ADOBE SYSTEMS INC
Form 10-Q
June 29, 2011

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 June 3, 2011

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

For the transition period from to

Commission File Number: 0-15175

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

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

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

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

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes 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 reporting company)	Smaller reporting company o

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 24, 2011 was 493,866,593.

ADOBE SYSTEMS INCORPORATED
FORM 10-Q

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PART I—FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ADOBE SYSTEMS INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

	June 3, 2011 (Unaudited)	December 3, 2010 (*)
ASSETS		
Current assets:		
Cash and cash equivalents	$827,475	$749,891
Short-term investments	1,798,045	1,718,124
Trade receivables, net of allowances for doubtful accounts of $14,603 and $15,233, respectively	568,570	554,328
Deferred income taxes	68,017	83,247
Prepaid expenses and other current assets	127,211	110,460
Total current assets	3,389,318	3,216,050
Property and equipment, net	463,415	448,881
Goodwill	3,693,505	3,641,844
Purchased and other intangibles, net	424,199	457,263
Investment in lease receivable	207,239	207,239
Other assets	162,040	169,871
Total assets	$8,339,716	$8,141,148
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Trade payables	$60,533	$52,432
Accrued expenses	496,535	564,275
Capital lease obligations	9,003	8,799
Accrued restructuring	5,260	8,119
Income taxes payable	40,970	53,715
Deferred revenue	438,078	380,748
Total current liabilities	1,050,379	1,068,088
Long-term liabilities:		
Debt and capital lease obligations	1,509,428	1,513,662
Deferred revenue	43,949	48,929
Accrued restructuring	7,203	8,254
Income taxes payable	173,023	164,713
Deferred income taxes	121,996	103,098
Other liabilities	44,323	42,017
Total liabilities	2,950,301	2,948,761
Stockholders' equity:		
Common stock, $0.0001 par value; 900,000 shares authorized; 600,834 shares issued; 493,763 and 501,897 shares outstanding, respectively	61	61
Additional paid-in-capital	2,611,997	2,458,278
Retained earnings	6,228,574	5,980,914

Accumulated other comprehensive income	54,342	17,428
Treasury stock, at cost (107,071 and 98,937 shares, respectively), net of reissuances	(3,505,559)	(3,264,294)
Total stockholders’ equity	5,389,415	5,192,387
Total liabilities and stockholders’ equity	$8,339,716	$8,141,148

(*) The Condensed Consolidated Balance Sheet at December 3, 2010 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 Month Ended	
	June 3, 2011	June 4, 2010	June 3, 2011	June 4, 2010
Revenue:				
Products	$830,281	$795,260	$1,672,970	$1,499,198
Subscription	109,169	92,279	215,340	187,786
Services and support	83,729	55,496	162,575	114,751
Total revenue	1,023,179	943,035	2,050,885	1,801,735
Cost of revenue:				
Products	34,666	39,645	65,383	63,155
Subscription	47,329	50,190	95,207	95,925
Services and support	27,206	17,998	56,250	38,121
Total cost of revenue	109,201	107,833	216,840	197,201
Gross profit	913,978	835,202	1,834,045	1,604,534
Operating expenses:				
Research and development	183,211	167,318	361,611	341,658
Sales and marketing	348,690	320,976	676,768	618,270
General and administrative	95,547	89,953	196,526	180,999
Restructuring charges	(586)	11,541	(545)	23,163
Amortization of purchased intangibles	10,392	18,129	20,627	36,326
Total operating expenses	637,254	607,917	1,254,987	1,200,416
Operating income	276,724	227,285	579,058	404,118
Non-operating income (expense):				
Interest and other income (expense), net	(839)	(6,313)	(1,656)	(5,702)
Interest expense	(16,727)	(16,076)	(33,747)	(23,771)
Investment gains (losses), net	86	(10,723)	1,676	(14,257)
Total non-operating income (expense), net	(17,480)	(33,112)	(33,727)	(43,730)
Income before income taxes	259,244	194,173	545,331	360,388
Provision for income taxes	29,808	45,562	81,304	84,623
Net income	$229,436	$148,611	$464,027	$275,765
Basic net income per share	$0.46	$0.28	$0.92	$0.53
Shares used to compute basic net income per share	499,686	526,148	501,910	525,124
Diluted net income per share	$0.45	$0.28	$0.91	$0.52
Shares used to compute diluted net income per share	506,280	533,259	509,572	533,305

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	
	June 3, 2011	June 4, 2010
Cash flows from operating activities:		
Net income	$464,027	$275,765
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	132,906	143,487
Stock-based compensation	145,851	124,577
Deferred income taxes	28,796	(178,038)
Unrealized (gains) losses on investments	(567)	12,222
Tax benefit from employee stock option plans	7,322	38,743
Other non-cash items	3,392	1,182
Excess tax benefits from stock-based compensation	(8,778)	(8,485)
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Trade receivables, net	(16,032)	(27,999)
Prepaid expenses and other current assets	(15,580)	(8,808)
Trade payables	8,101	(8,631)
Accrued expenses	(72,145)	53,132
Accrued restructuring	(4,206)	(18,962)
Income taxes payable	(4,004)	25,580
Deferred revenue	52,350	87,186
Net cash provided by operating activities	721,433	510,951
Cash flows from investing activities:		
Purchases of short-term investments	(1,137,730)	(1,202,326)
Maturities of short-term investments	254,706	285,889
Proceeds from sales of short-term investments	798,484	318,092
Acquisitions, net of cash acquired	(36,572)	—
Purchases of property and equipment	(69,922)	(75,175)
Purchases of long-term investments and other assets	(10,672)	(18,998)
Proceeds from sale of long-term investments	4,230	719
Other	(124)	2,177
Net cash used for investing activities	(197,600)	(689,622)
Cash flows from financing activities:		
Purchases of treasury stock	(545,015)	(250,020)
Proceeds from issuance of treasury stock	87,383	84,060
Excess tax benefits from stock-based compensation	8,778	8,485
Proceeds from debt	—	1,493,439
Repayment of debt and capital lease obligations	(3,624)	(1,000,058)
Debt issuance costs	—	(10,662)
Net cash (used for) provided by financing activities	(452,478)	325,244
Effect of foreign currency exchange rates on cash and cash equivalents	6,229	(8,454)
Net increase in cash and cash equivalents	77,584	138,119
Cash and cash equivalents at beginning of period	749,891	999,487
Cash and cash equivalents at end of period	$827,475	$1,137,606

Supplemental disclosures:		
Cash paid for income taxes, net of refunds	$54,381	$198,512
Cash paid for interest	$31,972	$2,742

See accompanying Notes to Condensed Consolidated Financial Statements.

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

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

We have prepared the accompanying unaudited Condensed Consolidated Financial Statements pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Pursuant to these rules and regulations, we have condensed or omitted certain information and footnote disclosures we normally include in our annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). In management's opinion, we have made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) necessary to fairly present our financial position, results of operations and cash flows. Our interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. Certain immaterial prior year amounts have been reclassified to conform to the current year presentation in the Condensed Consolidated Statements of Cash Flows. These financial statements and accompanying notes should be read in conjunction with the consolidated financial statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 3, 2010 on file with the SEC. The six months ended June 4, 2010 financial results benefited from an extra week in the first quarter of fiscal 2010 due to our 52/53 week financial calendar whereby fiscal 2010 was a 53-week year compared with fiscal 2011 which is a 52-week year.

There have been no material changes to our significant accounting policies as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 3, 2010.

Recent Accounting Pronouncements

There have been no new accounting pronouncements during the six months ended June 3, 2011, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the fiscal year ended December 3, 2010, that are of significance, or potential significance, to us.

NOTE 2. ACQUISITIONS

Demdex

On January 18, 2011, we completed our acquisition of privately held Demdex, a data management platform company. The impact of this acquisition was not material to our consolidated balance sheets or results of operations.

Day Software Holding AG

On October 28, 2010, we completed our acquisition of Day Software Holding AG ("Day"), a provider of Web content management solutions that many leading global enterprises rely on for Web 2.0 content application and content infrastructure. Day is based in Basel, Switzerland and Boston, Massachusetts. We believe that our acquisition of Day has enabled us to provide comprehensive solutions to create, manage, deliver and optimize Web content. Following the closing, we integrated Day as a product line within our Enterprise segment for financial reporting purposes. We have included the financial results of Day in our Condensed Consolidated Financial Statements beginning on the acquisition date.

Under the acquisition method of accounting, the total preliminary purchase price was allocated to Day's net tangible and intangible assets based upon their estimated fair values as of October 28, 2010. During the first six months of fiscal 2011, we finalized our purchase accounting after adjustments were made to the preliminary purchase price allocation. The total final purchase price for Day was approximately $248.3 million of which approximately $157.0 million was allocated to goodwill, $79.2 million to substantially all of the identifiable intangible assets and $9.0 million to net tangible assets. The impact of this acquisition was not material to our condensed consolidated balance sheets or results of operations.

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.

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Cash, cash equivalents and short-term investments consisted of the following as of June 3, 2011 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$181,036	$—	$—	$181,036
Cash equivalents:				
Commercial paper	28,044	—	—	28,044
Money market mutual funds and repurchase agreements	576,878	—	—	576,878
Municipal securities	601	—	—	601
Time deposits	40,916	—	—	40,916
Total cash equivalents	646,439	—	—	646,439
Total cash and cash equivalents	827,475	—	—	827,475
Short-term fixed income securities:				
Corporate bonds and commercial paper	1,038,924	9,263	(269)	1,047,918
Foreign government securities	16,443	137	—	16,580
Municipal securities	118,453	198	(18)	118,633
U.S. agency securities	214,279	1,424	—	215,703
U.S. Treasury securities	383,913	2,189	(1)	386,101
Subtotal	1,772,012	13,211	(288)	1,784,935
Marketable equity securities	10,778	2,332	—	13,110
Total short-term investments	1,782,790	15,543	(288)	1,798,045
Total cash, cash equivalents and short-term investments	$2,610,265	$15,543	$(288)	$2,625,520

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Cash, cash equivalents and short-term investments consisted of the following as of December 3, 2010 (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Current assets:				
Cash	$98,691	$—	$—	$98,691
Cash equivalents:				
Commercial paper	41,389	—	—	41,389
Money market mutual funds and repurchase agreements	477,259	—	—	477,259
Municipal securities	350	—	—	350
Time deposits	64,006	—	—	64,006
U.S. Treasury securities	68,195	1	—	68,196
Total cash equivalents	651,199	1	—	651,200
Total cash and cash equivalents	749,890	1	—	749,891
Short-term fixed income securities:				
Corporate bonds and commercial paper	977,889	8,079	(1,450)	984,518
Foreign government securities	33,079	309	(2)	33,386
Municipal securities	119,608	29	(32)	119,605
U.S. agency securities	229,772	778	(179)	230,371
U.S. Treasury securities	336,441	2,828	(209)	339,060
Subtotal	1,696,789	12,023	(1,872)	1,706,940
Marketable equity securities	11,196	1,122	(1,134)	11,184
Total short-term investments	1,707,985	13,145	(3,006)	1,718,124
Total cash, cash equivalents and short-term investments	$2,457,875	$13,146	$(3,006)	$2,468,015

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 a continuous unrealized loss position for less than twelve months, as of June 3, 2011 and December 3, 2010 (in thousands):

	2011		2010	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Corporate bonds and commercial paper	$96,582	$(269)	$257,615	$(1,450)
Foreign government securities	—	—	4,531	(2)
Marketable equity securities	—	—	9,380	(1,134)
Municipal securities	20,172	(18)	43,028	(32)
U.S. Treasury and agency securities	6,533	(1)	192,702	(388)
Total	$123,287	$(288)	$507,256	$(3,006)

As of June 3, 2011 and December 3, 2010, there were no securities in a continuous unrealized loss position for more than twelve months. There were 63 securities and 168 securities that were in an unrealized loss position at June 3, 2011 and at December 3, 2010, respectively.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the cost and estimated fair value of short-term fixed income securities classified as short-term investments based on stated effective maturities as of June 3, 2011 (in thousands):

	Amortized Cost	Estimated Fair Value
Due within one year	$776,046	$778,874
Due within two years	558,841	563,185
Due within three years	376,128	381,038
Due after three years	60,997	61,838
Total	$1,772,012	$1,784,935

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. As of June 3, 2011, we did not record any other-than-temporary impairment losses associated with our debt and marketable equity securities.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4. FAIR VALUE MEASUREMENTS

We measure certain financial assets and liabilities at fair value on a recurring basis. There have been no transfers between fair value measurement levels during the six months ended June 3, 2011.
The fair value of our financial assets and liabilities at June 3, 2011 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:				
Commercial paper	$28,044	$—	$28,044	$—
Foreign government securities	—	—	—	—
Money market mutual funds and repurchase agreements	576,878	576,878	—	—
Municipal securities	601	—	601	—
Time deposits	40,916	40,916	—	—
U.S. agency securities	—	—	—	—
U.S. Treasury securities	—	—	—	—
Short-term investments:				
Corporate bonds and commercial paper	1,047,918	—	1,047,918	—
Foreign government securities	16,580	—	16,580	—
Marketable equity securities	13,110	13,110	—	—
Municipal securities	118,633	—	118,633	—
U.S. agency securities	215,703	—	215,703	—
U.S. Treasury securities	386,101	—	386,101	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	10,026	—	10,026	—
Other assets:				
Deferred compensation plan assets	12,822	522	12,300	—
Total assets	$2,467,332	$631,426	$1,835,906	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$8,723	$—	$8,723	$—
Total liabilities	$8,723	$—	$8,723	$—

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair value of our financial assets and liabilities at December 3, 2010 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:				
Commercial paper	$41,389	$—	$41,389	$—
Money market mutual funds and repurchase agreements	477,259	477,259	—	—
Municipal securities	350	—	350	—
Time deposits	64,006	64,006	—	—
U.S. Treasury securities	68,196	—	68,196	—
Short-term investments:				
Corporate bonds and commercial paper	984,518	—	984,518	—
Foreign government securities	33,386	—	33,386	—
Marketable equity securities	11,184	11,184	—	—
Municipal securities	119,605	—	119,605	—
U.S. agency securities	230,371	—	230,371	—
U.S. Treasury securities	339,060	—	339,060	—
Prepaid expenses and other current assets:				
Foreign currency derivatives	18,821	—	18,821	—
Other assets:				
Deferred compensation plan assets	11,071	617	10,454	—
Total assets	$2,399,216	$553,066	$1,846,150	$—
Liabilities:				
Accrued expenses:				
Foreign currency derivatives	$1,945	$—	$1,945	$—
Total liabilities	$1,945	$—	$1,945	$—

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.

We also have direct investments in privately held companies accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. If we determine that an other-than-temporary impairment has occurred, we write-down the investment to its fair value. We estimate fair value of our cost method investments considering available information such as pricing in recent rounds of financing, current cash positions, earnings and cash flow forecasts, recent operational

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

performance and any other readily available market data. For the three and six months ended June 3, 2011, we determined there were no other-than-temporary impairments on our cost method investments. See Note 7 for further information regarding our cost method investments.

NOTE 5. DERIVATIVES AND HEDGING ACTIVITIES

In countries outside the U.S., we transact business in U.S. Dollars and in various other currencies. Therefore, we are subject to exposure from movements in foreign currency rates. We may use foreign exchange option contracts or forward contracts to hedge certain operational ("cash flow") exposures resulting from changes in foreign currency exchange rates. These foreign exchange contracts, carried at fair value, may have maturities between one and twelve months. The maximum original duration of any contract is 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 derivative instruments from hedging activities as either assets or liabilities on the balance sheet and measure them at fair value. Gains and losses resulting from changes in fair value are accounted for depending on the use of the derivative and whether it is designated and qualifies for hedge accounting. 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, net in our Condensed Consolidated Statements of Income at that time.

We also hedge our net recognized foreign currency assets and liabilities with foreign exchange forward contracts to reduce the risk that our earnings and cash flows will be adversely affected by changes in exchange rates. These derivative instruments hedge assets and liabilities that are denominated in foreign currencies and are carried at fair value with changes in the fair value recorded to interest and other income (expense), net in our Condensed Consolidated Statements of Income. These derivative instruments 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.

We mitigate concentration of risk related to foreign currency hedges as well as interest rate hedges through a policy that establishes counterparty limits. 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 under our counterparty risk assessment process. In addition, our hedging policy establishes maximum limits for each counterparty. We monitor ratings, credit spreads and potential downgrades on at least a quarterly basis. Based on our on-going assessment of counterparty risk, we will adjust our exposure to various counterparties.

The aggregate fair value of derivative instruments in net asset positions as of June 3, 2011 and December 3, 2010 was $10.0 million and $18.8 million, respectively. These amounts 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 up to $8.7 million and $1.9 million, respectively, of liabilities included in master netting arrangements with those same counterparties.

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ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The fair value of derivative instruments on our Condensed Consolidated Balance Sheets as of June 3, 2011 and December 3, 2010 were as follows (in thousands):

	2011		2010	
	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]	$4,849	$—	$6,092	$—
Derivatives not designated as hedging instruments:				
Foreign exchange forward contracts	5,177	8,723	12,729	1,945
Total derivatives	$10,026	$8,723	$18,821	$1,945

(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 to income within the next twelve months.

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 three and six months ended June 3, 2011 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]	$100	$—	$33	$—
Net gain (loss) reclassified from accumulated OCI into income, net of tax[2]	$184	$—	$184	$—
Net gain (loss) recognized in income[3]	$(6,717)	$—	$(15,023)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income[4]	$—	$(8,366)	$—	$(18,516)

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 three and six months ended June 4, 2010 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]	$28,425	$—	$38,789	$—

Net gain (loss) reclassified from accumulated OCI into income, net of tax(2)	$6,206	$—	$6,206	$—
Net gain (loss) recognized in income(3)	$(5,845)	$—	$(9,766)	$—
Derivatives not designated as hedging relationships:				
Net gain (loss) recognized in income(4)	$—	$10,761	$—	$21,801

(1) Net change in the fair value of the effective portion classified in other comprehensive income ("OCI").
(2) Effective portion classified as revenue.

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(Unaudited)

(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 June 3, 2011 and December 3, 2010 was $3.694 billion and $3.642 billion, respectively. The increase was due to our acquisition of Demdex and foreign currency translation adjustments offset in part by insignificant adjustments to our Day purchase price allocation and tax deductions from acquired stock options. During the second quarter of fiscal 2011, we completed our annual goodwill impairment test and determined there was no impairment of goodwill.
Purchased and other intangible assets subject to amortization as of June 3, 2011 and December 3, 2010 was as follows (in thousands):

	2011			2010		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Purchased technology	$270,026	$(79,459)	$190,567	$260,198	$(61,987)	$198,211
Customer contracts and relationships	$402,054	$(214,394)	$187,660	$398,421	$(197,459)	$200,962
Trademarks	41,357	(8,394)	32,963	172,019	(136,480)	35,539
Localization	13,215	(9,982)	3,233	14,768	(9,355)	5,413
Other intangibles	52,572	(42,796)	9,776	51,265	(34,127)	17,138
Total other intangible assets	$509,198	$(275,566)	$233,632	$636,473	$(377,421)	$259,052
Purchased and other intangible assets, net	$779,224	$(355,025)	$424,199	$896,671	$(439,408)	$457,263

Purchased and other intangible assets from prior acquisitions, primarily Macromedia, were removed from the balance sheet as they were fully amortized at the end of fiscal 2010. Amortization expense related to purchased and other intangible assets was $30.4 million and $60.4 million for the three and six months ended June 3, 2011, respectively. Comparatively, amortization expense was $42.2 million and $79.1 million for the three and six months ended June 4, 2010, respectively. Of these amounts, $20.2 million and $39.9 million were included in cost of sales for the three and six months ended June 3, 2011, respectively, and $24.0 million and $42.7 million were included in cost of sales for the three and six months ended June 4, 2010, respectively.
As of June 3, 2011, we expect amortization expense in future periods to be as follows (in thousands):

Fiscal Year	Purchased Technology	Other Intangible Assets
Remainder of 2011	$22,436	$28,501
2012	44,816	30,923
2013	40,752	27,693
2014	37,599	26,668
2015	34,881	26,241
Thereafter	10,083	93,606
Total expected amortization expense	$190,567	$233,632

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NOTE 7. OTHER ASSETS

Other assets as of June 3, 2011 and December 3, 2010 consisted of the following (in thousands):

	2011	2010
Acquired rights to use technology	$65,044	$71,521
Investments	23,971	25,018
Deferred compensation plan assets	12,822	11,071
Prepaid land lease	13,136	13,215
Security and other deposits	10,909	11,266
Debt issuance costs	8,987	9,574
Prepaid royalties	6,375	7,726
Restricted cash	2,627	2,499
Prepaid rent	492	787
Other(*)	17,677	17,194
Other assets	$162,040	$169,871

(*) Fiscal 2011 and 2010 includes a tax asset of approximately $11.0 million related to an acquired entity.
Investments represent our direct investments in privately held companies which are accounted for based on the cost method. We assess these investments for impairment in value as circumstances dictate.

NOTE 8. ACCRUED EXPENSES

Accrued expenses as of June 3, 2011 and December 3, 2010 consisted of the following (in thousands):

	2011	2010
Accrued compensation and benefits	$198,720	$290,366
Sales and marketing allowances	39,940	38,706
Accrued marketing	41,581	26,404
Taxes payable	23,088	21,800
Accrued interest expense	21,136	21,203
Other	172,070	165,796
Accrued expenses	$496,535	$564,275

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

NOTE 9. INCOME TAXES

The gross liability for unrecognized tax benefits at June 3, 2011 was $163.2 million, exclusive of interest and penalties. If the total unrecognized tax benefits at June 3, 2011 were recognized in the future, $147.9 million of unrecognized tax benefits would decrease the effective tax rate, which is net of an estimated $15.3 million federal benefit related to deducting certain payments on future state tax returns.

As of June 3, 2011, the combined amount of accrued interest and penalties related to tax positions taken on our tax returns was approximately $16.2 million. This amount is included in non-current income taxes payable.

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The timing of the resolution of income tax examinations is highly uncertain as are the amounts and timing of tax payments that are part of any audit settlement process. These events could cause large fluctuations in the balance sheet classification of current and non-current assets and liabilities. We believe that within the next 12 months, it is reasonably possible that either certain audits will conclude or statutes of limitations on certain income tax examination periods will expire, or both. Given the uncertainties described above, we can only determine a range of estimated potential decreases in underlying unrecognized tax benefits ranging from $0 to approximately $5 million. These amounts would decrease income tax expense.

NOTE 10. STOCK-BASED COMPENSATION

The assumptions used to value option grants during the three and six months ended June 3, 2011 and June 4, 2010 were as follows:

	Three Months		Six Months	
	2011	2010	2011	2010
Expected life (in years)	3.9 - 4.2	3.9 - 5.1	3.8 - 4.2	3.8 - 5.1
Volatility	30 - 31%	29 - 30%	30 - 35%	29 - 36%
Risk free interest rate	1.34 - 1.74%	2.06 - 2.66%	1.34 - 1.74%	1.76 - 2.66%

The expected life of employee stock purchase plan (“ESPP”) shares is the average of the remaining purchase periods under each offering period. The assumptions used to value employee stock purchase rights during the three and six months ended June 3, 2011 and June 4, 2010 were as follows:

	Three Months		Six Months	
	2011	2010	2011	2010
Expected life (in years)	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0
Volatility	32 - 34%	32%	32 - 34%	32%
Risk free interest rate	0.19 - 0.61%	0.18 - 1.09%	0.19 - 0.61%	0.18 - 1.09%

Summary of Stock Options

Option activity for the six months ended June 3, 2011 and the fiscal year ended December 3, 2010 was as follows (in thousands):

	2011	2010
Beginning outstanding balance	37,075	41,251
Granted	4,252	3,198
Exercised	(4,469)	(5,196)
Cancelled	(878)	(2,908)
Increase due to acquisition	130	730
Ending outstanding balance	36,110	37,075

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Information regarding stock options outstanding at June 3, 2011 and June 4, 2010 is summarized below:

	Number of Shares (thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2011				
Options outstanding	36,110	$31.67	3.70	$131.1
Options vested and expected to vest	34,746	$31.72	3.61	$126.4
Options exercisable	25,790	$32.55	2.92	$83.9
2010				
Options outstanding	39,288	$30.52	4.15	$153.5
Options vested and expected to vest	37,542	$30.58	4.05	$145.5
Options exercisable	26,486	$30.88	3.38	$96.6

(*) 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 June 3, 2011 and June 4, 2010 were $33.27 and $31.59, respectively.

Summary of Employee Stock Purchase Plan Shares

Employees purchased 1.4 million shares at an average price of $20.61 and 1.3 million shares at an average price of $20.20 for the six months ended June 3, 2011 and June 4, 2010, respectively. The intrinsic value of shares purchased during the six months ended June 3, 2011 and June 4, 2010 was $15.3 million and $21.4 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of purchase and the purchase price of the shares.

Summary of Restricted Stock Units

Restricted stock unit activity for the six months ended June 3, 2011 and the fiscal year ended December 3, 2010 was as follows (in thousands):

	2011	2010
Beginning outstanding balance	13,890	10,433
Awarded	7,319	7,340
Released	(2,919)	(2,589)
Forfeited	(648)	(1,294)
Increase due to acquisition	59	—
Ending outstanding balance	17,701	13,890

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Information regarding restricted stock units outstanding at June 3, 2011 and June 4, 2010 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2011			
Restricted stock units outstanding	17,701	1.73	$588.9
Restricted stock units vested and expected to vest	15,128	1.62	$502.7
2010			
Restricted stock units outstanding	14,364	1.88	$453.8
Restricted stock units vested and expected to vest	11,016	1.71	$347.8

(*) The intrinsic value is calculated as the market value as of the end of the fiscal period. As reported by the NASDAQ Global Select Market, the market values as of June 3, 2011 and June 4, 2010 were $33.27 and $31.59, respectively.

Summary of Performance Shares

Effective January 24, 2011, the Executive Compensation Committee adopted the 2011 Performance Share Program (the "2011 Program"). The purpose of the 2011 Program is to align key management and senior leadership with stockholders' interests and to retain key employees. The measurement period for the 2011 Program is our fiscal 2011 year. All members of our executive management and other key senior management are participating in the 2011 Program. Awards granted under the 2011 Program are granted in the form of performance shares pursuant to the terms of our 2003 Equity Incentive Plan. If pre-determined performance goals are met, shares of stock will be granted to the recipient, with one third vesting on the later of the date of certification of achievement or the first anniversary date of the grant, and the remaining two thirds vesting evenly on the following two annual anniversary dates of the grant, contingent upon the recipient's continued service to Adobe. Participants in the 2011 Program have the ability to receive up to 150% of the target number of shares originally granted.

The following table sets forth the summary of performance share activity under our 2011 Program for the six months ended June 3, 2011 (in thousands):

	Shares Granted	Maximum Shares Eligible to Receive
Beginning outstanding balance	—	—
Awarded	425	638
Forfeited	—	—
Ending outstanding balance	425	638

In the first quarter of fiscal 2011, the Executive Compensation Committee certified the actual performance achievement of participants in the 2010 Performance Share Program (the "2010 Program"). Based upon the achievement of goals outlined in the 2010 Program, participants had the ability to receive up to 150% of the target number of shares originally granted. Actual performance resulted in participants achieving 135% of target or approximately 0.3 million shares for the 2010 Program. One third of the shares under the 2010 Program vested in the first quarter of fiscal 2011 and the remaining two thirds vest evenly on the following two annual anniversary dates of the grant, contingent upon the recipient's continued service to Adobe.

The performance metrics under the 2009 Performance Share Program were not achieved and therefore no shares were awarded.

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The following table sets forth the summary of performance share activity under our 2007, 2008 and 2010 programs, based upon share awards actually achieved, for the six months ended June 3, 2011 and the fiscal year ended December 3, 2010 (in thousands):

	2011	2010
Beginning outstanding balance	557	950
Achieved	337	—
Released	(427)	(350)
Forfeited	(10)	(43)
Ending outstanding balance	457	557

Information regarding performance shares outstanding at June 3, 2011 and June 4, 2010 is summarized below:

	Number of Shares (thousands)	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value(*) (millions)
2011			
Performance shares outstanding	457	0.89	$15.2
Performance shares vested and expected to vest	421	0.87	$13.8
2010			
Performance shares units outstanding	593	1.06	$18.7
Performance shares vested and expected to vest	509	1.01	$15.9

(*) 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 June 3, 2011 and June 4, 2010 were $33.27 and $31.59, respectively.

Compensation Costs

As of June 3, 2011, there was $530.3 million of unrecognized compensation cost, adjusted for estimated forfeitures, related to non-vested stock-based awards which will be recognized over a weighted average period of 2.7 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 June 3, 2011 and June 4, 2010 were as follows (in thousands):

	2011		2010	
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	$232	$367	$341	$324
Cost of revenue—services and support	1,264	2,299	268	67
Research and development	7,024	19,444	10,871	11,990

Sales and marketing	8,334	20,616	11,773	13,001
General and administrative	5,255	10,024	5,636	5,826
Total	$22,109	$52,750	$28,889	$31,208

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Total stock-based compensation costs that have been included in our Condensed Consolidated Statements of Income for the six months ended June 3, 2011 and June 4, 2010 were as follows (in thousands):

Income Statement Classifications	2011		2010	
	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	$424	$688	$680	$604
Cost of revenue—services and support	2,359	4,374	685	598
Research and development	13,778	40,022	22,925	27,350
Sales and marketing	15,884	37,032	23,520	25,157
General and administrative	11,205	20,085	11,246	11,812
Total	$43,650	$102,201	$59,056	$65,521

NOTE 11. RESTRUCTURING CHARGES

Fiscal 2009 Restructuring Plan

In the fourth quarter of fiscal 2009, in order to appropriately align our costs in connection with our fiscal 2010 operating plan, we initiated a restructuring plan consisting of reductions in workforce and the consolidation of facilities. The restructuring activities related to this program affected only those employees and facilities that were associated with Adobe prior to the acquisition of Omniture on October 23, 2009.

During the second quarter of fiscal 2011, we continued to implement restructuring activities under this plan. We vacated approximately 16,000 square feet of sales facilities in Sweden and accrued $0.5 million for the fair value of our future contractual obligations under those operating leases. Total costs incurred for termination benefits through the second quarter of fiscal 2011 was $40.1 million. Total costs incurred to date and expected to be incurred for closing redundant facilities are $8.3 million and $11.0 million, respectively.

Omniture Restructuring Plan

We completed our acquisition of Omniture on October 23, 2009. In the fourth quarter of fiscal 2009, we initiated a plan to restructure the pre-merger operations of Omniture to eliminate certain duplicative activities, focus our resources on future growth opportunities and reduce our cost structure. In connection with this restructuring plan, we accrued a total of approximately $12.2 million in costs related to termination benefits, the closure of duplicative facilities and cancellation of certain contracts associated with the wind-down of subsidiaries and other service contracts held by Omniture through the second quarter of fiscal 2011. Substantially all of these costs were recorded as a part of the purchase price allocation.

Fiscal 2008 Restructuring Plan

In the fourth quarter of fiscal 2008, we initiated a restructuring program consisting of reductions in workforce and the consolidation of facilities, in order to reduce our operating costs and focus our resources on key strategic priorities. In connection with the restructuring plan, we recognized costs related to termination benefits for employee positions that were eliminated and for the closure of duplicative facilities. Total costs incurred to date for termination benefits was $35.2 million and was completed during the first quarter of fiscal 2011. Total costs incurred to date and expected to be incurred for closing redundant facilities are $8.3 million and $8.6 million, respectively.

Macromedia Restructuring Plan

We completed our acquisition of Macromedia on December 3, 2005. In connection with this acquisition, we initiated plans to restructure both the pre-merger operations of Adobe and Macromedia to eliminate certain duplicative activities, focus our resources on future growth opportunities and reduce our cost structure. In connection with the worldwide restructuring plan, we recognized costs related to termination benefits for employee positions that were eliminated and for the closure of duplicative

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facilities. We also recognized costs related to the cancellation of certain contracts associated with the wind-down of subsidiaries and other service contracts held by Macromedia. Total costs incurred for termination benefits and contract terminations were $27.0 million and $3.2 million, respectively, and those actions were completed during fiscal 2007.

Summary of Restructuring Plans

The following table sets forth a summary of restructuring activities related to all of our restructuring plans described above during the six months ended June 3, 2011 (in thousands):

	December 3, 2010	Costs Incurred	Cash Payments	Other Adjustments	June 3, 2011
Fiscal 2009 Plan:					
Termination benefits	$1,573	$—	$(357)	$3	$1,219
Cost of closing redundant facilities	7,302	543	(1,241)	(962)	5,642
Omniture Plan:					
Termination benefits	486	—	(4)	44	526
Cost of closing redundant facilities	2,720	—	(715)	373	2,378
Contract termination	179	—	—	—	179
Fiscal 2008 Plan:					
Termination benefits	300	—	(164)	(136)	—
Cost of closing redundant facilities	2,149	—	(300)	(114)	1,735
Macromedia Plan:					
Cost of closing redundant facilities	1,658	—	(874)	—	784
Other	6	—	(6)	—	—
Total restructuring plans	$16,373	$543	$(3,661)	$(792)	$12,463

Accrued restructuring charges of approximately $12.5 million at June 3, 2011 includes $5.3 million recorded in accrued restructuring, current and $7.2 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 2011 and facilities-related liabilities under contract through fiscal 2021.

NOTE 12. STOCKHOLDERS' EQUITY

Retained Earnings

The changes in retained earnings for the six months ended June 3, 2011 were as follows (in thousands):

Balance as of December 3, 2010	$5,980,914
Net income	464,027
Re-issuance of treasury stock	(216,367)
Balance as of June 3, 2011	$6,228,574

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 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 component of retained earnings in our Condensed Consolidated Balance Sheets.

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Comprehensive Income

The following table sets forth the activity for each component of comprehensive income, net of related taxes, for the three and six months ended June 3, 2011 and June 4, 2010 (in thousands):

	Three Months		Six Months	
	2011	2010	2011	2010
	Increase/(Decrease)		Increase/(Decrease)	
Net income	$229,436	$148,611	$464,027	$275,765
Other comprehensive income:				
Available-for-sale securities:				
Unrealized gains (losses) on available-for-sale securities	5,898	212	5,845	(546)
Reclassification adjustment for gains on available-for-sale securities recognized during the period	(630)	(359)	(1,174)	(703)
Subtotal available-for-sale securities	5,268	(147)	4,671	(1,249)
Derivatives designated as hedging instruments:				
Unrealized gains on derivative instruments	100	28,425	33	38,789
Reclassification adjustment for gains on derivative instruments recognized during the period	(184)	(6,206)	(184)	(6,206)
Subtotal derivatives designated as hedging instruments	(84)	22,219	(151)	32,583
Foreign currency translation adjustments	20,463	(11,187)	32,394	(15,786)
Other comprehensive income	25,647	10,885	36,914	15,548
Total comprehensive income, net of taxes	$255,083	$159,496	$500,941	$291,313

The following table sets forth the components of accumulated other comprehensive income, net of related taxes, as of June 3, 2011 and December 3, 2010 (in thousands):

	2011	2010
Net unrealized gains on available-for-sale securities:		
Unrealized gains on available-for-sale securities	$14,596	$12,138
Unrealized losses on available-for-sale securities	(280)	(2,493)
Total net unrealized gains on available-for-sale securities	14,316	9,645
Net unrealized gains on derivative instruments designated as hedging instruments	—	151
Cumulative foreign currency translation adjustments	40,026	7,632
Total accumulated other comprehensive income, net of taxes	$54,342	$17,428

Stock Repurchase Program

To facilitate our stock repurchase program, designed to return value to our stockholders and minimize dilution from stock issuances, we repurchase shares in the open market and also enter into structured repurchases with third-parties. During the third quarter of fiscal 2010, our Board of Directors approved an amendment to our stock repurchase program authorized in April 2007 from a non-expiring share-based authority to a time-constrained dollar-based authority. As part of this amendment, the Board of Directors granted authority to repurchase up to $1.6 billion in common stock through the end of fiscal 2012.

During the six months ended June 3, 2011, we entered into structured stock repurchase agreements with large financial institutions, whereupon we provided them with prepayments of $545.0 million. During the six months ended June 4, 2010, we entered into a structured repurchase agreement with a large financial institution, whereupon we provided them with a prepayment of $250.0 million. We enter into these agreements in order to take advantage of repurchasing shares at a guaranteed discount to

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the Volume Weighted Average Price ("VWAP") of our common stock over a specified period of time. We only enter into such transactions when the discount that we receive is higher than the foregone return on our cash prepayments to the financial institutions. There were no explicit commissions or fees on these structured repurchases. Under the terms of the agreements, there is no requirement for the financial institutions to return any portion of the prepayment to us. The financial institutions agree to deliver shares to us at monthly intervals during the contract term. The parameters used to calculate the number of shares deliverable are: the total notional amount of the contract, the number of trading days in the contract, the number of trading days in the interval and the average VWAP of our stock during the interval less the agreed upon discount. During the six months ended June 3, 2011, we repurchased approximately 16.3 million shares at an average price of $33.53 through structured repurchase agreements entered into during the six months ended June 3, 2011. During the six months ended June 4, 2010, we repurchased approximately 4.2 million shares at an average price of $34.72 through structured repurchase agreements entered into during fiscal 2009 and fiscal 2010.
As of June 3, 2011 and December 3, 2010, the prepayments were classified as treasury stock on our Condensed Consolidated Balance Sheets at the payment date, though only shares physically delivered to us by the financial statement date were excluded from the computation of earnings per share. As of June 3, 2011, no prepayments remained under these agreements. As of June 4, 2010, approximately $165.3 million of up-front payments remained under these agreements.
Subsequent to June 3, 2011, as part of our $1.6 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 $150.0 million. This amount will be classified as treasury stock on our Condensed Consolidated Balance Sheets. Upon completion of the $150.0 million stock repurchase agreement, $305.0 million remains under our time-constrained dollar-based authority. See Note 18 for further discussion of our stock repurchase program.

NOTE 13. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted net income per share for the three and six months ended June 3, 2011 and June 4, 2010 (in thousands, except per share data):

	Three Months		Six Months	
	2011	2010	2011	2010
Net income	$229,436	$148,611	$464,027	$275,765
Shares used to compute basic net income per share	499,686	526,148	501,910	525,124
Dilutive potential common shares:				
Unvested restricted stock and performance share awards	2,989	2,374	3,999	3,099
Stock options	3,605	4,737	3,663	5,082
Shares used to compute diluted net income per share	506,280	533,259	509,572	533,305
Basic net income per share	$0.46	$0.28	$0.92	$0.53
Diluted net income per share	$0.45	$0.28	$0.91	$0.52

For the three and six months ended June 3, 2011, options to purchase approximately 20.3 million and $19.8 million shares, respectively of common stock with exercise prices greater than the average fair market value of our stock of $33.88 and $33.12, respectively, were not included in the calculation because the effect would have been anti-dilutive. Comparatively, for the three and six months ended June 4, 2010, options to purchase approximately $18.5 million and $17.7 million shares, respectively, of common stock with exercise prices greater than the average fair market value of our stock of $34.32 and $34.73, respectively, were not included in the calculation because the effect would have been anti-dilutive.

NOTE 14. 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In August 2004, we extended the lease agreement for our East and West Towers for an additional five years with an option to extend for an additional five years solely at our election. In June 2009, we submitted notice to the lessor that we intended to exercise our option to renew this agreement for an additional five years effective August 2009. As stated in the original lease agreement, in conjunction with the lease renewal, we were required to obtain a standby letter of credit for approximately $16.5 million which enabled 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. In March 2007, the Almaden Tower lease was extended for five years, with a renewal option for an additional five years solely at our election. As part of the lease extensions, we purchased the lease receivable from the lessor of the East and West Towers for $126.8 million and a portion of the lease receivable from the lessor of the Almaden Tower for $80.4 million, both of which are recorded as investments in lease receivables on our Condensed Consolidated Balance Sheets. As of June 3, 2011, the carrying value of the lease receivables related to all three towers approximated fair value. This purchase may be credited against the residual value guarantee if we purchase the properties or will be repaid from the sale proceeds if the properties are sold to third-parties. 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 anytime during the lease term for approximately $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.

These two leases are both subject to standard covenants including certain financial ratios that are reported to the lessors quarterly. As of June 3, 2011, 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. Both leases qualify for operating lease accounting treatment and, as such, the buildings and the related obligations are not included on our Condensed Consolidated Balance Sheets. We utilized this type of financing in order to access bank-provided funding at the most favorable rates and to provide the lowest total cost of occupancy for the headquarter buildings. At the end of the lease term, we can extend the lease for an additional five year term, purchase the buildings for the lease balance, remarket or relinquish the buildings. If we choose to remarket or are required to do so upon relinquishing the buildings, we are bound to arrange the sale of the buildings to an unrelated party and will be required to pay the lessor any shortfall between the net remarketing proceeds and the lease balance, up to the residual value guarantee amount.

In June 2010, we entered into a sale-leaseback agreement to sell equipment totaling $32.2 million and leaseback the same equipment over a period of 43 months. This transaction was classified as a capital lease obligation and recorded at fair value. See Note 15 for further discussion of our capital lease obligation.

Guarantees

The lease agreements for our corporate headquarters provide for residual value guarantees as noted above. The fair value of a residual value guarantee in lease agreements entered into after December 31, 2002, must be recognized as a liability on our Condensed Consolidated Balance Sheets. As such, we recognized $5.2 million and $3.0 million in liabilities, related to the extended East and West Towers and Almaden Tower leases, respectively. These liabilities are recorded in other long-term liabilities with the offsetting entry recorded as prepaid rent in other assets. The balance will be amortized to the income statement over the life of the leases. As of June 3, 2011 and December 3, 2010, the unamortized portion of the fair value of the residual value guarantees, for both leases, remaining in other long-term liabilities and prepaid rent was $0.4 million and $0.7 million, respectively.

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 ordinary course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. 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.

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(Unaudited)

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

Legal Proceedings

In October 2009, Eolas Technologies Incorporated filed a complaint against us and 22 other companies for patent infringement in the United States District Court for the Eastern District of Texas. The complaint alleges, among other things, that a number of our Web pages and products infringe two patents owned by the plaintiff purporting to cover "Distributed Hypermedia Method for Automatically Invoking External Application Providing Interaction and Display of Embedded Objects within a Hypermedia Document" (U.S. Patent No. 5,838,906) and "Distributed Hypermedia Method and System for Automatically Invoking External Application Providing Interaction and Display of Embedded Objects within a Hypermedia Document" (U.S. Patent No. 7,599,985) and seeks injunctive relief, monetary damages, costs and attorneys' fees. We dispute these claims and intend to vigorously defend ourselves in this matter. As of June 3, 2011, we have not made any provisions on our financial statements related to this lawsuit, as we do not believe a loss to be probable or estimable at this time. The trial is currently scheduled to be held in October 2011.

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.

We are subject to legal proceedings, claims and investigations in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, indemnification claims, and claims relating to commercial, employment and other matters. 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. 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.

NOTE 15. DEBT

Our debt as of June 3, 2011 and December 3, 2010 consisted of the following (in thousands):

	2011	2010
Notes	$1,494,295	$1,493,969
Credit facility	—	—
Capital lease obligations	24,136	28,492
Total debt and capital lease obligations	1,518,431	1,522,461

Less: current portion	9,003	8,799
Debt and capital lease obligations	$1,509,428	$1,513,662

ADOBE SYSTEMS INCORPORATED

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 approximately $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 approximately $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 2011, we made a semi-annual interest payment of $31.1 million. The proceeds from the Notes are available for general corporate purposes, including repayment of any balance outstanding on our credit facility. Based on quoted market prices, the fair value of the Notes was approximately $1.6 billion as of June 3, 2011.

We may redeem the Notes at any time, subject to a make whole premium. In addition, upon the occurrence of certain change of control triggering events, we may be required to repurchase the Notes, at a price equal to 101% of their principal amount, plus accrued and unpaid interest to the date of repurchase. The Notes also include covenants that limit our ability to grant liens on assets and to enter into sale and leaseback transactions, subject to significant allowances. As of June 3, 2011, we were in compliance with all of the covenants.

Credit Agreement

In August 2007, we entered into an Amendment to our Credit Agreement dated February 2007 (the "Amendment"), which increased the total senior unsecured revolving facility from $500.0 million to $1.0 billion. The Amendment also permits us to request one-year extensions effective on each anniversary of the closing date of the original agreement, subject to the majority consent of the lenders. We also retain an option to request an additional $500.0 million in commitments, for a maximum aggregate facility of $1.5 billion.

In February 2008, we entered into a Second Amendment to the Credit Agreement dated February 26, 2008, which extended the maturity date of the facility by one year to February 16, 2013. The facility would terminate at this date if no additional extensions have been requested and granted. All other terms and conditions remain the same.

The facility contains a financial covenant requiring us not to exceed a certain maximum leverage ratio. At our option, borrowings under the facility accrue interest based on either the London interbank offered rate ("LIBOR") for one, two, three or six months, or longer periods with bank consent, plus a margin according to a pricing grid tied to this financial covenant, or a base rate. The margin is set at rates between 0.20% and 0.475%. Commitment fees are payable on the facility at rates between 0.05% and 0.15% per year based on the same pricing grid. The facility is available to provide loans to us and certain of our subsidiaries for general corporate purposes. On February 1, 2010, we paid the outstanding balance on our credit facility and the entire $1.0 billion credit line under this facility remains available for borrowing.

Capital Lease Obligation

In June 2010, we entered into a sale-leaseback agreement to sell equipment totaling $32.2 million and leaseback the same equipment over a period of 43 months. This transaction was classified as a capital lease obligation and recorded at fair value. As of June 3, 2011, our capital lease obligations of $24.1 million includes $9.0 million of current debt.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 16. NON-OPERATING INCOME (EXPENSE)

Non-operating income (expense) for the three and six months ended June 3, 2011 and June 4, 2010 included the following (in thousands):

	Three Months		Six Months	
	2011	2010	2011	2010
Interest and other income (expense), net:				
Interest income	$5,865	$4,986	$11,964	$10,091
Foreign exchange gains (losses)	(7,629)	(12,190)	(15,403)	(17,275)
Realized gains on fixed income investment	633	355	1,238	698
Realized losses on fixed income investment	(4)	—	(65)	—
Other	296	536	610	784
Interest and other income (expense), net	$(839)	$(6,313)	$(1,656)	$(5,702)
Interest expense	$(16,727)	$(16,076)	$(33,747)	$(23,771)
Investment gains (losses), net:				
Realized investment gains	$195	$3	$1,997	$187
Unrealized investment gains	—	—	329	—
Realized investment losses	—	(358)	(650)	(764)
Unrealized investment losses	(109)	(10,368)	—	(13,680)
Investment gains (losses), net	$86	$(10,723)	$1,676	$(14,257)
Non-operating income (expense), net	$(17,480)	$(33,112)	$(33,727)	$(43,730)

NOTE 17. SEGMENTS

We have the following reportable segments:

- Creative and Interactive Solutions—Our Creative and Interactive Solutions segment focuses on delivering a complete professional line of integrated tools for a full range of design and publishing and developer tasks to an extended set of customers.
- Digital Media Solutions—Our Digital Media Solutions segments contains our professional imaging and video products and focuses on many of the same creative professional customers as our Creative and Interactive Solutions business.
- Knowledge Worker—Our Knowledge Worker segment focuses on the needs of knowledge worker customers, providing essential applications and services to help them share information and collaborate. This segment contains our Acrobat family of products.
- Enterprise—Our Enterprise segment provides server-based Customer Experience Management Solutions to enterprise and government customers to optimize their information intensive customer-facing processes and improve the overall customer experience of their constituents. This segment contains our Adobe Connect, Day and LiveCycle lines of products.
- Omniture—Our Omniture segment provides web analytics and online business optimization products and services to manage and enhance online, offline and multi-channel marketing initiatives.
- Print and Publishing—Our Print and Publishing segment addresses market opportunities ranging from the diverse publishing needs of technical and business publishing to our legacy type and OEM printing businesses.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Effective in the first quarter of fiscal 2011, we modified our segments due to changes in how we operate our business. We split our prior Creative Solutions segment into two new segments: Creative and Interactive Solutions and Digital Media Solutions. Creative and Interactive Solutions contains our Creative Suite family of products including our professional page layout and Web layout products, whereas Digital Media Solutions contains our imaging and video products for professionals and hobbyists. We also merged our former Platform segment into the new Creative and Interactive Solutions segment to better align our focus with market trends and our opportunities. In addition to our business unit reorganization, we moved several products to different businesses. Our Scene7 products were moved from our Creative Solutions business to our Omniture business; our ColdFusion products were moved from our Platform business to our Print and Publishing business; and our Adobe Presenter product that was part of our Adobe Connect offering was moved from our Enterprise business to our Print and Publishing business. Prior year information in the table below has been reclassified to reflect these changes.

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 chief operating decision maker reviews revenue and gross margin information for each of our reportable segments. Operating expenses are not reviewed 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.

(in thousands)	Creative and Interactive Solutions	Digital Media Solutions	Knowledge Worker	Enterprise	Omniture	Print and Publishing	Total
Three months ended June 3, 2011							
Revenue	$433,098	$136,652	$182,043	$101,517	$115,892	$53,977	$1,023,179
Cost of revenue	21,559	9,766	4,994	25,309	47,344	229	109,201
Gross profit	$411,539	$126,886	$177,049	$76,208	$68,548	$53,748	$913,978
Gross profit as a percentage of revenue	95 %	93 %	97 %	75 %	59 %	100 %	89 %
Three months ended June 4, 2010							
Revenue	$423,311	$139,261	$156,012	$75,859	$91,886	$56,706	$943,035
Cost of revenue	24,328	11,723	5,094	14,222	49,191	3,275	107,833
Gross profit	$398,983	$127,538	$150,918	$61,637	$42,695	$53,431	$835,202
Gross profit as a percentage of revenue	94 %	92 %	97 %	81 %	46 %	94 %	89 %

(in thousands)	Creative and Interactive Solutions	Digital Media Solutions	Knowledge Worker	Enterprise	Omniture	Print and Publishing	Total

Six months ended June 3, 2011							
Revenue	$857,926	$288,306	$363,886	$206,338	$226,756	$107,673	$2,050,885
Cost of revenue	36,650	19,532	10,808	51,796	95,163	2,891	216,840
Gross profit	$821,276	$268,774	$353,078	$154,542	$131,593	$104,782	$1,834,045
Gross profit as a percentage of revenue	96 %	93 %	97 %	75 %	58 %	97 %	89 %
Six months ended June 4, 2010							
Revenue	$755,869	$269,879	$321,874	$154,745	$187,876	$111,492	$1,801,735
Cost of revenue	36,755	20,660	9,735	29,705			