, in the office and across devices, 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 offered both through subscription and perpetual licenses.

Annualized Recurring Revenue (“ARR”) is currently the key performance metric our management uses 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 first quarter of fiscal 2017 are based on currency rates set at the start of fiscal 2017 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

Creative ARR

Digital Media ARR +  
Document  
Cloud ARR

Creative ARR exiting the first quarter of fiscal 2017 was \$3.76 billion, up from \$3.52 billion at the end of fiscal 2016. Document Cloud ARR exiting the first quarter of fiscal 2017 was \$493 million, up from \$472 million at the end of fiscal 2016. Total Digital Media ARR grew to \$4.25 billion at the end of the first quarter of fiscal 2017, up from \$3.99 billion at the end of fiscal 2016.

Our success in driving growth in ARR has positively affected our revenue growth. Creative revenue in the first quarter of fiscal 2017 was \$942.2 million, up from \$732.9 million in the first quarter of fiscal 2016 and representing 29% year-over-year growth. Document Cloud revenue in the first quarter of fiscal 2017 was \$195.9 million, slightly down from \$198.8 million in the first quarter of fiscal 2016 as we continue to transition Document Cloud to a subscription-based model. Total Digital Media segment revenue grew to \$1,138.1 million in the first quarter of fiscal 2017, up from \$931.7 million in the first quarter of fiscal 2016 and representing 22% year-over-year growth.

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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 of solutions, including Adobe Analytics, Adobe Target, Adobe Social, Adobe Media Optimizer (“AMO”), Adobe Experience Manager (“AEM”), 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. We achieved record Marketing Cloud revenue of \$477.3 million in the first quarter of fiscal 2017, which represents 26% year-over-year revenue growth. In December 2016, we acquired TubeMogul and we began integrating TubeMogul in our Digital Marketing business in the first quarter of fiscal 2017. TubeMogul’s advertising platform offerings contributed \$32.1 million to the increase in Marketing Cloud revenue in the first quarter of fiscal 2017. We expect that the addition of TubeMogul and sustained demand across our portfolio of Marketing Cloud solutions will drive revenue growth in future years.

## 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 three months ended March 3, 2017, 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 December 2, 2016.

Recent Accounting Pronouncements

See Note 1 of our notes to condensed consolidated financial statements for information regarding recent accounting pronouncements that are of significance or potential significance to us.

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## RESULTS OF OPERATIONS

## Financial Performance Summary for the First Quarter of Fiscal 2017

Our results of operations for the first quarter of fiscal 2016 were favorably impacted by an extra week due to our first quarter of fiscal 2016 having 14 weeks as compared to 13 weeks in the first quarter of fiscal 2017.

Total Digital Media ARR of approximately \$4.25 billion as of March 3, 2017 increased by \$265 million, or 7%, from \$3.99 billion as of December 2, 2016. The change in our Digital Media ARR is primarily due to strong adoption of our Creative Cloud and Document Cloud subscription offerings.

- Creative revenue during the three months ended March 3, 2017 of \$942.2 million increased by \$209.3 million, or 29% compared with the year-ago period. The increase was primarily due to the increase in subscription revenue associated with our Creative Cloud offerings.

Adobe Marketing Cloud revenue of \$477.3 million during the three months ended March 3, 2017 increased by \$99.9 million, or 26%, compared with the year-ago period. The increase was primarily due to continued adoption of our AEM offerings and increases in revenue associated with AMO which includes revenue from our advertising platform offerings from our acquisition of TubeMogul in the first quarter of fiscal 2017.

Our total deferred revenue of \$2.06 billion as of March 3, 2017 increased by \$45.5 million, or 2%, from \$2.01 billion as of December 2, 2016 primarily due to new contracts and renewals for our Adobe Marketing Cloud services.

Cost of revenue of \$237.3 million during the three months ended March 3, 2017 increased by \$38.8 million, or 19%, compared with the year-ago period primarily due to increases in data center costs, media costs related to our advertising platform offerings from our acquisition of TubeMogul in the first quarter of fiscal 2017, and costs associated with compensation and related benefits driven by increased headcount.

Operating expenses of \$975.3 million during the three months ended March 3, 2017 increased by \$98.3 million, or 11%, 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 \$398.4 million during the three months ended March 3, 2017 increased by \$144.1 million, or 57%, compared with the year-ago period primarily due to subscription revenue increases.

Net cash flow from operations of \$730.4 million during the three months ended March 3, 2017 increased by \$232.8 million, or 47%, compared to the three months ended March 4, 2016 primarily due to higher net income and the decrease in trade receivables, excluding TubeMogul acquired trade receivables.

## Revenue for the Three Months Ended March 3, 2017 and March 4, 2016 (dollars in millions)

Revenue for the three months ended March 4, 2016 were favorably impacted by an extra week due to our first quarter of fiscal 2016 having 14 weeks as compared to 13 weeks in the first quarter of fiscal 2017.

	Three Months		%
	2017	2016	Change
Subscription	\$1,383.8	\$1,070.2	29 %
Percentage of total revenue	82	% 77	%
Product	183.4	201.1	(9 )%
Percentage of total revenue	11	% 15	%

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Services and support	114.4	112.0	2	%
Percentage of total revenue	7	%	8	%
Total revenue	\$1,681.6	\$1,383.3	22	%

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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.

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 months ended March 3, 2017 and March 4, 2016 are as follows (dollars in millions):

	Three Months		
	2017	2016	% Change
Digital Media	\$1,006.9	\$781.9	29 %
Digital Marketing	367.1	280.9	31 %
Print and Publishing	9.8	7.4	32 %
Total subscription revenue	\$1,383.8	\$1,070.2	29 %

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

## Segment Information (dollars in millions)

	Three Months		
	2017	2016	% Change
Digital Media	\$1,138.1	\$931.7	22 %
Percentage of total revenue	68	% 68	%
Digital Marketing	501.1	406.2	23 %
Percentage of total revenue	30	% 29	%