ADOBE SYSTEMS INC
Form 10-Q
June 25, 2014

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

FORM 10-Q
(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 30, 2014

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

For the transition period from to

Commission File Number: 0-15175

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

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

345 Park Avenue, San Jose, California 95110-2704
(Address of principal executive offices and zip code)

(408) 536-6000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

reporting company)

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

The number of shares outstanding of the registrant's common stock as of June 20, 2014 was 497,375,239.

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)

	May 30, 2014 (Unaudited)	November 29, 2013 (*)
ASSETS		
Current assets:		
Cash and cash equivalents	$817,020	$834,556
Short-term investments	2,513,191	2,339,196
Trade receivables, net of allowances for doubtful accounts of $7,929 and $10,228, respectively	531,557	599,820
Deferred income taxes	72,489	102,247
Prepaid expenses and other current assets	180,086	170,110
Total current assets	4,114,343	4,045,929
Property and equipment, net	642,450	659,774
Goodwill	4,773,798	4,771,981
Purchased and other intangibles, net	532,317	605,254
Investment in lease receivable	207,239	207,239
Other assets	102,052	90,121
Total assets	$10,372,199	$10,380,298
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	$54,858	$62,096
Accrued expenses	656,940	656,939
Debt and capital lease obligations	609,742	14,676
Accrued restructuring	3,627	6,171
Income taxes payable	13,696	10,222
Deferred revenue	879,109	775,544
Total current liabilities	2,217,972	1,525,648
Long-term liabilities:		
Debt and capital lease obligations	896,551	1,499,297
Deferred revenue	49,495	53,268
Accrued restructuring	6,099	7,717
Income taxes payable	139,870	132,545
Deferred income taxes	351,612	375,634
Other liabilities	73,712	61,555
Total liabilities	3,735,311	3,655,664
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; 497,247 and 496,261 shares outstanding, respectively	61	61
Additional paid-in-capital	3,562,682	3,392,696

Retained earnings	6,806,104	6,928,964
Accumulated other comprehensive income	46,642	46,103
Treasury stock, at cost (103,587 and 104,573 shares, respectively), net of reissuances	(3,778,601)	(3,643,190)
Total stockholders' equity	6,636,888	6,724,634
Total liabilities and stockholders' equity	$10,372,199	$10,380,298

(*) The Condensed Consolidated Balance Sheet as of November 29, 2013 has been derived from the audited Consolidated Financial Statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended		Six Months Ended	
	May 30, 2014	May 31, 2013	May 30, 2014	May 31, 2013
Revenue:				
Products	$479,247	$644,899	$950,701	$1,320,688
Subscription	476,694	254,521	900,257	478,787
Services and support	112,267	111,129	217,370	218,947
Total revenue	1,068,208	1,010,549	2,068,328	2,018,422
Cost of revenue:				
Products	24,499	26,805	51,997	78,787
Subscription	84,147	66,527	160,879	129,107
Services and support	46,258	41,949	90,537	84,071
Total cost of revenue	154,904	135,281	303,413	291,965
Gross profit	913,304	875,268	1,764,915	1,726,457
Operating expenses:				
Research and development	209,092	203,097	418,617	412,735
Sales and marketing	426,830	402,208	836,971	800,241
General and administrative	129,138	120,870	268,122	253,723
Restructuring and other charges	(366)	24,992	297	24,994
Amortization of purchased intangibles	13,352	12,792	26,904	25,231
Total operating expenses	778,046	763,959	1,550,911	1,516,924
Operating income	135,258	111,309	214,004	209,533
Non-operating income (expense):				
Interest and other income (expense), net	2,563	1,268	5,708	2,514
Interest expense	(17,103)	(17,205)	(33,693)	(34,039)
Investment gains (losses), net	553	(4,245)	144	(3,397)
Total non-operating income (expense), net	(13,987)	(20,182)	(27,841)	(34,922)
Income before income taxes	121,271	91,127	186,163	174,611
Provision for income taxes	32,744	14,581	50,590	32,948
Net income	$88,527	$76,546	$135,573	$141,663
Basic net income per share	$0.18	$0.15	$0.27	$0.28
Shares used to compute basic net income per share	497,931	503,384	497,439	500,996
Diluted net income per share	$0.17	$0.15	$0.27	$0.28
Shares used to compute diluted net income per share	506,687	512,446	508,227	511,535

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		Six Months Ended	
	May 30, 2014	May 31, 2013	May 30, 2014	May 31, 2013
	Increase/(Decrease)		Increase/(Decrease)	
Net income	$88,527	$76,546	$135,573	$141,663
Other comprehensive income, net of taxes:				
Available-for-sale securities:				
Unrealized gains / losses on available-for-sale securities	1,977	(5,255)	3,488	(4,553)
Reclassification adjustment for gains / losses on available-for-sale securities recognized	(1,251)	(788)	(1,888)	(2,372)
Net increase (decrease) from available-for-sale securities	726	(6,043)	1,600	(6,925)
Derivatives designated as hedging instruments:				
Unrealized gains / losses on derivative instruments	2,001	10,885	1,971	32,660
Reclassification adjustment for gains / losses on derivative instruments recognized	(2,616)	(15,299)	(5,414)	(22,392)
Net increase (decrease) from derivatives designated as hedging instruments	(615)	(4,414)	(3,443)	10,268
Foreign currency translation adjustments	(10,060)	(2,192)	2,382	(6,594)
Other comprehensive income, net of taxes	(9,949)	(12,649)	539	(3,251)
Total comprehensive income, net of taxes	$78,578	$63,897	$136,112	$138,412

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Six Months Ended	
	May 30, 2014	May 31, 2013
Cash flows from operating activities:		
Net income	$135,573	$141,663
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	155,289	157,702
Stock-based compensation	165,798	163,066
Deferred income taxes	4,632	18,661
Write down of assets held for sale	—	23,838
Unrealized (gains) losses on investments	623	3,894
Other non-cash items	4,375	(9,191)
Excess tax benefits from stock-based compensation	(4,875)	—
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Trade receivables, net	69,337	147,839
Prepaid expenses and other current assets	(23,977)	(18,651)
Trade payables	(7,238)	3,437
Accrued expenses	12,071	(46,482)
Accrued restructuring	(4,082)	(5,209)
Income taxes payable	11,891	(30,132)
Deferred revenue	99,792	70,744
Net cash provided by operating activities	619,209	621,179
Cash flows from investing activities:		
Purchases of short-term investments	(895,758)	(1,358,634)
Maturities of short-term investments	128,661	196,201
Proceeds from sales of short-term investments	587,384	641,203
Acquisitions, net of cash acquired	—	(96,356)
Purchases of property and equipment	(56,591)	(106,439)
Purchases of long-term investments and other assets	(6,946)	(59,768)
Proceeds from sale of long-term investments	896	3,240
Net cash used for investing activities	(242,354)	(780,553)
Cash flows from financing activities:		
Purchases of treasury stock	(350,000)	(300,000)
Proceeds from issuance of treasury stock	109,143	356,771
Cost of issuance of treasury stock	(150,095)	(83,550)
Excess tax benefits from stock-based compensation	4,875	—
Proceeds from debt and capital lease obligations	—	25,703
Repayment of debt and capital lease obligations	(8,059)	(9,804)
Debt issuance costs	—	(357)
Net cash used for financing activities	(394,136)	(11,237)
Effect of foreign currency exchange rates on cash and cash equivalents	(255)	(8,031)
Net decrease in cash and cash equivalents	(17,536)	(178,642)
Cash and cash equivalents at beginning of period	834,556	1,425,052
Cash and cash equivalents at end of period	$817,020	$1,246,410

Supplemental disclosures:		
Cash paid for income taxes, net of refunds	$27,532	$68,507
Cash paid for interest	$32,130	$32,676
Non-cash investing activities:		
Issuance of common stock and stock awards assumed in business acquisitions	$—	$661

See accompanying Notes to Condensed Consolidated Financial Statements.

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

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

We have prepared the accompanying unaudited Condensed Consolidated Financial Statements pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Pursuant to these rules and regulations, we have condensed or omitted certain information and footnote disclosures we normally include in our annual Consolidated Financial Statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). In management's opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) necessary to fairly present our financial position, results of operations and cash flows. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the Consolidated Financial Statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended November 29, 2013 on file with the SEC (our "Annual Report").

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

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. Early adoption is not permitted. The updated standard becomes effective for us in the first quarter of fiscal 2018. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new revenue standard discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the six months ended May 30, 2014, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 29, 2013, that are of significance or potential significance to us.

NOTE 2. ACQUISITIONS

On July 22, 2013, we completed our acquisition of privately held Neolane, a leader in cross-channel campaign management technology. During the third quarter of fiscal 2013, we began integrating Neolane into our Digital Marketing reportable segment. Neolane brings a platform for automation and execution of marketing campaigns across the web, e-mail, social, mobile, call center, direct mail, point of sale and other emerging channels which will drive consistent brand experiences and personalized campaigns for our customers.

Under the acquisition method of accounting, the total final purchase price was allocated to Neolane's net tangible and intangible assets based upon their estimated fair values as of July 22, 2013. The total final purchase price for Neolane was $616.7 million of which $515.2 million was allocated to goodwill that was non-deductible for tax purposes, $115.0 million to identifiable intangible assets and $13.5 million to net liabilities assumed. The impact of this acquisition was not material to our Condensed Consolidated Financial Statements.

On December 20, 2012, we completed our acquisition of privately held Behance, an online social media platform to showcase and discover creative work. During the first quarter of fiscal 2013, we began integrating Behance into our Digital Media reportable segment. Behance's community and portfolio capabilities has brought additional community features to Creative Cloud since its acquisition. We have included the financial results of Behance in our Condensed Consolidated Financial Statements beginning on the acquisition date.

Under the acquisition method of accounting, the total purchase price was allocated to Behance's net tangible and intangible assets based upon their estimated fair values as of December 20, 2012. The total final purchase price for Behance was $111.1 million of which $91.4 million was allocated to goodwill, $28.5 million to identifiable intangible assets and $8.8 million to net liabilities assumed. The impact of this acquisition was not material to our Condensed

Consolidated Financial Statements.

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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 May 30, 2014 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$286,379	$—	$—	$286,379
Cash equivalents:				
Money market mutual funds	441,576	—	—	441,576
Municipal securities	1,500	2	—	1,502
Time deposits	61,064	—	—	61,064
U.S. Treasury securities	26,499	—	—	26,499
Total cash equivalents	530,639	2	—	530,641
Total cash and cash equivalents	817,018	2	—	817,020
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,402,478	7,998	(229)	1,410,247
Foreign government securities	20,697	79	—	20,776
Municipal securities	181,886	671	(2)	182,555
U.S. agency securities	471,961	1,477	(101)	473,337
U.S. Treasury securities	425,007	920	(75)	425,852
Subtotal	2,502,029	11,145	(407)	2,512,767
Marketable equity securities	178	246	—	424
Total short-term investments	2,502,207	11,391	(407)	2,513,191
Total cash, cash equivalents and short-term investments	$3,319,225	$11,393	$(407)	$3,330,211

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Cash, cash equivalents and short-term investments consisted of the following as of November 29, 2013 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$286,221	$—	$—	$286,221
Cash equivalents:				
Money market mutual funds	429,373	—	—	429,373
Time deposits	104,711	—	—	104,711
U.S. Treasury securities	14,251	—	—	14,251
Total cash equivalents	548,335	—	—	548,335
Total cash and cash equivalents	834,556	—	—	834,556
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,261,375	7,116	(631)	1,267,860
Foreign government securities	11,213	56	—	11,269
Municipal securities	186,320	328	(24)	186,624
U.S. agency securities	446,615	1,516	(186)	447,945
U.S. Treasury securities	424,076	799	(97)	424,778
Subtotal	2,329,599	9,815	(938)	2,338,476
Marketable equity securities	177	543	—	720
Total short-term investments	2,329,776	10,358	(938)	2,339,196
Total cash, cash equivalents and short-term investments	$3,164,332	$10,358	$(938)	$3,173,752

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 May 30, 2014 and November 29, 2013 (in thousands):

	2014		2013	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$93,651	$(95)	$225,759	$(631)
Municipal securities	15,742	(2)	13,522	(24)
U.S. Treasury and agency securities	38,156	(29)	105,278	(283)
Total	$147,549	$(126)	$344,559	$(938)

There were 78 securities and 177 securities in an unrealized loss position for less than twelve months at May 30, 2014 and at November 29, 2013, respectively.

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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 May 30, 2014 (in thousands):

	2014	
	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$20,841	$(134)
U.S. Treasury and agency securities	29,437	(147)
Total	$50,278	$(281)

As of May 30, 2014, there were 19 securities in an unrealized loss position for more than twelve months. As of November 29, 2013, there were no securities in an unrealized loss position for more than twelve months.
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 May 30, 2014 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	$598,760	$599,985
Due between one and two years	889,136	893,246
Due between two and three years	766,734	770,962
Due after three years	247,399	248,574
Total	$2,502,029	$2,512,767

We review our debt and marketable equity securities classified as short-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. We consider factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer and our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment's amortized cost basis. If we believe that an other-than-temporary decline exists in one of these securities, we write down these investments to fair value. For debt securities, the portion of the write-down related to credit loss would be recorded to interest and other income, net in our Condensed Consolidated Statements of Income. Any portion not related to credit loss would be recorded to accumulated other comprehensive income, which is reflected as a separate component of stockholders' equity in our Condensed Consolidated Balance Sheets. For equity securities, the write-down would be recorded to investment gains (losses), net in our Condensed Consolidated Statements of Income. During the six months ended May 30, 2014, we did not consider any of our investments to be other-than-temporarily impaired.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4. FAIR VALUE MEASUREMENTS

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

We measure certain financial assets and liabilities at fair value on a recurring basis. There have been no transfers between fair value measurement levels during the six months ended May 30, 2014.

The fair value of our financial assets and liabilities at May 30, 2014 was determined using the following inputs (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	$441,576	$441,576	$—	$—
Municipal securities	1,502	—	1,502	—
Time deposits	61,064	61,064	—	—
U.S. Treasury securities	26,499	—	26,499	—
Short-term investments:				
Corporate bonds and commercial paper	1,410,247	—	1,410,247	—
Foreign government securities	20,776	—	20,776	—
Marketable equity securities	424	424	—	—
Municipal securities	182,555	—	182,555	—
U.S. agency securities	473,337	—	473,337	—
U.S. Treasury securities	425,852	—	425,852	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	6,184	—	6,184	—
Other assets:				
Deferred compensation plan assets	23,382	528	22,854	—
Total assets	$3,073,398	$503,592	$2,569,806	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$1,120	$—	$1,120	$—
Total liabilities	$1,120	$—	$1,120	$—

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair value of our financial assets and liabilities at November 29, 2013 was determined using the following inputs (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash equivalents:				
Money market mutual funds	$429,373	$429,373	$—	$—
Time deposits	104,711	104,711	—	—
U.S. Treasury securities	14,251	—	14,251	—
Short-term investments:				
Corporate bonds and commercial paper	1,267,860	—	1,267,860	—
Foreign government securities	11,269	—	11,269	—
Marketable equity securities	720	720	—	—
Municipal securities	186,624	—	186,624	—
U.S. agency securities	447,945	—	447,945	—
U.S. Treasury securities	424,778	—	424,778	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	11,891	—	11,891	—
Other assets:				
Deferred compensation plan assets	19,816	894	18,922	—
Total assets	$2,919,238	$535,698	$2,383,540	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$1,067	$—	$1,067	$—
Total liabilities	$1,067	$—	$1,067	$—

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

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

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

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

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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. During the three and six months ended May 30, 2014, we determined there were no other-than-temporary impairments on our cost method investments. Comparatively, during the three and six months ended May 31, 2013, we determined there was an other-than-temporary impairment of $5.0 million on our cost method investments and wrote down the investments to fair value.

As of May 30, 2014, the carrying value of our lease receivables approximated fair value, based on Level 2 valuation inputs which include Treasury rates, LIBOR rates and applicable credit spreads. See Note 12 for further details regarding our investment in lease receivables. The fair value of our debt was $1.6 billion as of May 30, 2014, based on Level 2 quoted prices in inactive markets. See Note 13 for further details regarding our debt.

NOTE 5. DERIVATIVES AND HEDGING ACTIVITIES

Hedge Accounting

We recognize derivative instruments and hedging activities as either assets or liabilities in our Condensed Consolidated Balance Sheets and measure them at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting.

Economic Hedging—Hedges of Forecasted Transactions

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

We recognize these contracts as derivative instruments and they are classified as either assets or liabilities on the balance sheet and measured on a recurring basis at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the contract and whether it is designated and qualifies for hedge accounting. To receive hedge accounting treatment, all hedging relationships are formally documented at the inception of the hedge, and the hedges must be highly effective in offsetting changes to future cash flows on hedged transactions. We record changes in the intrinsic value of these cash flow hedges in accumulated other comprehensive income in our Condensed Consolidated Balance Sheets, until the forecasted transaction occurs. When the forecasted transaction occurs, we reclassify the related gain or loss on the cash flow hedge to revenue. In the event the underlying forecasted transaction does not occur, or it becomes probable that it will not occur, we reclassify the gain or loss on the related cash flow hedge from accumulated other comprehensive income to interest and other income (expense), net in our Condensed Consolidated Statements of Income at that time. If we do not elect hedge accounting, or the contract does not qualify for hedge accounting treatment, the changes in fair market value from period to period are recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.

Balance Sheet Hedging—Hedging of Foreign Currency Assets and Liabilities

We also 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.

The bank counterparties to these contracts expose us to credit-related losses in the event of their nonperformance. However, to mitigate that risk, we only contract with counterparties who meet our minimum requirements as determined by our counterparty risk assessment process. We monitor ratings, credit spreads and potential downgrades on at least a quarterly basis. Based on our ongoing assessment of counterparty risk, we may adjust our exposure to various counterparties. In addition, our hedging policy establishes maximum limits for each counterparty to mitigate any concentration of risk.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

We evaluate hedge effectiveness at the inception of the hedge prospectively as well as retrospectively and record any ineffective portion of the hedging instruments in interest and other income (expense), net on our Condensed Consolidated Statements of Income. The net gain (loss) recognized in interest and other income (expense), net for cash flow hedges due to hedge ineffectiveness was insignificant for the periods presented. The time value of purchased contracts is recorded in interest and other income (expense), net in our Condensed Consolidated Statements of Income.
The fair value of derivative instruments on our Condensed Consolidated Balance Sheets as of May 30, 2014 and November 29, 2013 were as follows (in thousands):

	2014		2013	
	Fair Value Asset Derivatives[1]	Fair Value Liability Derivatives[2]	Fair Value Asset Derivatives[1]	Fair Value Liability Derivatives[2]
Derivatives designated as hedging instruments:				
Foreign exchange option contracts[3]	$5,574	$—	$8,913	$—
Derivatives not designated as hedging instruments:				
Foreign exchange forward contracts	610	1,120	2,978	1,067
Total derivatives	$6,184	$1,120	$11,891	$1,067

(1) Included in prepaid expenses and other current assets on our Condensed Consolidated Balance Sheets.
(2) Included in accrued expenses on our Condensed Consolidated Balance Sheets.
(3) Hedging effectiveness expected to be recognized into income within the next twelve months.

The aggregate fair value of derivative instruments in net asset positions represent the maximum exposure to loss at the reporting date as a result of all of the counterparties failing to perform as contracted. This exposure could be reduced by the fair value of liabilities included in master netting arrangements with those same counterparties.

The effect of derivative instruments designated as cash flow hedges and of derivative instruments not designated as hedges in our Condensed Consolidated Statements of Income for the three and six months ended May 30, 2014 was as follows (in thousands):

	Three Months		Six Months	
	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax[1]	$2,001	$—	$1,971	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[2]	$2,616	$—	$5,414	$—
Net gain (loss) recognized in income[3]	$(3,653)	$—	$(7,196)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[4]	$—	$(515)	$—	$720

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The effect of derivative instruments designated as cash flow hedges and of derivative instruments not designated as hedges in our Condensed Consolidated Statements of Income for the three and six months ended May 31, 2013 was as follows (in thousands):

	Three Months		Six Months	
	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts	Foreign Exchange Option Contracts	Foreign Exchange Forward Contracts
Derivatives in cash flow hedging relationships:				
Net gain (loss) recognized in OCI, net of tax[1]	$10,885	$—	$32,660	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[2]	$15,299	$—	$22,392	$—
Net gain (loss) recognized in income[3]	$(4,999)	$—	$(9,667)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[4]	$—	$3,318	$—	$4,796

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

NOTE 6. GOODWILL AND PURCHASED AND OTHER INTANGIBLES

Goodwill as of May 30, 2014 and November 29, 2013 was $4.774 billion and $4.772 billion, respectively. During the second quarter of fiscal 2014, we completed our annual goodwill impairment test associated with our three reporting units—Digital Media, Digital Marketing and Print and Publishing—and determined there was no impairment of goodwill.

Purchased and other intangible assets subject to amortization as of May 30, 2014 and November 29, 2013 were as follows (in thousands):

	2014			2013		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	$403,427	$(237,064)	$166,363	$423,237	$(220,414)	$202,823
Customer contracts and relationships	$389,821	$(131,342)	$258,479	$389,800	$(111,416)	$278,384
Trademarks	67,171	(32,228)	34,943	67,546	(27,933)	39,613
Acquired rights to use technology	155,827	(87,480)	68,347	155,322	(76,740)	78,582
Localization	3,402	(1,686)	1,716	3,404	(2,172)	1,232
Other intangibles	12,484	(10,015)	2,469	16,447	(11,827)	4,620
Total other intangible assets	$628,705	$(262,751)	$365,954	$632,519	$(230,088)	$402,431
Purchased and other intangible assets, net	$1,032,132	$(499,815)	$532,317	$1,055,756	$(450,502)	$605,254

In the first quarter of fiscal 2013, we acquired rights to use certain technology for $51.8 million. Of this cost, an estimated $25.3 million was related to future licensing rights that has been capitalized and is being amortized on a straight-line basis over the estimated useful lives ranging from five to ten years. We estimated that the remaining cost of $26.5 million was related to historical use of licensing rights and was expensed as cost of product revenue.

In the second quarter of fiscal 2014, certain purchased intangibles associated with our acquisitions of Efficient Frontier and Day Software Holding AG became fully amortized and were removed from the Condensed Consolidated Balance Sheets.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Amortization expense related to purchased and other intangible assets was $37.6 million and $76.0 million for the three and six months ended May 30, 2014, respectively. Comparatively, excluding the expense associated with historical use of the acquired rights to use the technology discussed in the paragraph above, amortization expense was $37.5 million and $74.9 million for the three and six months ended May 31, 2013. Of these amounts, $24.2 million and $49.1 million were included in cost of sales for the three and six months ended May 30, 2014, respectively, and $25.0 million and $50.2 million for the three and six months ended May 31, 2013. As of May 30, 2014, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2014	$37,573	$38,040
2015	61,461	68,267
2016	22,936	62,283
2017	15,459	52,875
2018	9,059	41,810
Thereafter	19,875	102,679
Total expected amortization expense	$166,363	$365,954

NOTE 7. ACCRUED EXPENSES

Accrued expenses as of May 30, 2014 and November 29, 2013 consisted of the following (in thousands):

	2014	2013
Accrued compensation and benefits	$311,085	$318,219
Sales and marketing allowances	72,063	66,502
Accrued corporate marketing	35,255	22,801
Taxes payable	19,381	18,225
Royalties payable	17,428	14,778
Accrued interest expense	20,744	20,613
Other	180,984	195,801
Accrued expenses	$656,940	$656,939

Other primarily includes general corporate accruals for technical support and local and regional expenses, including our accrual for a loss contingency as of May 30, 2014. Other is also comprised of deferred rent related to office locations with rent escalations and foreign currency liability derivatives. See Note 12 for further information regarding the loss contingency.

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NOTE 8. STOCK-BASED COMPENSATION

Summary of Restricted Stock Units

Restricted stock unit activity for the six months ended May 30, 2014 and the fiscal year ended November 29, 2013 was as follows (in thousands):

	2014	2013
Beginning outstanding balance	17,948	18,415
Awarded	3,654	7,236
Released	(6,520)	(6,224)
Forfeited	(785)	(1,479)
Ending outstanding balance	14,297	17,948

Information regarding restricted stock units outstanding at May 30, 2014 and May 31, 2013 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2014			
Restricted stock units outstanding	14,297	1.28	$922.7
Restricted stock units vested and expected to vest	12,552	1.22	$804.0
2013			
Restricted stock units outstanding	18,304	1.47	$785.4
Restricted stock units vested and expected to vest	16,009	1.40	$684.6

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market values as of May 30, 2014 and May 31, 2013 were $64.54 and $42.91, respectively.

Summary of Performance Shares

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

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

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As of May 30, 2014, the shares awarded under our 2013 and 2014 Performance Share Programs are yet to be achieved. The following table sets forth the summary of performance share activity under our 2013 and 2014 Performance Share Programs for the six months ended May 30, 2014 (in thousands):

	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	854	1,707
Awarded	709	1,417
Forfeited	(19)	(38)
Ending outstanding balance	1,544	3,086

In the first quarter of fiscal 2013, the Executive Compensation Committee certified the actual performance achievement of participants in the 2012 Performance Share Program ("2012 Program"). Based upon the achievement of specific and/or market-based performance goals outlined in the 2012 Program, participants had the ability to receive up to 150% of the target number of shares originally granted. Actual performance resulted in participants achieving 116% of target or approximately 1.3 million shares for the 2012 Program. One third of the shares under the 2012 Program vested in the first quarter of fiscal 2013 and the remaining two thirds vest evenly on the following two anniversaries of the grant date, contingent upon the recipient's continued service to Adobe.

The following table sets forth the summary of performance share activity under our 2010, 2011 and 2012 Programs, based upon share awards actually achieved, for the six months ended May 30, 2014 and the fiscal year ended November 29, 2013 (in thousands):

	2014	2013
Beginning outstanding balance	861	388
Achieved	—	1,279
Released	(486)	(665)
Forfeited	(17)	(141)
Ending outstanding balance	358	861

Information regarding performance shares outstanding at May 30, 2014 and May 31, 2013 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2014			
Performance shares outstanding	358	0.65	$23.1
Performance shares vested and expected to vest	335	0.65	$21.5
2013			
Performance shares outstanding	877	1.08	$37.6
Performance shares vested and expected to vest	793	1.06	$33.9

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market values as of May 30, 2014 and May 31, 2013 were $64.54 and $42.91, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Summary of Stock Options

There were no option grants during the six months ended May 30, 2014 and May 31, 2013. Option activity for the six months ended May 30, 2014 and the fiscal year ended November 29, 2013 was as follows (in thousands):

	2014	2013
Beginning outstanding balance	7,359	24,517
Granted	—	25
Exercised	(2,272)	(15,872)
Cancelled	(115)	(1,584)
Increase due to acquisition	—	273
Ending outstanding balance	4,972	7,359

Information regarding stock options outstanding at May 30, 2014 and May 31, 2013 is summarized below:

	Number of Shares (thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2014				
Options outstanding	4,972	$29.37	3.14	$174.9
Options vested and expected to vest	4,922	$29.47	3.11	$172.6
Options exercisable	4,140	$30.59	2.74	$140.5
2013				
Options outstanding	12,780	$31.84	2.89	$142.1
Options vested and expected to vest	12,576	$31.95	2.84	$138.5
Options exercisable	10,387	$33.05	2.36	$102.9

(*) The intrinsic value is calculated as the difference between the market value as of the end of the fiscal period and the exercise price of the shares. As reported by the NASDAQ Global Select Market, the market values as of May 30, 2014 and May 31, 2013 were $64.54 and $42.91, respectively.

Summary of Employee Stock Purchase Plan Shares

There were no stock purchases under the employee stock purchase plan (“ESPP”) during the three months ended May 30, 2014 and May 31, 2013. The assumptions used to value employee stock purchase rights during the six months ended May 30, 2014 and May 31, 2013 were as follows:

	Six Months	
	2014	2013
Expected life (in years)	0.5 - 2.0	0.5 - 2.0
Volatility	27% - 28%	26 - 30%
Risk free interest rate	0.09% - 0.39%	0.12 - 0.27%

The expected life of the ESPP shares is the average of the remaining purchase periods under each offering period.

Employees purchased 1.2 million shares at an average price of $27.84 and 1.2 million shares at an average price of $25.49 for the six months ended May 30, 2014 and May 31, 2013, respectively. The intrinsic value of shares purchased during the six months ended May 30, 2014 and May 31, 2013 was $39.0 million and $14.5 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Compensation Costs

As of May 30, 2014, there was $509.6 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock-based awards which will be recognized over a weighted average period of 1.9 years. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

Total stock-based compensation costs that have been included in our Condensed Consolidated Statements of Income for the three months ended May 30, 2014 and May 31, 2013 were as follows (in thousands):

	2014		2013	
Income Statement Classifications	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$505	$1,441	$446	$1,181
Cost of revenue—services and support	964	1,682	826	2,360
Research and development	3,989	25,910	4,734	23,210
Sales and marketing	4,316	25,363	4,893	24,026
General and administrative	1,494	17,346	2,146	15,048
Total	$11,268	$71,742	$13,045	$65,825

Total stock-based compensation costs that have been included in our Condensed Consolidated Statements of Income for the six months ended May 30, 2014 and May 31, 2013 were as follows (in thousands):

	2014		2013	
Income Statement Classifications	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards	Option Grants and Stock Purchase Rights	Restricted Stock and Performance Share Awards
Cost of revenue—subscription	$966	$2,810	$1,083	$2,244
Cost of revenue—services and support	1,695	3,220	1,681	4,810
Research and development	8,246	52,467	10,554	48,941
Sales and marketing	9,079	51,094	11,560	47,778
General and administrative	3,280	32,941	4,660	29,755
Total	$23,266	$142,532	$29,538	$133,528

NOTE 9. RESTRUCTURING CHARGES

Restructuring Plans

Our restructuring plans consist of reductions in workforce and the consolidation of facilities to better align our resources around our business strategies. As of May 30, 2014, we considered our restructuring plans to be substantially complete. We continue to make cash outlays to settle obligations under these plans, however the current impact to our Condensed Consolidated Financial Statements is not significant.

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(Unaudited)

Summary of Restructuring Plans

The following table sets forth a summary of restructuring activities related to all of our restructuring plans during the six months ended May 30, 2014 (in thousands):

	November 29, 2013	Costs Incurred	Cash Payments	Other Adjustments	May 30, 2014
Termination benefits	$2,233	$—	$(567)	$(377)	$1,289
Cost of closing redundant facilities	11,655	528	(3,811)	65	8,437
Total restructuring plans	$13,888	$528	$(4,378)	$(312)	$9,726

Accrued restructuring charges of $9.7 million as of May 30, 2014 includes $3.6 million recorded in accrued restructuring, current and $6.1 million related to long-term facilities obligations recorded in accrued restructuring, non-current on our Condensed Consolidated Balance Sheets. We expect to pay accrued termination benefits through fiscal 2014 and facilities-related liabilities under contract through fiscal 2021 of which approximately 36% will be paid through 2015.

NOTE 10. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the six months ended May 30, 2014 were as follows (in thousands):

Balance as of November 29, 2013	$6,928,964
Net income	135,573
Re-issuance of treasury stock	(258,433)
Balance as of May 30, 2014	$6,806,104

We account for treasury stock under the cost method. When treasury stock is re-issued at a price higher than its cost, the difference is recorded as a component of additional paid-in-capital in our Condensed Consolidated Balance Sheets. When treasury stock is re-issued at a price lower than its cost, the difference is recorded as a component of additional paid-in-capital to the extent that there are treasury stock gains to offset the losses. If there are no treasury stock gains in additional paid-in-capital, the losses upon re-issuance of treasury stock are recorded as a reduction of retained earnings in our Condensed Consolidated Balance Sheets.

The components of accumulated other comprehensive income and activity, net of related taxes, as of May 30, 2014 were as follows (in thousands):

	November 29, 2013	Increase / Decrease	Reclassification Adjustments	May 30, 2014
Net unrealized gains on available-for-sale securities:				
Unrealized gains on available-for-sale securities	$ 10,178	$2,993	$ (1,925)	$11,246
Unrealized losses on available-for-sale securities	(937)	495	37	(405)
Net unrealized gains on available-for-sale securities	9,241	3,488	(1,888) (1)	10,841
Net unrealized gains on derivative instruments designated as hedging instruments	5,367	1,971	(5,414) (2)	1,924
Cumulative foreign currency translation adjustments	31,495	2,382	—	33,877
Total accumulated other comprehensive income, net of taxes	$ 46,103	$7,841	$ (7,302)	$46,642

(1) Classified in interest and other income (expense), net.

(2) Classified as revenue.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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The following table sets forth the taxes related to each component of other comprehensive income for the three and six months ended May 30, 2014 and May 31, 2013 (in thousands):

	Three Months		Six Months Ended	
	2014	2013	2014	2013
Available-for-sale securities:				
Unrealized gains / losses	$(11)	$24	$(31)	$34
Reclassification adjustments	(2)	—	(3)	—
Subtotal available-for-sale securities	(13)	24	(34)	34
Derivatives designated as hedging instruments:				
Unrealized gains on derivative instruments*	—	—	—	—
Reclassification adjustments*	—	—	—	—
Subtotal derivatives designated as hedging instruments	—	—	—	—
Foreign currency translation adjustments	(560)	(196)	(558)	(500)
Total taxes, other comprehensive income	$(573)	$(172)	$(592)	$(466)

(*) Taxes related to derivative instruments were zero based on the tax jurisdiction where the 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. We are currently repurchasing common stock under our $2.0 billion authority granted by our Board of Directors in April 2012, which can be used through the end of fiscal 2015.

During the six months ended May 30, 2014 and May 31, 2013, we entered into several structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments totaling $350.0 million and $300.0 million, respectively. We enter into these agreements in order to take advantage of repurchasing shares at a guaranteed discount to the Volume Weighted Average Price ("VWAP") of our common stock over a specified period of time. We only enter into such transactions when the discount that we receive is higher than the foregone return on our cash prepayments to the financial institutions. There were no explicit commissions or fees on these structured repurchases. Under the terms of the agreements, there is no requirement for the financial institutions to return any portion of the prepayment to us.

The financial institutions agree to deliver shares to us at monthly intervals during the contract term. The parameters used to calculate the number of shares deliverable are: the total notional amount of the contract, the number of trading days in the contract, the number of trading days in the interval and the average VWAP of our stock during the interval less the agreed upon discount. During the six months ended May 30, 2014, we repurchased approximately 7.1 million shares at an average price of $60.55 through structured repurchase agreements entered into during fiscal 2013 and the six months ended May 30, 2014. During the six months ended May 31, 2013, we repurchased approximately 6.6 million shares at an average price of $41.07 through structured repurchase agreements entered into during 2012 and the six months ended May 31, 2013.

As of May 30, 2014, the prepayments were classified as treasury stock on our Condensed Consolidated Balance Sheets at the payment date, though only shares delivered to us by the financial statement date were excluded from the computation of earnings per share. As of May 30, 2014, $50.8 million of prepayment remained under this agreement.

Subsequent to May 30, 2014, as part of our $2.0 billion stock repurchase program, we entered into a structured stock repurchase agreement with a large financial institution whereupon we provided them with a prepayment of $125.0

million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the $125.0 million stock repurchase agreement, $325.0 million remains under our current authority.

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NOTE 11. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three and six months ended May 30, 2014 and May 31, 2013 (in thousands, except per share data):

	Three Months		Six Months Ended	
	2014	2013	2014	2013
Net income	$88,527	$76,546	$135,573	$141,663
Shares used to compute basic net income per share	497,931	503,384	497,439	500,996
Dilutive potential common shares:				
Unvested restricted stock and performance share awards	6,618	5,758	8,454	7,262
Stock options	2,138	3,304	2,334	3,277
Shares used to compute diluted net income per share	506,687	512,446	508,227	511,535
Basic net income per share	$0.18	$0.15	$0.27	$0.28
Diluted net income per share	$0.17	$0.15	$0.27	$0.28

For the three and six months ended May 30, 2014, there were no options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of $63.90 and $62.40, respectively, that would have been anti-dilutive. Comparatively, for the three months ended May 31, 2013, options to purchase shares of common stock with exercise prices greater than the average fair market value of our stock of $43.60 were not included in the calculation because the effect would have been anti-dilutive. The number of shares of common stock under these options was immaterial. For the six months ended May 31, 2013, options to purchase approximately 1.5 million shares of common stock with exercise prices greater than the average fair market value of our stock of $40.76 were not included in the calculation because the effect would have been anti-dilutive.

NOTE 12. COMMITMENTS AND CONTINGENCIES

Lease Commitments

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

The lease agreements for the East and West Towers and the Almaden Tower are effective through August 2014 and March 2017, respectively. We are the investors in the lease receivables related to these leases for the East and West Towers and the Almaden Tower in the amount of $126.8 million and $80.4 million, respectively, which is recorded as investment in lease receivables on our Condensed Consolidated Balance Sheets. As of May 30, 2014, the carrying value of the lease receivables related to the towers approximated fair value. Under the agreement for the East and West Towers and the agreement for the Almaden Tower, we have the option to purchase the buildings at any time during the lease term for $143.2 million and $103.6 million, respectively. The residual value guarantees under the East and West Towers and the Almaden Tower obligations are $126.8 million and $89.4 million, respectively. If we purchase the properties, the investments in the lease receivables may be credited against the purchase price.

These two leases are both subject to standard covenants including certain financial ratios that are reported to the lessors quarterly. In addition, we are required to maintain a standby letter of credit for $16.6 million for one of the leases which enables us to secure a lower interest rate and reduce the number of covenants. As defined in the lease agreement, the standby letter of credit primarily represents the lease investment equity balance which is callable in the event of default. As of May 30, 2014, we were in compliance with all of the covenants. In the case of a default, the lessor may demand we purchase the buildings for an amount equal to the lease balance, or require that we remarket or relinquish the buildings. If we choose to remarket or are required to do so upon relinquishing the buildings, we are bound to arrange the sale of the buildings to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the residual value guarantee amount less our investment in the lease receivables. Both leases qualify for operating lease accounting treatment and, as such, the buildings and the related obligations are not included in our Condensed Consolidated Balance Sheets.

In the first quarter of fiscal 2013, we entered into a sale-leaseback agreement totaling $25.7 million over a period of 24 months. This transaction was classified as a capital lease obligation and recorded at fair value.

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 shipped or a percentage of the underlying revenue.

Indemnifications

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

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

Legal Proceedings

In connection with disputes relating to the validity or alleged infringement of third-party intellectual property rights, including patent rights, we have been, are currently and may in the future be subject to claims, negotiations or complex, protracted litigation. Intellectual property disputes and litigation may be very costly and can be disruptive to our business operations by diverting the attention and energies of management and key technical personnel. Although we have successfully defended or resolved past litigation and disputes, we may not prevail in any ongoing or future litigation and disputes. Third-party intellectual property disputes could subject us to significant liabilities, require us to enter into royalty and licensing arrangements on unfavorable terms, prevent us from licensing certain of our products or offering certain of our services, subject us to injunctions restricting our sale of products or services, cause severe disruptions to our operations or the markets in which we compete, or require us to satisfy indemnification commitments with our customers including contractual provisions under various license arrangements and service agreements.

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

All defendants deny the allegations and that they engaged in any wrongdoing of any kind. On October 24, 2013, the court certified a class of all persons who worked in the technical, creative, and/or research and development fields on a salaried basis in the United States for one or more of the following: (a) Apple from March 2005 through December 2009; (b) Adobe from May 2005 through December 2009; (c) Google from March 2005 through December 2009; (d) Intel from March 2005 through December 2009; (e) Intuit from June 2007 through December 2009; (f) Lucasfilm from January 2005 through December 2009; or (g) Pixar from January 2005 through December 2009, excluding retail employees, corporate officers, members of the boards of directors, and senior executives of all defendants. During the second quarter of fiscal 2014, the parties reached a settlement to resolve this lawsuit, subject to the Court's approval. On May 22, 2014, the parties jointly submitted a settlement agreement for the Court's preliminary approval. We accrued a loss contingency of $10.0 million associated with this matter during the first quarter of fiscal 2014.

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.

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

We make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case. Unless otherwise specifically disclosed in this note, we have determined that no provision for liability nor disclosure is required related to any claim against us because: (a) there is not a reasonable possibility that a loss exceeding amounts already recognized (if any) may be incurred with respect to such claim; (b) a reasonably possible loss or range of loss cannot be estimated; or (c) such estimate is immaterial.

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

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

NOTE 13. DEBT

Notes

In February 2010, we issued $600.0 million of 3.25% senior notes due February 1, 2015 (the “2015 Notes”) and $900.0 million of 4.75% senior notes due February 1, 2020 (the “2020 Notes” and, together with the 2015 Notes, the “Notes”). Our proceeds were $1.5 billion and were net of an issuance discount of $6.6 million. The Notes rank equally with our other unsecured and unsubordinated indebtedness. In addition, we incurred issuance costs of $10.7 million. Both the discount and issuance costs are being amortized to interest expense over the respective terms of the Notes using the effective interest method. The effective interest rate including the discount and issuance costs is 3.45% for the 2015 Notes and 4.92% for the 2020 Notes. Interest is payable semi-annually, in arrears, on February 1 and August 1, commencing on August 1, 2010. In February 2014, we made a semi-annual interest payment of $31.1 million. Based on quoted prices in inactive markets, the fair value of the Notes was $1.6 billion as of May 30, 2014.

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 May 30, 2014, we were in compliance with all of the covenants.

During the first quarter of fiscal 2014, we reclassified $599.8 million as current debt on our Condensed Consolidated Balance Sheets, which represented the 2015 Notes, net of unamortized original issuance discount. We intend to refinance the current portion of our debt on or before the due date.

Credit Agreement

On March 2, 2012, we entered into a five-year $1.0 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 $500.0 million in commitments, for a maximum aggregate commitment of $1.5 billion. Loans under the Credit Agreement will bear interest at either (i) the London Interbank Offered Rate (“LIBOR”) plus a margin, based on our 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 public 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.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Credit Agreement contains customary representations, warranties, affirmative and negative covenants, including a financial covenant, events of default and indemnification provisions in favor of the lenders. The negative covenants include restrictions regarding the incurrence of liens and indebtedness, certain merger and acquisition transactions, dispositions and other matters, all subject to certain exceptions. The financial covenant, based on a quarterly financial test, requires us not to exceed a maximum leverage ratio.

On March 1, 2013, we exercised an option under the Credit Agreement to extend the maturity date of the Credit Agreement by one year to March 2, 2018. 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 May 30, 2014, there were no outstanding borrowings under this Credit Agreement and we were in compliance with all covenants.

Capital Lease Obligations

In fiscal 2013, we entered into a sale-leaseback agreement totaling $25.7 million over a period of 24 months. As of May 30, 2014, our capital lease obligations of $9.9 million are presented as current debt in our Condensed Consolidated Balance Sheets.

NOTE 14. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three and six months ended May 30, 2014 and May 31, 2013 included the following (in thousands):

	Three Months		Six Months Ended	
	2014	2013	2014	2013
Interest and other income (expense), net:				
Interest income	$5,240	$5,606	$10,374	$11,288
Foreign exchange gains (losses)	(4,263)	(5,418)	(7,066)	(11,592)
Realized gains on fixed income investment	1,254	800	1,924	2,399
Realized losses on fixed income investment	(3)	(13)	(36)	(27)
Other	335	293	512	446
Interest and other income (expense), net	$2,563	$1,268	$5,708	$2,514
Interest expense	$(17,103)	$(17,205)	$(33,693)	$(34,039)
Investment gains (losses), net:				
Realized investment gains	$183	$76	$733	$494
Unrealized investment gains	370	679	465	1,123
Realized investment losses	—	(5,000)	(1,054)	(5,014)
Investment gains (losses), net	$553	$(4,245)	$144	$(3,397)
Non-operating income (expense), net	$(13,987)	$(20,182)	$(27,841)	$(34,922)

NOTE 15. SEGMENTS

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

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

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

We have the following reportable segments:

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

Our segment results for the three and six months ended May 30, 2014 and May 31, 2013 were as follows (dollars in thousands):

	Digital Media	Digital Marketing	Print and Publishing	Total
Three months ended May 30, 2014				
Revenue	$691,575	$330,357	$46,276	$1,068,208
Cost of revenue	36,063	115,873	2,968	154,904
Gross profit	$655,512	$214,484	$43,308	$913,304
Gross profit as a percentage of revenue	95 %	65 %	94 %	85 %
Three months ended May 31, 2013				
Revenue	$669,998	$285,399	$55,152	$1,010,549
Cost of revenue	34,881	97,752	2,648	135,281
Gross profit	$635,117	$187,647	$52,504	$875,268
Gross profit as a percentage of revenue	95 %	66 %	95 %	87 %

	Digital Media	Digital Marketing	Print and Publishing	Total
Six months ended May 30, 2014				
Revenue	$1,332,678	$644,788	$90,862	$2,068,328
Cost of revenue	74,150	223,890	5,373	303,413
Gross profit	$1,258,528	$420,898	$85,489	$1,764,915
Gross profit as a percentage of revenue	94 %	65 %	94 %	85 %
Six months ended May 31, 2013				
Revenue	$1,358,398	$553,099	$106,925	$2,018,422
Cost of revenue	88,590	196,031	7,344	291,965
Gross profit	$1,269,808	$357,068	$99,581	$1,726,457
Gross profit as a percentage of revenue	93 %	65 %	93 %	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 and market opportunities which involve risks and uncertainties that could cause actual results to differ materially from these forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section entitled "Risk Factors" in Part II, Item 1A of this report. You should carefully review the risks described herein and in other documents we file from time to time with the U.S. Securities and Exchange Commission ("the SEC"), including our Annual Report on Form 10-K for fiscal 2013. When used in this report, the words "will," "expects," "could," "would," "may," "anticipates," "intends," "plans," "believes," "seeks," "targets," "estimates," "looks for," "looks to," "continues" and similar ex well as statements regarding our focus for the future, are generally intended to identify forward-looking statements. You should not place undue reliance on these forward-looking statements which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document, except as required by law.

BUSINESS OVERVIEW

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

We maintain executive offices and principal facilities at 345 Park Avenue, San Jose, California 95110-2704. Our telephone number is 408-536-6000. We maintain a website at 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.

OPERATIONS OVERVIEW

For our second quarter of fiscal 2014, we reported financial results consistent with the continued execution of our long-term plans for our two strategic growth areas, Digital Media and Digital Marketing, while continuing to market and license a broad portfolio of products and solutions.

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

We offer Creative Cloud for individuals and for teams, and we enable larger enterprise customers to acquire Creative Cloud capabilities through Enterprise Term License Agreements ("ETLAs"). The three Creative Cloud offerings address the multiple routes to market we use to license our creative software to targeted customers. Adoption of Creative

Cloud is transforming 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. This model drives our revenue to be more recurring and predictable as revenue is recognized ratably.

We continue to implement strategies that will accelerate awareness, consideration and purchase of subscriptions to our Creative Cloud offering. These strategies include increasing the value Creative Cloud users receive, as well as targeted promotions

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and offers that attract past customers and potential users to try out and ultimately subscribe to Creative Cloud. Additionally, in May 2013 we announced we would exclusively deliver new creative product innovations and features to Creative Cloud subscribers, and that Adobe Creative Suite 6 (“CS6”), which was released in May 2012, would be the last major update we provide for perpetual licensees. More recently, we announced the removal of general availability of CS6 on a perpetual licensing basis from legacy shrinkwrap and volume licensing channels. We will still offer CS6 through our Adobe.com website and in certain markets.

Because of the shift towards Creative Cloud subscriptions and ETLAs, we have stated we expect perpetual revenue for CS6 to decline, and in the second half of fiscal 2014 we expect revenue from perpetual licensing of our creative professional products to be immaterial.

Total Digital Media revenue grew during the second quarter of fiscal 2014 compared to the year ago period and the first quarter of fiscal 2014 as strong adoption of our Creative Cloud subscription offering continued. Also contributing to the sequential increase in total Digital Media revenue was the increase in perpetual revenue from our channel-driven CS6 offerings. The increase in CS6 perpetual revenue was expected due to the second quarter of fiscal 2014 being the last quarter we broadly offered volume licensing of CS6 through channel resellers targeting enterprise customers. As a result, there was a final surge of CS6 perpetual product purchases during the second quarter of fiscal 2014.

To assist with an understanding of this transition and the related shift in revenue described above, we are using certain performance metrics to assess the health and trajectory of our overall Digital Media segment. These metrics include the total number of current paid subscriptions and Annualized Recurring Revenue (“ARR”). 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.

For our Creative business, we define Creative ARR as the sum of:

- the number of current subscriptions, multiplied by the average subscription price paid per user per month, multiplied by twelve months; plus,
- twelve months of contract value of ETLAs where the revenue is ratably recognized over the life of the contract; plus
- twelve months of Adobe Digital Publishing Suite contract value where the revenue is ratably recognized.

We exited the second quarter of fiscal 2014 with 2.308 million paid Creative Cloud subscriptions, up 60% from 1.439 million at the end of fiscal 2013. Total Creative ARR exiting the second quarter of fiscal 2014 was $1.20 billion, up from $801 million at the end of fiscal 2013.

Our Digital Media segment also includes our Document Services products and solutions, including Acrobat, Acrobat cloud services and EchoSign e-signing solution. In the second quarter of fiscal 2014 we continued to drive solid adoption of our Acrobat family of products primarily through license agreements with enterprise customers. During the second quarter of fiscal 2014, a higher percentage of these agreements were ETLAs, which like ETLAs with our creative customers, cause more revenue to be recognized over time rather than at the time of contract signing. This has caused a year-over-year decline in Acrobat revenue which was partially offset by increases associated with our Acrobat cloud services during the second quarter of fiscal 2014 compared to the year ago period.

We expect that the benefit of ETLAs will improve our growth potential over time. In addition to Acrobat, we also drove strong adoption of subscription based services including our Acrobat cloud services. Combined, adoption of Acrobat through ETLAs and our Document Services subscription offerings helped grow Document Services ARR to

$183 million exiting the second quarter of fiscal 2014, up from $82 million at the end of the second quarter of fiscal 2013.

Total Digital Media ARR, which we define as the sum of Creative ARR and Document Services ARR, grew to $1.38 billion at the end of the second quarter of fiscal 2014, up from $444 million at the end of the second quarter fiscal 2013, demonstrating the progress we have made with the transformation of our business to a more recurring, ratable and predictable revenue model.

We are a market leader in the fast-growing category addressed by our Digital Marketing segment. Our Adobe Marketing Cloud includes six solutions addressing the expanding needs of marketers, the newest of which is Adobe Campaign—a cross-channel campaign management tool that we added to our portfolio with the acquisition of Neolane during the third quarter of fiscal 2013.

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Revenue from Adobe Marketing Cloud increased 23% during the three months ended May 30, 2014 compared to the year ago period. Helping to drive this performance was strong adoption of our Adobe Experience Manager ("AEM") offering and the addition of Neolane in mid-third quarter of fiscal 2013.

AEM, our fastest growing digital marketing solution, has typically been licensed by our customers as an on-premise offering where license revenue is recognized at the time of the transaction. In the past year, we introduced a managed services offering of AEM for which revenue is recognized ratably. We expect continued adoption of the newer managed services offering, which will increasingly migrate AEM revenue in this segment to be recurring. Given the comparisons involving more new license revenue being recognized over time versus past license revenue being recognized up front, we anticipate this trend may impact overall Adobe Marketing Cloud reported revenue growth in the near term.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

In preparing our Condensed Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America ("GAAP") and pursuant to the rules and regulations of the SEC, we make assumptions, judgments and estimates that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. We base our assumptions, judgments and estimates on historical experience and various other factors that we believe to be reasonable under the circumstances. Actual results could differ materially from these estimates under different assumptions or conditions. On a regular basis, we evaluate our assumptions, judgments and estimates. We also discuss our critical accounting policies and estimates with the Audit Committee of the Board of Directors.

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

There have been no significant changes in our critical accounting policies and estimates during the six months ended May 30, 2014, as compared to the critical accounting policies and estimates disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended November 29, 2013.

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. Early adoption is not permitted. The updated standard becomes effective for us in the first quarter of fiscal 2018. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

With the exception of the new revenue standard discussed above, there have been no other recent accounting pronouncements or changes in accounting pronouncements during the six months ended May 30, 2014, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended November 29, 2013, that are of significance or potential significance to us.

RESULTS OF OPERATIONS

Financial Performance Summary for the Second Quarter of Fiscal 2014

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Consistent with our strategy, during the three months ended May 30, 2014, our subscription revenue as a percentage of total revenue increased to 45% compared with 25%, in the year ago period, as we transition more of our business to a subscription-based model.

- We exited the second quarter of fiscal 2014 with 2.308 million paid Creative Cloud subscriptions, up 60% from 1.439 million at the end of fiscal 2013.

- Total Digital Media ARR of approximately $1.38 billion as of May 30, 2014 increased by $434 million, or 46%, from $944 million as of November 29, 2013. The change in our Digital Media ARR is primarily due to increases in the number of paid Creative Cloud individual and team subscriptions and continued adoption of our enterprise Creative Cloud offering through our ETLAs.

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- Adobe Marketing Cloud revenue of $282.9 million during the three months ended May 30, 2014 increased by $53.4 million, or 23% compared with the year ago period. The increase was primarily due to strong adoption of our AEM offering and the addition of Neolane which we acquired in the third quarter of fiscal 2013.

- Our total deferred revenue of $928.6 million as of May 30, 2014 increased by $99.8 million, or 12% from November 29, 2013, primarily due to increases in subscriptions, ETLAs and renewals for our Adobe Marketing Cloud services.

- Cost of revenue of $154.9 million during the three months ended May 30, 2014 increased by $19.6 million, or 14% compared with the year ago period, primarily due to increased hosting and server costs associated with our subscription and SaaS offerings and costs associated with compensation and related benefits driven by additional headcount.

- Operating expenses of $778.0 million during the three months ended May 30, 2014 increased by $14.0 million, or 2% compared with the year ago period, primarily due to increased costs associated with compensation and related benefits.

- Net income of $88.5 million during the three months ended May 30, 2014 increased by $12.0 million, or 16% compared with the year ago period.

- Net cash flow from operations was $619.2 million during the six months ended May 30, 2014 and remained relatively stable compared to the six months ended May 31, 2013.

Revenue for the Three and Six Months Ended May 30, 2014 and May 31, 2013 (dollars in millions)

	Three Months			Six Months		
	2014	2013	% Change	2014	2013	% Change
Product	$479.2	$644.9	(26)%	$950.7	$1,320.7	(28)%
Percentage of total revenue	45 %	64 %		46 %	65 %	
Subscription	476.7	254.5	87 %	900.2	478.8	88 %
Percentage of total revenue	45 %	25 %		44 %	24 %	
Services and support	112.3	111.1	1 %	217.4	218.9	(1)%
Percentage of total revenue	10 %	11 %		10 %	11 %	
Total revenue	$1,068.2	$1,010.5	6 %	$2,068.3	$2,018.4	2 %

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

As described in Note 15 of our Notes to Condensed Consolidated Financial Statements, we have the following segments: Digital Media, Digital Marketing and Print and Publishing. Subscription revenue by reportable segment for the three and six months ended May 30, 2014 and May 31, 2013 are as follows (dollars in millions):

	Three Months			Six Months		
	2014	2013	% Change	2014	2013	% Change
Digital Media	$282.8	$94.5	199 %	$520.7	$163.6	218 %
Digital Marketing	191.8	159.5	20 %	375.6	314.3	19 %
Print and Publishing	2.1	0.5	320 %	3.9	0.9	333 %
Total subscription revenue	$476.7	$254.5	87 %	$900.2	$478.8	88 %

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.

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Segment Information (dollars in millions)

	Three Months			Six Months		
	2014	2013	% Change	2014	2013	% Change
Digital Media	$691.6	$670.0	3 %	$1,332.7	$1,358.4	(2)%
Percentage of total revenue	65 %	66 %		65 %	67 %	
Digital Marketing	330.3	285.4	16 %	644.7	553.1	17 %
Percentage of total revenue	31 %	28 %		31 %	28 %	
Print and Publishing	46.3	55.1	(16)%	90.9	106.9	(15)%
Percentage of total revenue	4 %	6 %		4 %	5 %	
Total revenue	$1,068.2	$1,010.5	6 %	$2,068.3	$2,018.4	2 %

Digital Media

Revenue from Digital Media increased during the three months ended May 30, 2014, as compared to the three months ended May 31, 2013 primarily driven by increased subscription revenue from continued strong adoption of Creative Cloud and ETLAs as we continue to transition more of our business to a subscription based model. Revenue from Digital Media decreased slightly during the six months ended May 30, 2014, as compared to the six months ended May 31, 2013 as the increases in subscription revenue were offset by declines in revenue associated with our perpetual creative offerings.

Revenue related to our creative professional products, which includes our Creative Cloud, Creative Suite editions and CS point products, increased during the three and six months ended May 30, 2014 , as compared to the three and six months ended May 31, 2013. Due to the increase in subscriptions and ETLAs, our revenue from Creative Cloud increased during the three and six months ended May 30, 2014 as compared to the year-ago periods. The increases were offset by declines in revenue from our CS point products and Creative Suite editions during the three and six months ended May 30, 2014 as compared to the year-ago periods.

Revenue associated with our other creative products decreased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 primarily due to decreases associated with distribution of third-party software via Flash Player downloads and lower than expected demand for our Photoshop Elements family of products. These decreases were offset in part by increases in revenue associated with our Digital Publishing Suite.

For our creative offerings, the total number of perpetual units licensed decreased while the number of subscription units licensed increased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013. Unit average selling prices for our perpetual units licensed decreased during the three and six months ended May 30, 2014 as compared to the same periods in the prior year.

Document Services revenue, which includes our Acrobat product family, remained relatively stable during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 primarily due to increases in our Acrobat cloud service revenue offset by decreases in Acrobat desktop and EchoSign revenue as well as the continued shift to ETLAs.

Within Document Services, excluding large enterprise license agreement deals, the number of units licensed decreased while the unit average selling prices increased for the three and six months ended May 30, 2014, as compared to the three and six months ended May 31, 2013.

Digital Marketing

Revenue from Digital Marketing increased $44.9 million and $91.6 million during the three and six months ended May 30, 2014, as compared to the three and six months ended May 31, 2013. The increases were primarily due to continued revenue growth associated with our Adobe Marketing Cloud, which increased 23% and 24% during the three and six months ended May 30, 2014, respectively, as compared to the year ago period. Contributing to this increase was strong adoption of all of our Digital Marketing offerings, particularly AEM, and the addition of Neolane which we acquired in the third quarter of fiscal 2013.

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Print and Publishing

Revenue from Print and Publishing decreased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013, primarily due to a nonrecurring font licensing transaction in the second quarter of fiscal 2013, decreases in legacy product revenue and, to a lesser extent, increased ETLAs for some products in this group.

Geographical Information (dollars in millions)

	Three Months			Six Months Ended		
	2014	2013	% Change	2014	2013	% Change
Americas	$579.2	$525.4	10 %	$1,115.8	$1,025.7	9 %
Percentage of total revenue	54 %	52 %		54 %	51 %	
EMEA	296.6	262.8	13 %	596.4	560.3	6 %
Percentage of total revenue	28 %	26 %		29 %	28 %	
APAC	192.4	222.3	(13)%	356.1	432.4	(18)%
Percentage of total revenue	18 %	22 %		17 %	21 %	
Total revenue	$1,068.2	$1,010.5	6 %	$2,068.3	$2,018.4	2 %

Overall revenue during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 increased in the Americas and EMEA and declined in APAC. Revenue in the Americas and EMEA increased during the three and six months ended May 30, 2014 as compared to the year-ago periods due to increases in Digital Media and Digital Marketing, partially offset by declines in Print and Publishing. The weakening of the U.S. Dollar against the Euro and the British Pound also caused revenue in EMEA to increase during the three and six months ended May 31, 2013 as compared to the year-ago periods. Revenue in APAC decreased across all reportable segments during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 which was due in part to the strengthening of the U.S. Dollar against the Japanese Yen. Within each geographical region, the fluctuations in revenue by reportable segment were attributable to the factors noted in the segment information above.

Included in the overall increase in revenue for the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 were impacts associated with foreign currency as shown below.

(in millions)	Three Months	Six Months
Revenue impact:	Increase/(Decrease)	
EMEA:		
Euro	$8.1	$12.6
British Pound	4.1	5.1
Other currencies	0.4	0.5
Total EMEA	12.6	18.2
Japanese Yen	(6.1)	(19.3)
Other currencies	(3.4)	(6.7)
Total revenue impact	3.1	(7.8)
Hedging impact:		
Japanese Yen	2.6	5.4
Total impact	$5.7	$(2.4)

During the three and six months ended May 30, 2014, the U.S. Dollar strengthened against the Japanese Yen and other Asian currencies causing revenue in APAC measured in U.S. Dollar equivalents to decrease compared with the same reporting periods last year. This decrease was partially offset by the favorable impact to revenue measured in EMEA currencies as the U.S. Dollar weakened against the Euro and the British Pound. Our Yen currency hedging programs resulted in hedging gains during the three and six months ended May 30, 2014.

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Cost of Revenue for the Three and Six Months Ended May 30, 2014 and May 31, 2013 (dollars in millions)

	Three Months			Six Months		
	2014	2013	% Change	2014	2013	% Change
Product	$24.5	$26.8	(9)%	$52.0	$78.8	(34)%
Percentage of total revenue	2%	3%		3%	4%	
Subscription	84.1	66.5	26%	160.9	129.1	25%
Percentage of total revenue	8%	7%		8%	6%	
Services and support	46.3	42.0	10%	90.5	84.1	8%
Percentage of total revenue	4%	4%		4%	4%	
Total cost of revenue	$154.9	$135.3	14%	$303.4	$292.0	4%

Product

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

Cost of product revenue decreased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 due to the following:

	% Change 2014-2013 QTD	% Change 2014-2013 YTD
Amortization of purchased intangibles and technology license arrangements	—%	(33)%
Cost of sales	(5)	(2)
Royalty cost	6	2
Excess and obsolete inventory	(5)	3
Various individually insignificant items	(5)	(4)
Total change	(9)%	(34)%

Amortization of purchased intangibles and technology license arrangements decreased during the six months ended May 30, 2014 as compared to the six months ended May 31, 2013 as we entered into certain technology licensing arrangements for which payments of $26.5 million related to historical use of certain technology licensing arrangements were expensed as cost of product revenue during the first quarter of fiscal 2013.

Cost of sales decreased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 due to decreases in the number of perpetual units sold and the associated packaging costs as we continue to focus our development efforts on Creative Cloud.

Royalty cost increased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 due to increases in obligations to certain key vendors.

Excess and obsolete inventory decreased during the three months ended May 30, 2014 as compared to the three months ended May 31, 2013 as a result of decreased reserve requirements due to shipment of previously reserved CS6 products. Excess and obsolete inventory increased during the six months ended May 30, 2014 as compared to the six months ended May 31, 2013 due to changes in reserve requirements for CS6 shrink boxes and point-of-sale activation keycards as we have discontinued the general availability of these products on a perpetual licensing basis.

Subscription

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

Cost of subscription revenue increased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 primarily due to the increase in hosted server costs. Hosted server costs increased during the three

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and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 primarily due to increases in data center costs related to higher transaction volumes in our Adobe Marketing Cloud and Creative Cloud services, depreciation expense from higher capital expenditures late in fiscal 2013, and compensation and related benefits driven by additional headcount, including from our acquisition of Neolane in the third quarter of fiscal 2013.

Services and Support

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

Cost of services and support revenue increased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 primarily due to increases in compensation and related benefits driven by additional headcount.

Operating Expenses for the Three and Six Months Ended May 30, 2014 and May 31, 2013 (dollars in millions)

	Three Months						Six Months					
	2014		2013		% Change		2014		2013		% Change	
Research and development	$209.1		$203.1		3	%	418.6		412.7		1	%
Percentage of total revenue	20	%	20	%			20	%	20	%		
Sales and marketing	426.8		402.2		6	%	837.0		800.3		5	%
Percentage of total revenue	40	%	40	%			40	%	40	%		
General and administrative	129.1		120.9		7	%	268.1		253.7		6	%
Percentage of total revenue	12	%	12	%			13	%	13	%		
Restructuring and other charges	(0.4	)	25.0		**		0.3		25.0		**	
Percentage of total revenue	*		2	%			*		1	%		
Amortization of purchased intangibles	13.4		12.8		5	%	26.9		25.2		7	%
Percentage of total revenue	1	%	1	%			1	%	1	%		
Total operating expenses	$778.0		$764.0		2	%	1,550.9		1,516.9		2	%

(*) Percentage is less than 1%.

(**) Percentage is not meaningful.

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

The increase in research and development, sales and marketing and general and administrative expenses during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 is primarily due to increases in cash incentives and stock-based compensation. The increase in stock compensation was driven by higher share prices during fiscal 2014 as compared to fiscal 2013, as well as a shorter vesting term which decreased from four years to three years for stock awards granted as part of our annual review process during the first quarter of fiscal 2014.

Research and Development

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

Research and development expenses increased during the three and six months ended May 30, 2014 as compared to the three and six months ended May 31, 2013 due to the following:

	% Change 2014-2013 QTD	% Change 2014-2013 YTD